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"Flaw-Backs:" Executive Compensation Clawbacks and Their Costly Flaw

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“FLAW-BACKS:” EXECUTIVE COMPENSATION CLAWBACKS AND THEIR COSTLY FLAW

CONNOR DOUGLAS MAAG

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ABSTRACT

Saving money should not be expensive. Compensation “clawbacks” are a legal mechanism for companies to reclaim employee compensation, but the legislative framework is complex and disorganized. There are four primary federal clawback provisions: Sarbanes-Oxley § 304, Dodd-Frank § 954, 12 U.S.C.A. § 5221 (TARP), and Dodd-Frank § 956—as well as voluntary contractual clawback policies. This comment untangles the web of clawback legislation by overlaying each clawback mechanism to extract a single, clear, and concise description of executive compensation clawbacks, called the “Comprehensive Clawback Coverage.” The Comprehensive Clawback Coverage reveals a major flaw in the legal and regulatory framework: clawbacks increase agency costs. In other words, they are expensive. The logical solution involves legislative repeal, legislative amendment, or regulatory policy shift with respect to executive compensation clawback provisions.

I. INTRODUCTION

In late 2016, the American public was outraged when Wells Fargo CEO John Stumpf testified before the Senate Banking Committee that his employees stole from roughly two million of their customers.¹ Compensation “clawbacks” have been used to recover $69,000,000 from Stumpf.² Although many were satisfied by Stumpf’s fate, the Wells Fargo scandal highlights a larger debate in American jurisprudence over whether clawbacks are a sound corporate governance tool.³

Compensation clawbacks are a legal mechanism for companies to reclaim employee compensation,⁴ but the legislative framework is complex and disorganized. There are four primary federal clawback provisions: Sarbanes-Oxley § 304, Dodd-Frank § 954, 12 U.S.C.A. § 5221 (TARP), and Dodd-Frank § 956, as well as relevant proposed legislation. In addition, companies often utilize contractual clawback policies with coverage extending beyond statutory requirements.⁵ Furthermore, each clawback mechanism has distinct targets, triggers, penalties,

² See infra notes 202, 209.
enforcement bodies, and purposes. This paper untangles the complex web of clawback legislation by examining each factor with respect to each clawback mechanism, then overlays the clawback mechanisms to extract a single, clear, and concise description of executive compensation clawbacks called the "Comprehensive Clawback Coverage."

The Comprehensive Clawback Coverage reveals a major flaw in the current legal framework: clawbacks increase agency costs. To facilitate a better understanding of the practical effects of clawbacks, this comment includes two case studies, including the Wells Fargo scandal involving John Stumpf, as well as an original empirical study by the author. The analysis leads to only one logical solution to the agency cost problem that strains companies, shareholders, and the American financial system: repeal or amend the statutory clawback provisions.

II. STATUTORY CLAWBACK MECHANISMS

Under federal law, there are four statutory clawback mechanisms: Sarbanes-Oxley § 304, Dodd-Frank § 954, 12 U.S.C. § 5221 (TARP), and the proposed regulations pursuant to Dodd-Frank § 956. This section distinguishes and discusses the target, trigger, penalty, enforcement, and purpose of each statutory clawback.

A. Sarbanes-Oxley Section 304

Sarbanes-Oxley § 304 targets the compensation of the chief executive officer and chief financial officer of an issuer that files accounting statements with the SEC. In June 2016, JPMorgan estimated that there were 4,333 publicly-listed companies to which Section 304 would apply.

Clawbacks under § 304 are triggered “[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws.” Sarbanes-Oxley § 302 outlines the financial reporting requirements, which require “the principal executive officer or officers and the principal financial officer or officers . . . [to] certify in each annual or quarterly report . . . [and] the signing officers—(A) [to be held] responsible for establishing and maintaining internal controls.”

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6 In the context of executive compensation, “agency costs” are costs incurred by companies as a result of conflicts of interest between companies and their executives. See infra note 196.
9 Sarbanes-Oxley, supra note 7, at § 304(a).
10 Id. at § 302.
While § 304 does not define “misconduct,” the standard of liability is whether the CEO or the CFO “believed, knew, or should have known that the information was material and incorrect.” Case law has determined that personal misconduct by the CEO or the CFO is not required; misconduct by anyone in the company can trigger a clawback. For example in *SEC v. Jenkins*, an Arizona district court denied the defendant CEO’s motion to dismiss even though the complaint did not allege wrongdoing by the CEO. In *SEC v. Jensen*, the Ninth Circuit also held that “the disgorgement remedy authorized under [Sarbanes-Oxley §] 304 applies regardless of whether a restatement was caused by the personal misconduct of an issuer’s CEO and CFO or by other issuer misconduct.”

The penalty under § 304 is mandatory reimbursement of any bonus or other incentive-based or equity-based compensation received . . . from the issuer during the 12–month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12–month period.

Only the SEC has the authority to enforce § 304 clawbacks; § 304 does not expressly create a private right of action. In *In Re Digimarc Corporation Litigation*, the Ninth Circuit reasoned that § 304 does not create an implied private right of action either, because other Sarbanes-Oxley provisions, “expressly create[] a private right of action to enforce” and the absence of an express private right of action must have been intentional. Other federal circuits concur with this interpretation.

By implication, companies are also prohibited from indemnifying CEOs and CFOs subject to § 304 clawbacks. In *Cohen v. Viray*, the Second Circuit held

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13 See generally Jenkins, 718 F. Supp. 2d at 1070.
14 SEC v. Jensen, 835 F.3d 1100, 1104 (9th Cir. 2016).
15 Section 304 “imposes a mandatory duty on those subject to it . . . CEO and CFO ‘shall reimburse’ . . . [and] it vests the SEC with the authority to exempt any person from the obligation.” Cohen v. Viray, 622 F.3d 188, 195 (2d Cir. 2010) (citing 15 U.S.C. § 7243(a)).
16 Sarbanes-Oxley, supra note 7, at § 304.
17 Cohen, 622 F.3d at 195 (citing 15 U.S.C. §§ 78u(d)(1)).
18 Diaz v. Davis (*In Re Digimarc Corp. Derivative Litig.*), 549 F.3d 1223, 1233 (9th Cir. 2008).
19 Id. at 1232.
21 See generally Cohen, 622 F.3d at 195.
that, “indemnification and release provisions of the Settlement violate § 304.”

The court reasoned that “Congress . . . provided only the SEC authority to exempt persons from § 304(a), indicating that only the SEC has that authority and that other parties do not.”

The court also reasoned that indemnification must be prohibited, because § 304 would otherwise have no deterrent effect if CEOs and CFOs could defer liability to the company.

On the other hand, the Ninth Circuit’s reasoning is not entirely correct, because executives still “suffer a penalty” when bargaining for indemnification protections upon hiring, often accepting a lower salary in return.

More accurately, indemnification would allow executives to accelerate the timing of paying for wrongdoings.

The strongest criticism of § 304 is that if the SEC does not enforce clawbacks, § 304 is powerless. In practice, SEC enforcement has been rare; the first § 304 clawback did not occur until more than five years after Sarbanes-Oxley was adopted. By 2008, the SEC had only brought two § 304 actions despite thousands of accounting restatements. By 2012, the SEC clawed back compensation from just ten CEOs or CFOs.

One study calculated that by the end of 2016, only twenty-five CEOs or CFOs had ever been subject to § 304 compensation “recoveries,” which does not distinguish between clawbacks and voluntary reimbursement.

Of those twenty-five recoveries, nine did not involve executive misconduct.

Section 304’s purposes are 1) to primarily “ensure that a company’s CEO and CFO take a proactive role in their company’s public disclosure,” 2) equitable, and 3) incidentally punitive.
First, § 304 incentivizes managerial oversight of full and accurate financial disclosures. In its entirety, Sarbanes-Oxley was “designed to improve the quality of and transparency in financial reporting and auditing of public companies” in the aftermath of numerous accounting scandals. Sarbanes-Oxley was therefore created to reform disclosure practices, rather than directly reform compensation regulations. Section 302 requires “the principal executive officer or officers and the principal financial officer or officers . . . [to] certify in each annual or quarterly report . . . [and] the signing officers—(A) are responsible for establishing and maintaining internal controls.” Section 304 imposes clawbacks on CEOs and CFOs who fail to meet the § 302 accounting disclosure and internal control maintenance requirements. By requiring CEOs and CFOs to certify accounting statements that may lead to personal compensation clawbacks, the CEO and the CFO—the individuals in the best position to ensure accurate disclosures—are incentivized to provide the most accurate disclosure possible.

Second, § 304 achieves equitable reimbursement to the company. In SEC v. Microtune, the SEC argued that “repayment of profits from stock sales under Section 304 . . . restores the status quo ante by returning equity-based compensation to [the company].” In dicta, the Ninth Circuit supported the same justification, explaining that § 304’s “disgorgement remedies are equitable (in the sense that they require wrongdoers to reimburse the issuer for ill-gotten gains).” The Federal District of Arizona was less decisive, however, stating that “it is not clear . . . that the statute’s purpose must be remedial.” Regardless, the effect of a clawback—returning money to a company—is certainly equitable.

Equitable reimbursement can also be viewed from the perspective of preventing unjust enrichment to executives who do not deserve to keep the profits. Some justify § 304 clawbacks because “the CEO may unfairly benefit from a misperception of the financial position of the issuer that results from those misstated financials, even if the CEO was unaware of the misconduct leading to misstated

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33 Cohen v. Viray, 622 F.3d 188, 195 (2d Cir. 2010).
35 See SEC Requires CEO and CFO Certification of Quarterly and Annual Reports, supra note 11.
36 Sarbanes-Oxley, supra note 7, at § 302.
37 Id. at § 304.
38 SEC v. Microtune, Inc., 783 F. Supp. 2d 867, 885 (N.D. Tex. 2011) (citing Miss. Dep’t of Econ. & Cmty. Dev. v. United States DOL, 90 F.3d 110, 113 (5th Cir. 1996)).
39 Diaz v. Davis (In re Digimarc Corp. Derivative Litig.), 549 F.3d 1223, 1233 (9th Cir. 2008).
financials.”  

Profits earned during the twelve-month period preceding an accounting misstatement would also benefit an executive who did not “perform” for that pay.  

Third, legislative history and case law suggest that § 304 is at most incidentally punitive. The House Bill proposing § 304 required scienter, limiting clawbacks to situations where “the [Securities and Exchange] Commission can prove extreme misconduct on the part of [the] officer or director” to disgorge profits. The final version approved by the Senate eliminated the scienter requirement. In SEC v. Microtune, the SEC also acknowledged that “repayment of profits from stock sales under Section 304 . . . is not punitive.” In 2010, an Arizona district court hesitantly stated, “Nor is it yet clear . . . that [Section 304] has punitive aspects.” In 2012, however, the Ninth Circuit decisively held that “Ninth Circuit law is clear that the reimbursement provision of [Sarbanes-Oxley §] 304 is considered an equitable disgorgement remedy and not a legal penalty.”

Still, § 304 resembles a quasi-criminal punishment. The Second Circuit reasoned that it was “Congress’s effort[] to make high ranking corporate officers of public companies directly responsible for their actions,” so long as enforcement was in the public’s interest. An explicit punitive purpose may be problematic though, by tying penalties to events unrelated to the clawback trigger. For example, § 304 requires disgorgement of “any . . . incentive-based or equity-based compensation,” but does not distinguish between the stock value that accrued before and after the trigger; clawbacks can include stock value that accrued before the wrongdoing. The defendant CEO in SEC v. Jenkins similarly argued that any benefit he might have received from the sale of stock was “not, in any way, traceable to any misstatement of [the company’s] financial positions.” Because determining § 304 had a punitive purpose would have implicated constitutionally-required findings of culpability, the court inferred that Congress did not intend

41 Id. at 1075.
42 Id. at 1073.
43 H.R. 3763 §12; Jenkins, 718 F. Supp. 2d at 1077.
45 See S. 2673, 107th Cong. (June 25, 2002); see also H.R. 3763, 107th Cong. (July 15, 2002).
46 SEC v. Microtune, Inc., 783 F. Supp. 2d 867, 885 (N.D. Tex. 2011) (citing Brief Opinion at 5–6; citing Miss. Dep’t of Econ. & Cmty. Dev. v. United States DOL, 90 F.3d 110, 113 (5th Cir. 1996)).
47 Jenkins, 718 F. Supp. 2d at 1076.
48 SEC v. Jasper, 678 F.3d 1116, 1130 (9th Cir. 2012).
49 Cohen v. Viray, 622 F.3d 188, 195 (2d Cir. 2010).
50 Kelsh, supra note 34, at 1030–34.
51 Sarbanes-Oxley, supra note 7, at § 304.
52 Jenkins, 718 F. Supp. 2d at 1075.
53 “As the Supreme Court has repeatedly noted, the Due Process Clauses of the Fifth and Fourteenth Amendments ‘impose[] substantive limits beyond which penalties may not go’[footnote omitted]. One significant such limit is that on certain impositions of liability in the absence of personal culpability.” Kelsh, supra note 34, at 1030–31.
to require personal wrongdoing—only wrongdoing by the corporate entity.\textsuperscript{54} Therefore, it is not necessary to piecemeal disgorged profits to the extent of the executive’s role.\textsuperscript{55}

On one hand, § 304 can never be entirely unrelated to the CEO or the CFO, because the CEO and the CFO are required to sign and endorse accounting statements pursuant to Sarbanes-Oxley § 302.\textsuperscript{56} In addition, an explicit punitive purpose might deter the types of “accounting debacles\textsuperscript{57}” that Congress intended to deter. Like the Dodd-Frank Pay-Ratio provisions,\textsuperscript{58} which arguably deter excessive compensation packages by shaming executives,\textsuperscript{59} an explicit punitive purpose in § 304 might shame and deter executives from engaging in conduct that triggers clawbacks.

In conclusion, § 304 is primarily intended to ensure the CEO and the CFO provide full and accurate disclosure in accounting statements. Additionally, § 304 provides an equitable remedy. While § 304 is not explicitly punitive, it somewhat resembles the punitive aspect of the House Bill that was never implemented. In practice, the SEC can more easily enforce clawbacks without having to prove an additional punitive element. Furthermore, facilitating enforcement while avoiding Constitutional hurdles is preferable to the deterrent benefits of an explicit punitive justification—which seem to permeate into the courts’ § 304 decisions anyway.\textsuperscript{60}

\textbf{B. Dodd-Frank Section 954}

Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act targets the compensation of “any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement.”\textsuperscript{61} In 2015, the SEC estimated that § 954 was applicable to approximately 4,845 listed companies.\textsuperscript{62}

Clawbacks under § 954 are triggered if “the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any

\begin{itemize}
\item \textsuperscript{54} Jenkins, 718 F. Supp. 2d at 1074–76.
\item \textsuperscript{55} See generally SEC v. Jenkins, 718 F. Supp. 2d 1070 (D. Ariz. 2010).
\item \textsuperscript{56} Sarbanes-Oxley, supra note 7, at § 302.
\item \textsuperscript{58} Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 § 951 (2010) [hereinafter Dodd-Frank].
\item \textsuperscript{59} Murphy, supra note 27, at 117.
\item \textsuperscript{60} See, e.g., Cohen v. Viray, 622 F.3d 188, 195 (2d Cir. 2010) (“make high ranking corporate officers of public companies directly responsible for their actions”).
\item \textsuperscript{61} Dodd-Frank, supra note 58, at § 954(b)(2) (emphasis added).
\end{itemize}
financial reporting requirement under the securities laws . . . [that requires] an accounting restatement."63 Furthermore, § 954 has a mandatory clawback trigger, because it "require[s] each issuer to develop and implement a policy . . . [whereby] the issuer will recover [compensation]."64

Section 954 lacks a misconduct requirement. As it currently stands, executives may be required to return excess incentive-based compensation even if they had no role in the accounting misstatement.65 This may change in the near future however. The Republican House released a “discussion draft” of the Financial CHOICE Act of 2017 (dubbed the “CHOICE Act 2.0”66) on April 19, 2017 that would amend Dodd-Frank § 954 to apply “where such executive officer had control or authority over the financial reporting that resulted in the accounting restatement.”67

The penalty under § 954 allows the

issuer [to] recover . . . any . . . incentive-based compensation (including stock options awarded as compensation) during the 3–year period preceding the date on which the issuer is required to prepare an accounting restatement . . . in excess of what would have been paid to the executive officer under the accounting restatement.68

Section 954 is therefore backward-looking, disgorging compensation received within the period of three years before an accounting restatement.

Section 954 is enforced by 1) the SEC, 2) publicly listed companies, and 3) national securities exchanges and national securities associations. First, the SEC “shall require each issuer to develop and implement a [clawback] policy” in compliance with § 954(b).69 Second, publicly listed companies are required to enforce those clawback policies.70 Section 954 creates both a direct cause of action, brought by the board of directors, and a derivative cause of action, brought by the shareholders. Third, national securities exchanges and national securities associations are required to de-list companies that do not develop and implement a clawback policy in compliance with § 954(b).71

63 Dodd-Frank, supra note 58, at § 954(b)(2).
64 Dodd-Frank, supra note 58, at § 954(b).
65 Listing Standards, supra note 62, at 41176.
68 Dodd-Frank, supra note 58, at § 954(b)(2).
69 Dodd-Frank, supra note 58, at § 954(b).
70 Dodd-Frank, supra note 58, at § 954(b)(2).
71 Dodd-Frank, supra note 58, at § 954(a).
Like Sarbanes-Oxley, the purpose of Dodd-Frank is best understood in historical context. Dodd-Frank was enacted in response to the 2008 financial crisis. In its entirety, Dodd-Frank was enacted to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail’, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.”

Specifically, § 954 is corrective and equitable, focusing only on unjust enrichment from compensation not “earned.” The SEC explained that, “shareholders of these listed issuers would benefit from a policy to recover excess incentive-based compensation and that . . . will further the statutory goal of assuring that executive officers do not retain incentive-based compensation that they received erroneously.” Furthermore, by limiting the clawback to the excess of what would have been paid to the executive officer under the accounting restatement, § 954 is not punitive.

Some commentators criticize the scope of companies to which § 954 applies. By applying to all listed companies, § 954 effectively reformed United States corporate law as a whole, rather than targeting only the “too big to fail” financial institutions as Dodd-Frank intended. For example, in the SEC’s Proposed Listing Standards, the SEC stated, “we read the language of Section 10D [as modified by Dodd-Frank Section 954] as generally calling for a broad application of the mandated listing standards.” Section 954’s broad application seems to fulfill the “Creeping Federalization of Corporate Law” that Stephen Bainbridge predicted in 2003 after Sarbanes-Oxley.

Furthermore, § 954 may create incentives that are misaligned with Dodd-Frank’s purpose. For example, Dodd-Frank does not specifically deter the executives able to “promote the financial stability of the United States.” By broadly applying to “any executive” at a target company, Dodd-Frank impacts many executives with no access and control over compliance with accounting standards, even though this ultra-broad scope will eventually include the decision makers.

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73 Dodd-Frank, supra note 58, at Introduction.
75 Listing Standards, supra note 62, at 41147.
77 Listing Standards, supra note 62, at 41176.
79 Sharp, supra note 28, at 336.
In addition, executives might be incentivized to hide accounting errors, rather than promote transparency. For example, by triggering clawbacks at the moment accounting restatements are required, executives are incentivized to hide, rather than correct, past accounting errors that may trigger clawbacks of their own compensation.\(^80\) This suggests that agency costs are increased by misalignment of shareholder and managerial interests.

In conclusion, the general purpose of Dodd-Frank is to ensure U.S. economic stability and to prevent systemic economic failures. The purpose of § 954 is corrective and equitable, but arguably reaches beyond the general purpose of Dodd-Frank and creates unfavorable incentives.

\(\text{C. TARP Executive Compensation Provisions}\)

The executive compensation provisions of the Troubled Asset Relief Program (TARP) are codified in 12 U.S.C. § 5221.\(^81\) Section 5221 targets the compensation of the “top 5 most highly paid executives of a public company . . . and any of the next 20 most highly-compensated employees . . . .”\(^82\) Section 5221 only applies to those employees of a TARP recipient company that have not repaid the U.S. Treasury, which includes, “any entity that has received or will receive financial assistance under the financial assistance provided under the TARP.”\(^83\) Because § 5221 only applies to TARP recipients with outstanding debts, the number of companies subject to § 5221 will diminish as debts are repaid to the Treasury.\(^84\) While TARP funds were initially distributed to eight major banks,\(^85\) there were eventually 966 TARP recipients.\(^86\) 780 of which received funds in the form of investments,\(^87\) subjecting them to § 5221 clawbacks. Of those 780 investment recipients, 734 were banks.\(^88\) As of 2017, TARP funds from 41 recipients are still outstanding\(^89\) and subject to § 5221 clawbacks.

\(^{80}\) Id.


\(^{85}\) Murphy, supra note 27, at 104.


\(^{87}\) Id.


\(^{89}\) See State of the Bailout, supra note 86.
Clawbacks under § 5221 are triggered by, “statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.”\(^{90}\) Ambiguously, the “facts and circumstances” determine whether a statement is materially inaccurate.\(^{91}\) While personal misconduct is not required,\(^{92}\) knowingly false statements and omissions are always considered materially inaccurate.\(^{93}\) Furthermore, § 5221 clawbacks are not limited to financial misstatements under federal securities law, because some companies that received TARP funds are not required to file with the SEC.\(^{94}\)

The penalty under § 5221 is a mandatory clawback of, “any bonus, retention award, or incentive compensation,”\(^{95}\) which is not expressly limited to the excess compensation received as a result of the inaccurate financial statement.\(^{96}\) Furthermore, § 5221 applies retroactively\(^{97}\) rather than only to compensation after a financial misstatement. Section 5221 also does not reference any time period and can apply as far back as the date on which TARP funds were received.\(^{98}\)

A TARP recipient must enforce § 5221 clawbacks, “except to the extent it demonstrates that it is unreasonable to do so, for example if the expense of enforcing the rights would exceed the amount recovered.”\(^{99}\) It is unclear whether the Treasury Secretary or Special Master also have a cause of action to specifically enforce clawbacks against a TARP recipient employee.\(^{100}\)

Like Sarbanes-Oxley and Dodd-Frank, the purpose of § 5221 is best understood in historical context. TARP was a direct response to the 2008 financial crisis, granting the Treasury Secretary authority to initiate capital injections into failing companies to prevent national economic collapse.\(^{101}\) Specifically, § 5221 was also intended to protect the government’s investment in TARP recipients, and reign in excessive Wall Street bonuses.

\(^{91}\) What actions are necessary for a TARP recipient to comply with the standards established under section 111(b)(3)(B) of EESA (the “clawback” provision requirement)?, 31 C.F.R. 30.8 (2009).
\(^{92}\) Bachelder, supra note 84.
\(^{93}\) What actions are necessary for a TARP recipient to comply with the standards established under section 111(b)(3)(B) of EESA (the “clawback” provision requirement)?, 31 C.F.R. 30.8 (2009).
\(^{94}\) Bachelder, supra note 84.
\(^{96}\) Bachelder, supra note 84.
\(^{97}\) Murphy, supra note 27, at 104.
\(^{98}\) See Bachelder, supra note 84.
\(^{99}\) What actions are necessary for a TARP recipient to comply with the standards established under section 111(b)(3)(B) of EESA (the “clawback” provision requirement)?, 31 C.F.R. 30.8 (2009).
First, § 5221 seeks to avoid another financial crisis by targeting individuals most likely to cause systemic financial risk. While executives are often the “decision makers” at recipient companies, highly-paid non-executive employees played a major role in the 2008 financial crisis. Section 5221 therefore targets five executives, but also the next twenty most highly-compensated employees because “banks can have non-officer employees making significantly more than the highest-paid officers.” In addition, § 5221 can apply to unlisted companies not required to file with the SEC if they received TARP funds. Section 5221 can therefore apply to companies such as hedge funds that are otherwise unregulated by clawback provisions linked to the SEC financial misstatements.

Second, the government sought to protect its investment in TARP recipients on behalf of American taxpayers. For each TARP recipient, the government functions either as a shareholder with an equity position or as a lender with a creditor position. Section 5221 incentivizes executives and highly-paid employees to protect the government’s financial interest and that of the U.S. taxpayer.

Third, legislative history suggests § 5221 was intended to reign in Wall Street compensation at the financial institutions responsible for the 2008 crisis. Originally, Treasury Secretary Hank Paulson’s TARP proposal, “contained no constraints on executive compensation, fearing that restrictions would discourage firms from selling potentially valuable assets to the government at relatively bargain prices.” On the other hand, “[l]imiting executive pay . . . was a long-time top priority for Democrats and some Republican congressmen, who viewed the ‘Wall Street bonus culture’ as a root cause of the financial crisis.” Congress ultimately prevailed over Paulson.

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102 See Origins of the Financial Crisis, supra note 72.
103 Bachelder, supra note 80.
104 § 5221 does not single out listed companies, but instead broadly targets any “TARP recipients.” See 12 U.S.C.A. § 5221(b)(2).
106 See U.S. Department of the Treasury, supra note 101.
108 Murphy, supra note 27, at 103.
109 Id.
D. Dodd-Frank Section 956

Section 956 imposes requirements on both “Appropriate Federal Regulators”¹¹⁰ and “Covered Financial Institutions.”¹¹¹ Moreover, § 956 defers rule-making obligations to the Appropriate Federal Regulators to determine clawback triggers and penalties for the targets defined in § 956.¹¹²

First, § 956 requires the six Appropriate Federal Regulators to,

jointly prescribe [disclosure] regulations or guidelines [applicable to] each covered financial institution . . . [and to] prohibit any types of incentive-based payment arrangement . . . that the regulators determine encourages inappropriate risks by covered financial institutions (1) by providing . . . excessive compensation . . . or (2) that could lead to material financial loss to the covered financial institution.¹¹³

While § 956 does not define “inappropriate risks,” Dodd-Frank’s statement of purpose¹¹⁴ suggests that inappropriate risks are risks that jeopardize the financial stability of the United States and fail to protect consumers from abusive financial services practices, similar to financial practices that caused the 2008 Subprime Mortgage Crisis.¹¹⁵

Second, § 956 requires Covered Financial Institutions to “disclose to the appropriate Federal regulator the structures of all incentive-based compensation arrangements . . . sufficient to determine whether the compensation structure (A)
provides . . . excessive compensation, fees, or . . . (B) could lead to material financial loss to the covered financial institution.”

Within these Covered Financial Institutions, § 956 targets, “an executive officer, employee, director, or principal shareholder of [a] covered financial institution . . . [that implements] an incentive-based payment arrangement . . . [and has] assets [equal to or greater] than $1 Billion.” On one hand, § 956 targets a broader scope of employees than any other clawback statute; on the other hand, § 956 targets a narrow group of companies (Covered Financial Institutions) similar to TARP, which almost exclusively targets financial institutions as well.

The purpose of § 956 is to ensure U.S. economic stability and prevent systemic economic failures. Section 956 specifically addresses the “evidence that flawed incentive-based compensation practices in the financial industry were one of many factors contributing to the financial crisis that began in 2007,” because § 956 is triggered by excessive compensation or compensation arrangements that could lead to material financial loss. By targeting a large group of employees at a small group of financial institutions, the combined scope of § 956 more directly addresses Dodd-Frank’s general purpose than § 954, which may reach beyond Dodd-Frank’s general purpose.

1. Dodd-Frank Section 956 Proposed Rules

The Appropriate Federal Regulators proposed regulations in 2011 pursuant to § 956 which were revised and re-proposed in 2016. As of July 2017, the 2016 proposal (Proposed Rules) is still pending, and likely will not apply to Covered Financial Institutions any earlier than 2019. The Proposed Rules would require compensation deferral arrangements, but the triggers, penalties, and enforcement of clawbacks are ultimately discretionary.

116 Dodd-Frank, supra note 58, at § 956(a).
117 Id. at § 956.
118 State of the Bailout, supra note 86.
119 Dodd-Frank, supra note 58, at Introduction.
121 Dodd-Frank, supra note 58, at Introduction.
122 See Fried, supra note 76.
124 See generally Incentive-Based Compensation Arrangements, 81 Fed. Reg. 37669, supra note 120.
125 “The compliance date of the proposed rule would be no later than the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register. The proposed rule would not apply to any incentive-based compensation plan with a performance period that begins before the compliance date.” Id. at 37679.
126 See generally id. at 37669.
The Proposed Rules would target Senior Executive Officers and Significant Risk Takers because these are the individuals who “initiate activities that generate risk of material financial loss . . . [and] play an important role in identifying, addressing, and mitigating that risk.” The Proposed Rules would only target these individuals at Covered Institutions, which are distinguished by size as Level 1 (assets greater than $250 billion) and Level 2 (assets between $50 billion and $250 billion).

Clawbacks under the Proposed Rules would be triggered if “the covered institution determines that the senior executive officer or significant risk-taker engaged in misconduct that resulted in significant financial or reputational harm to the covered institution, fraud, or intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker’s incentive-based compensation.”

Furthermore, the Proposed Rules clarify two significant ambiguities regarding the clawback policies Covered Institutions would be required to implement. First, excessive compensation is defined as compensation that is “unreasonable or disproportionate to the value of the services performed by a covered person,” taking into account various factors. Second, incentive-based compensation would “encourage inappropriate risks that could lead to material financial loss.”

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127 “Senior Executive Officer” is defined as a, “person who holds the title or, without regard to title, salary, or compensation, performs the function of one or more of the following positions at a covered institution for any period of time in the relevant performance period: President, chief executive officer (CEO), executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, chief compliance officer, chief audit executive, chief credit officer, chief accounting officer, or head of a major business line or control function.” Id. at 37691.

128 “Significant Risk-Takers” are defined as, “individuals who are not senior executive officers but are in the position to put a Level 1 or Level 2 covered institution at risk of material financial loss . . . .” which occurs if either of two tests are met: “The [Relative Compensation Test] is based on the amounts of annual base salary and incentive-based compensation of a covered person relative to other covered persons working for the covered institution and its affiliate covered institutions . . . [and] The [Exposure Test] is based on whether the covered person has authority to commit or expose 0.5 percent or more of the capital of the covered institution or an affiliate that is itself a covered institution.” Id. at 37691–92.

129 Id. at 37691.

130 The Proposed Rules clarify that Covered Financial Institutions are more clearly defined as any institution regulated by the six Appropriate Federal Regulators. Id. at 37684.

131 Id. at 37687. The Proposed Rules also define “Level 3” Covered Financial Institutions, to which clawbacks would not apply. Id.

132 Id. at 37681.

133 The factors considered include: 1) The combined value of all compensation, fees, or benefits provided to a covered person; 2) The compensation history of the covered person and other individuals with comparable expertise at the covered institution; 3) The financial condition of the covered institution; 4) Compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the covered institution’s operations and assets; 5) For post-employment benefits, the projected total cost and benefit to the covered institution; 6) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered institution. Id. at 37679.
loss to the covered institution,” unless certain conditions are met.

The penalty under the Proposed Rules would be complicated by mandatory compensation deferral arrangements, requiring portions of compensation to vest pro rata over a minimum number of years. The specific requirements vary based on 1) Level 1 and Level 2 Institutions, 2) Senior Executive Officers and Significant Risk Takers, and 3) Long-Term Incentive Compensation Plans and Qualifying Incentive-Based Compensation. The following table consolidates the minimum compensation deferral amounts under the Proposed Rules.

<table>
<thead>
<tr>
<th>Level 1 Institutions</th>
<th>Senior Executive Officer</th>
<th>Significant Risk Taker</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualifying Incentive-Based Compensation</td>
<td>60% for at least 4 years</td>
<td>50% for at least 4 years</td>
</tr>
<tr>
<td>Long-Term Incentive Plan</td>
<td>60% for at least 2 years</td>
<td>50% for at least 2 years</td>
</tr>
</tbody>
</table>

| Level 2 Institutions | Qualifying Incentive-Based Compensation | 50% for at least 3 years | 40% for at least 3 years |
|----------------------|-----------------------------------------|--------------------------|
| Long Term Incentive Plan | 50% for at least 1 year | 40% for at least 1 year |

Compensation not yet vested would be subject to forfeiture or downward adjustment (essentially ex ante clawbacks), and vested compensation would be subject to clawbacks. The Proposed Rules would require Level 1 and Level 2 Covered Institutions to 1) consider imposing forfeiture or downward adjustment of unvested, deferred compensation under certain circumstances and 2) adopt policies empowering the Covered Institution to clawback vested compensation for at

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134 Those conditions are that the compensation arrangement: “[1] Appropriately balances risk and reward; [2] Is compatible with effective risk management and controls; and [3] Is supported by effective governance.” Id. Furthermore, incentive-based compensation would not “appropriately balance risk and reward, unless it: [1] Includes financial and non-financial measures of performance; [2] Is designed to allow non-financial measures of performance to override financial measures of performance, when appropriate; and [3] Is subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies, or other measures or aspects of financial and non-financial performance.” Id. at 37679–80.

135 “Long-term incentive plan means a plan to provide incentive-based compensation that is based on a performance period of at least three years.” Id. at 37801.

136 “Qualifying incentive-based compensation means the amount of incentive-based compensation . . . excluding amounts awarded . . . under a long-term incentive plan.” Id.

137 This table was consolidated by the author using the SEC’s Proposed Rules pursuant to Dodd-Frank Section 956. See id. at 37679–80.

138 Id.

139 Those conditions are: “[1] Poor financial performance attributable to a significant deviation
least, “seven years following the date on which such compensation vests.”\textsuperscript{140} Compensation recovery is thus both forward-looking (forfeiture and downward adjustment) and backward-looking (clawbacks) under the Proposed Rules.

Clawbacks would also be discretionary\textsuperscript{141} and enforced only by the Covered Institution.\textsuperscript{142} Level 1 and Level 2 companies would be required to maintain policies and procedures that “[i]dentify and describe the role of any employees, committees, or groups authorized to make incentive-based compensation decisions, including when discretion is authorized; [and] [d]escribe how discretion is exercised to achieve balance.”\textsuperscript{143}

The purpose of the Proposed Rules is consistent with the purpose of § 956. For example, the Proposed Rules distinguish between larger Level 1 and Level 2 financial institutions because, “larger financial institutions can present greater potential systemic risks . . . to U.S. financial stability.”\textsuperscript{144} In addition, deferral requirements were proposed to function as a “tool to balance risk and reward.”\textsuperscript{145}

In conclusion, the Proposed Rules further clarify the mandatory clawback policies required by § 956. Although the Proposed Rules would require mandatory compensation deferral, the triggers, penalties, and enforcement of clawbacks and the forfeiture would ultimately be discretionary.

2. Analysis of Dodd-Frank Section 956 Proposed Rules

The Proposed Rules have yet to gain clear support. Some argue that the Proposed Rules are under-inclusive and fail to achieve the purpose of § 956, while others argue that the Proposed Rules are over-inclusive, unwise public policy.

This argument stems from the basis that: 1) the deferral period is too short; 2) clawbacks should be mandatory, not discretionary; and 3) clawback triggers are too limited.\textsuperscript{146} First, the deferral period is too short. Several U.S. Senators have argued that the effects of executive wrongdoing often manifest over a much from the covered institution’s risk parameters set forth in the covered institution’s policies and procedures; [2] Inappropriate risk-taking, regardless of the impact on financial performance; [3] Material risk management or control failures; [4] Non-compliance with statutory, regulatory, or supervisory standards resulting in enforcement or legal action brought by a federal or state regulator or agency, or a requirement that the covered institution report a restatement of a financial statement to correct a material error; and [5] Other aspects of conduct or poor performance as defined by the covered institution.” \textit{Id.} at 37681.

\textsuperscript{140} Id.
\textsuperscript{141} Id. (Clawbacks are only triggered “if the covered institution determines . . .”).
\textsuperscript{142} Id.
\textsuperscript{143} Id. at 37682.
\textsuperscript{144} Id. at 37716.
\textsuperscript{145} Id. at 37717.
longer time-frame than the maximum four-year deferral arrangement. For example, in the recent Wells Fargo fraudulent accounts scandal, fraudulent bank accounts dating back to 2005 were not publicly recognized until 2013. Wells Fargo clawbacks have not been triggered under current statutory clawback provisions and would not be triggered under the Proposed Rules. Instead, clawbacks only occurred under the company’s voluntary contractual clawback policy, and only after CEO John Stumpf’s highly-publicized Senate Banking Committee Hearing.

Second, clawbacks should be mandatory, not discretionary. Senators have also argued that companies rarely enforce clawbacks that are discretionary. For example, Managerial Power Theory might explain the rare enforcement if managerial influence over directors curtails enforcement. On the other hand, some research suggests that rare enforcement may be due to increased compliance with securities disclosures.

Third, the proposed clawback triggers are too limited. Because the trigger under the Proposed Rules is limited to fraud, misrepresentation, or misconduct of individual employees, it is unclear whether negligence or oversight failures would trigger clawbacks. Dodd-Frank’s purpose was to prevent systemic economic risk in response to the 2008 financial crisis, and negligence and oversight failures contributed to that crisis.

Others argue that the Proposed Rules are over-inclusive because: 1) the Proposed Rules cover too many issuers, executives, and types of compensation; 2) the Proposed Rules will drive talented employees to seek jobs where regulations do not apply; and 3) the government should not intervene in public sector decisions.

First, the Proposed Rules cover too many issuers, executives, and types of

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147 See Senate Letter, supra note 146.
148 See discussion infra Section V.A.2.
151 See, e.g., SENATOR ELIZABETH WARREN, Senator Elizabeth Warren questions Wells Fargo CEO John Stumpf at Banking Committee Hearing, YOUTUBE (Sept. 20, 2016), https://www.youtube.com/watch?v=xJhkX74D10M.
152 See Senate Letter, supra note 146.
155 Senate Letter, supra note 146.
156 See Origins of the Financial Crisis, supra note 72.
compensation. As a result, executives may engage in actual earnings management rather than artificial misstatements, forego associated, valuable projects that involve difficult accounting judgments, and thus, risk accounting misstatements, overinvest in financial reporting to protect themselves at a high cost to shareholders, or otherwise attempt to reduce the clawback penalty.

Second, the Proposed Rules may drive talented employees to seek jobs where regulations do not apply. The proposed “CHOICE Act 1.0” argues that, “[t]he mitigating systemic risk, driving talented professionals out of the financial services sector only increases the likelihood of a future financial crisis.” Over-inclusive clawbacks may incentivize highly-compensated employees to leave Covered Institutions for smaller banks, hedge funds, or non-U.S. companies. As a result, systemic financial risk is not eliminated; Significant Risk Takers would merely be shuffled amongst different companies or possibly different countries.

Third, the government should not intervene in private sector decisions. For example, the Republican’s Financial CHOICE Act 1.0 would repeal § 956, because it gives too much power to the government to intervene in private sector compensation decisions. The CHOICE Act 1.0 asserts that,

[only in Washington does the idea of giving government bureaucrats – some of whom have never worked in the private sector – the authority to dictate ‘incentive-based compensation’ standards at private companies make any sense at all. Worse yet, the specific statutory directive on compensation is, like much else in the Dodd-Frank Act, riddled with vague and open-ended terms that essentially give regulators unbridled discretion to design compensation packages.]

In conclusion, the Proposed Rules have yet to gain clear support while they are currently pending approval. Some argue that the Proposed Rules are under-inclusive because the deferral period is too short, the penalty should be mandatory, and the triggers are too limited; others argue that they are over-inclusive, because the targets are too broad, unfavorable incentives are created, and the government should not interfere with the private sector.

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157 See Fried, supra note 30, at 65.
158 Id. at 34.
159 Financial Choice Act 1.0, supra note 111, at 110.
161 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SARBANES-OXLEY ACT IN PERSPECTIVE ch.4, pt. 7, § 4:90.
162 Financial Choice Act 1.0, supra note 111, at 111.
III. VOLUNTARY CONTRACTUAL CLAWBACK POLICIES

Contractual clawback policies are the wildcard of clawback mechanisms. Statutory provisions create minimum clawback requirements, but contractual clawback policies often reiterate statutory clawback requirements or additionally “serve to fill gaps in existing recoupment doctrine.”163 Contractual policies are becoming more popular; one report found that in 2003, less than 1% of companies had clawback policies, while in 2010, 39.8% of S&P 500 companies had publicly disclosed clawback policies.164 By 2009, 73% of Fortune 100 companies had publicly disclosed clawback policies,165 which increased to 86% in 2013.166 Companies may be adopting these policies in anticipation of the Dodd-Frank § 956 Proposed Rules.

Contractual clawback policies can be tailored to target anyone the company chooses. Trends suggest that most contractual clawbacks are triggered by financial restatements and require misconduct in ultra-large companies to a greater degree than the average listed company. For example, one study of companies in the Dow Jones Industrial Average167 (DJIA) found that clawbacks are triggered solely by a financial restatement in 63% of companies, either by a financial restatement or revision of other performance metrics in 17% of companies, solely by misconduct in 13% of companies, and by “other” triggers in 7% of companies.168 Collectively, financial restatements trigger clawbacks in 80% of DJIA companies,169 suggesting that shareholders and investors simply demanded accurate financial disclosures, even when not required by federal statute.

The DJIA study also found that 60% of companies require culpability, 30% do not require culpability, and 10% of companies cannot be clearly identified into either category.170 By contrast, a 2015 study by the SEC of all listed companies found that only 33% specifically required misconduct.171 This dichotomy suggests that ultra-large companies prefer fault-based triggers, while the average listed companies prefer no-fault triggers.

The penalties under contractual clawback provisions vary widely. The 2015 SEC study found that 61.5% of listed companies provided for recovery of any

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164 Lombardi, supra note 163, at 893–94.
165 Sharp, supra note 28, at 323.
166 Murphy, supra note 27, at 113.
167 The Dow Jones Industrial Average tracks 30 of the most significant stocks traded on the NYSE and NASDAQ, exclusively including some of the largest U.S. corporations like Apple, Merck, and ExxonMobil. See Dow Jones Industrial Average – DJIA, INVESTOPEDIA, https://www.investopedia.com/terms/d/djia.asp (last accessed May 11, 2018).
168 Lombardi, supra note 163, at 901.
169 Id.
170 Id. at 896–97.
171 The study examined 104 randomly-selected issuers out of the 1,116 issuers that disclosed a recovery policy in the period 7/1/2013 to 6/30/2014. Listing Standards, supra note 62, at n.274.
incentive-based compensation; 73% provided for recovery of excess incentive-based compensation; and 90% had a look-back period of three years or longer.\textsuperscript{172} The DJIA study found that only 3% of DJIA companies provided for recovery of any incentive-based compensation; 20% provided for recovery of all or part of incentive-based compensation; 27% provided for recovery of excess incentive-based compensation; 7% used unconventional methods; and 43% did not disclose the amount subject to clawbacks.\textsuperscript{173}

There is a clear preference for discretionary enforcement of contractual clawbacks. The DJIA study found that 100% of DJIA companies have some form of discretion to enforce clawbacks: 80% of companies have complete discretion, 13% have discretion to determine culpability, and 7% have discretion if the company does not find the employee culpable.\textsuperscript{174}

The purposes of contractual policies vary, but they are most prominently used for 1) calming public outrage in the event of public scandal, 2) incentivizing desired behaviors, and 3) reimbursing the company or its shareholders.

First and most significantly, contractual clawbacks calm public outrage in the event of public scandal.\textsuperscript{175} Contractual policies are often only enforced in the event of public scandal, and “boards pull clawbacks out of their hip pocket only when politically expedient, [which] will undermine their effectiveness as a risk management tool.”\textsuperscript{176} Furthermore, contractual clawback policies may decrease the likelihood of federal clawback enforcement, because “after the implementation of a recovery policy, an auditor is less likely to report a material weakness in an issuer’s internal controls over financial reporting.”\textsuperscript{177}

Second, contractual clawback policies create incentives that align shareholder and managerial interests. Contractual clawback policies have been referred to as a “commitment device” whereby executives are more likely to follow promises they made to their “future self.”\textsuperscript{178} Shareholders benefit when managers fulfill their promises to shareholders. Similarly, some contractual policies expressly seek to punish executives for specified conduct, unlike statutory clawbacks. The market also tends to impose its own penalties for financial restatements; one study found that from 2005–2012, the market capitalization of the average issuer declined by 2.3% after announcing a significant financial restatement.\textsuperscript{179}

\textsuperscript{172} Id.
\textsuperscript{173} Lombardi, supra note 163, at 904.
\textsuperscript{174} Id.
\textsuperscript{175} Id.
\textsuperscript{176} Lombardi, supra note 163, at 888.
\textsuperscript{177} Lombardi, supra note 62, at 41175 (citing Lombardi, supra note 163, at 904).
\textsuperscript{178} Lombardi, supra note 62, at 41175 (citing Lombardi, supra note 163, at 904).
Companies can also tailor contractual policies to their self-determined interests, rather than to interests defined by generalized statutes. Some argue that statutory clawbacks are unnecessary for this reason because federal requirements disrupt the ability of the shareholders and directors to decide their own rights and powers.\textsuperscript{180}

Third, contractual clawbacks compensate both the company and shareholders.\textsuperscript{181} Shareholders may be better served by contractual clawbacks, because the company can recover compensation more efficiently than the SEC.\textsuperscript{182}

In sum, although there are clear trends that companies favor discretionary enforcement and no-fault triggers caused by financial restatements, there are no clear trends for the amount of compensation subject to clawbacks. In addition, the purposes behind contractual policies vary widely.

IV. COMPREHENSIVE CLAWBACK COVERAGE

This Part condenses the targets, triggers, penalties, enforcement bodies, and purposes of each clawback mechanism to create the “Comprehensive Clawback Coverage.” The Comprehensive Clawback Coverage provides the clearest and most concise description of the legal framework for executive compensation clawbacks.

First, targeted individuals are determined solely by their employment position under Sarbanes-Oxley § 304 and Dodd-Frank § 954. More specifically, Sarbanes-Oxley § 304 targets only the CEO and the CFO, while Dodd-Frank § 954 targets any current or former executive officer of the issuer who received incentive-based compensation.

Targeted individuals are determined by a hybrid of position and compensation level under Dodd-Frank § 956 and TARP. The Dodd-Frank § 956 Proposed Rules target Senior Executive Officers and Significant Risk Takers. TARP targets the top five most highly paid executives of a public company and the next twenty most highly-compensated employees. Contractual clawback policies target any employee who contracts for a clawback provision.

Clawback mechanisms target various groups of companies. Like Sarbanes-Oxley § 304, which targets approximately 4,333 companies required to file with the SEC,\textsuperscript{183} Dodd-Frank § 954 targets approximately 4,845 listed companies.\textsuperscript{184} By contrast, TARP and Dodd-Frank § 956 specifically target financial institu-

\textsuperscript{180} Sharp, supra note 28, at 335.
\textsuperscript{181} Lombardi, supra note 163, at 889.
\textsuperscript{182} Sharp, supra note 28, at 326.
\textsuperscript{183} Ibrahim, supra note 8.
\textsuperscript{184} Listing Standards, supra note 62, at 41172.
TARP targets TARP recipients with outstanding TARP funds (41 companies in 2017\textsuperscript{185}), and the Dodd-Frank § 956 Proposed Rules target Covered Financial Institutions based on asset size. In addition, voluntary contractual clawback policies have been adopted by nearly 90% of Fortune 100 companies\textsuperscript{186} and 40% of S&P 500 companies.\textsuperscript{187}

Second, most clawbacks are triggered by some form of disclosure inaccuracy. Sarbanes-Oxley § 304 (misstatements) and Dodd-Frank § 954 (restatements) are triggered by material inaccuracies under federal securities law. TARP is triggered by a materially inaccurate financial statement but is not limited to statements required by federal securities law. Most voluntary contractual clawback policies are also triggered by financial restatements.\textsuperscript{188} By contrast, clawbacks under Dodd-Frank § 956 are triggered if the target employee “engaged in misconduct that resulted in significant financial or reputational harm to the covered institution, fraud, or intentional misrepresentation of information used to determine . . . incentive-based compensation.”\textsuperscript{189}

Clawback mechanisms are divided on whether misconduct is required. While Sarbanes-Oxley § 304 and the Dodd-Frank § 956 Proposed Rules require misconduct, Dodd-Frank § 954 and TARP do not. The most recent draft of the CHOICE Act 2.0 would add an element of misconduct to § 954 by imposing clawbacks only where the executive “had control or authority over the financial reporting.”\textsuperscript{189} In addition, misconduct is required by voluntary contractual clawback policies in ultra-large companies to a greater degree than the average listed company.\textsuperscript{190}

Clawbacks are discretionary under the Dodd-Frank § 956 Proposed Rules and nearly all contractual clawback policies.\textsuperscript{191} For example, contractual clawbacks were discretionary in the Wells Fargo fraudulent account scandal and the Walmart foreign bribery scandal.\textsuperscript{192} By contrast, clawbacks are mandatory under Sarbanes-Oxley § 304 and Dodd-Frank § 954 (which requires target companies to adopt policies that “will” claw back compensation under certain circumstances). Clawbacks are also mandatory under TARP unless the company can demonstrate enforcement is “unreasonable.”

Third, the clawback penalty consists of any incentive-based compensation under the Dodd-Frank § 956 Proposed Rules (subject to mandatory deferral requirements) and TARP. Sarbanes-Oxley § 304 also claws back any bonuses and profits realized from the sale of stock. By contrast, Dodd-Frank § 954 limits clawbacks to the excess of what would have been paid to the executive officer under

\textsuperscript{185} State of the Bailout, supra note 82.
\textsuperscript{186} Murphy, supra note 27, at 113.
\textsuperscript{187} Lombardi, supra note 158, at 893–94.
\textsuperscript{188} Id.
\textsuperscript{190} See Lombardi, supra note 163, at 901.
\textsuperscript{191} Id.
\textsuperscript{192} See discussion infra Section IV.A.2.
the accounting restatement. Clawback penalties under voluntary contractual clawback policies vary widely among companies. For SEC-regulated companies, 61.5% provide for recovery of any incentive-based compensation and 73% provide for recovery of excess incentive-based compensation; for DJIA companies, 27% claw back the portion erroneously awarded, while 23% claw back all or part of the amount realized (43% not reporting).

The time period subject to clawbacks is 12 months after accounting misstatement under Sarbanes-Oxley § 304; 3 years preceding an accounting restatement under Dodd-Frank § 954; and any time during which TARP funds are outstanding under TARP. In addition, one study found that 90% of DJIA companies had a look-back period of 3 years or longer. Under the Dodd-Frank § 956 Proposed Rules, clawback and forfeiture time periods are dependent on mandatory compensation deferral requirements. Clawbacks are forward-looking from the moment of the clawback trigger under Sarbanes-Oxley § 304 and the Dodd-Frank § 956 Proposed Rules on Forfeiture, but backward-looking under Dodd-Frank § 954, TARP, and the Dodd-Frank § 956 Proposed Rules on Clawbacks.

Fourth, clawbacks are enforced only by the SEC under Sarbanes-Oxley § 304. By contrast, clawbacks are enforced by the company under TARP, Dodd-Frank § 954, and the Dodd-Frank § 965 Proposed Rules—although the SEC and Listing Exchanges also have tangential enforcement obligations. In addition, voluntary contractual clawback policies are enforced by companies under state law.

Fifth, the purpose of clawbacks mechanisms vary widely. Purposes under Sarbanes-Oxley § 304 include encouraging proactive oversight, equity, and punishment (though not explicitly). TARP, Dodd-Frank § 954, and Dodd-Frank § 956 are intended to ensure national economic stability, although Dodd-Frank § 954 arguably reaches beyond this purpose by broadly reforming U.S. corporate law. TARP was additionally intended to protect the government’s investment in TARP recipients and reign in excessive Wall Street bonuses. Contractual clawback policies are often used to calm public outrage, reimburse the company, and incentivize desired behavior.

Clawback purposes expose the alignment of interests under each clawback mechanism. Sarbanes-Oxley § 304 aligns the interests of managers and investors by preventing manipulation of financial disclosures. Dodd-Frank § 954 aligns the interests of managers and society by preventing another economic crisis. TARP aligns the interests of managers and the government by protecting the government’s financial investment. Voluntary contractual clawback policies align the managers’ interests with the company’s interests, as defined by the board in executive employment contracts, by granting the board discretion to enforce clawbacks.

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193 Lombardi, supra note 163, at 904.
194 See Fried, supra note 76.
195 See Lombardi, supra note 163, at 889; see also discussion infra Section IV.A.2.
V. THE FLAW: CLAWBACKS INCREASE AGENCY COSTS

Michael Jensen and William Meckling first identified the “agency problem” in executive compensation: conflicts of interest between companies and executives generate additional costs for companies that are ultimately borne by shareholders.\(^{196}\) Clawbacks likely increase agency costs by 1) failing to prevent executive wrongdoing, 2) possibly increasing executive compensation in the form of a “risk premium,” 3) incentivizing the circumvention of clawback rules, and 4) driving away talented employees.

A. Clawbacks Increase Agency Costs by Failing to Prevent Costly Executive Wrongdoing

Clawbacks likely increase agency costs by failing to prevent costly executive wrongdoing, because 1) the Comprehensive Clawback Coverage is weak, and 2) discretionary clawbacks are often not enforced in relation to the underlying wrongdoing, as illustrated by case studies of Wells Fargo and Walmart.

1. The Comprehensive Clawback Coverage is Weak

Kevin Murphy explained that the statutory “‘clawback’ provision of Sarbanes-Oxley—which was subsequently extended in the TARP legislation and Dodd-Frank . . . was notable mostly for its ineffectiveness.”\(^{197}\) On the surface, Sarbanes-Oxley § 304 applies to thousands of SEC-regulated companies, but only the CEO and the CFO are targeted, and clawbacks have been enforced against no more than twenty-five individuals as of 2017.\(^{198}\) In addition, TARP only applies to a diminishing group of financial institutions.\(^{199}\) While Dodd-Frank § 954 targets a broad group of employees and a broad group of companies, the penalty clawing back excess realized compensation is merely corrective and not punitive.\(^{200}\) In addition, contractual clawback policies and the Dodd-Frank § 956 Proposed Rules provide for discretionary enforcement, which is often used to calm public outrage after a scandal, rather than prevent the underlying wrongdoing.\(^{201}\) The Comprehensive Clawback Coverage is therefore too weak and disorganized to effectively deter costly executive wrongdoing.

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\(^{197}\) Murphy, supra note 27, at 89.

\(^{198}\) Fried, supra note 30, at app. tbls. 1, 2.

\(^{199}\) See Bachelder, supra note 84.

\(^{200}\) Murphy, supra note 27, at 12.

\(^{201}\) Id. at 1.
2. Case Studies

Two case studies demonstrate that discretionary clawback enforcement is often tied to a company’s financial success rather than the underlying wrongdoing. First, discretionary contractual clawbacks were enforced in the Wells Fargo fraudulent account scandal only when the company suffered long-term financial harm. Second, discretionary contractual clawbacks were never enforced in the Walmart foreign bribery scandal, where the company did not suffer long-term financial harm.

i. The Wells Fargo Fraudulent Account Scandal

Wells Fargo has maintained a contractual policy authorizing clawbacks for causing “reputational or other harm to the Company.” Since 2002, former Wells Fargo CEO John Stumpf, who then served as head of Wells Fargo’s southwest and western regional banking groups, knew of employees’ systemic practice to fraudulently open customer accounts in order to meet internal sales targets. Over the next decade, executives were consistently notified about similar fraud.

In 2010, the Office of the Comptroller, one of the Appropriate Federal Regulators enforcing Dodd-Frank clawbacks, failed to notify the public or take action against Wells Fargo, admitting in 2017 to “several missed opportunities to perform comprehensive analyses and take more timely action beginning in 2010.” As of 2017, statutory clawbacks have not been enforced, most likely due to Regulator apathy and enforcement difficulty.
In 2013, the Los Angeles Times publicly exposed the scandal for the first time, resulting in public outrage. Clawbacks were not enforced under Wells Fargo’s contractual policy immediately after the public exposure, even though employees fraudulently opened more than two million fake accounts. Instead, the company fired 5,300 employees and paid $185 million in government fines.

On September 20, 2016, public outrage peaked when Wells Fargo’s CEO Stumpf appeared before the Senate Banking Committee, famously scolded by Congresswoman Elizabeth Warren. Just five days later, Wells Fargo enforced the contractual clawback policy, likely under the “reputational harm” provision. Stumpf forfeited $41 million in bonuses and unvested equity awards; Carrie Tolstedt, head of the Community Bank division, forfeited $19 million. On April 10, 2017, Wells Fargo enforced additional clawbacks; Stumpf forfeited an additional $28 million and Tolstedt forfeited an additional $47.3 million. In total, Wells Fargo clawed back more $180 million from executives.

Wells Fargo’s clawback enforcement is correlated to the company’s financial success, as measured by market capitalization, suggesting that clawbacks only occurred in relation to the company’s financial success and not in relation to the underlying wrongdoing.


210 Wells Fargo & Co., supra note 150.


212 Government fines total $185M: $100M to the Consumer Financial Protection Bureau, $50M to the City and County of Los Angeles, and $35M to the Office of the Comptroller of the Currency. Corkery, supra note 208.


216 INDEPENDENT DIRECTORS OF THE BOARD OF WELLS FARGO & COMPANY, supra note 202, at 19.

217 Id. at Overview of the Report.

Wells Fargo did not enforce clawbacks from 2002 to 2016 when the company knew about the fraudulent activity, but rather when market capitalization increased by $218 billion.\textsuperscript{219} Wells Fargo’s market capitalization was $77 billion in 2002 when Stumpf first learned of the fraudulent activity, which rose to $130 billion in 2010 during the OCC investigation, which further rose to $220 billion in 2013 after the LA Times article, which again rose to $295 billion in June 2016\textsuperscript{220}. After each significant event where Wells Fargo’s financial position did not suffer, Wells Fargo declined to enforce clawbacks.

Wells Fargo finally enforced clawbacks in 2016 and 2017 when market capitalization declined by $61 billion and failed to recover.\textsuperscript{221} Wells Fargo’s market capitalization dropped from $295 billion in June 2016 to $234 billion in September 2016 when Stumpf appeared before the Senate Banking Committee;\textsuperscript{222} contractual clawbacks were enforced just five days later.\textsuperscript{223} By March 2017, Wells Fargo’s $276 billion market capitalization failed to recover to its 2016 heights.\textsuperscript{224} By contrast, the market capitalization of a comparable bank, JPMorgan Chase, grew by $87 billion over the same period to reach an all-time high after President Trump’s election.\textsuperscript{225} Failing to recover while peer banks flourished, Wells Fargo enforced additional clawbacks in April 2017.\textsuperscript{226} After each significant event where Wells Fargo’s financial position suffered, Wells Fargo enforced clawbacks.

In conclusion, Wells Fargo enforced clawbacks during periods of financial harm, but not during financial success. After events causing “reputational harm” where market capitalization nevertheless increased by $218 billion, clawbacks were not enforced; after events causing “reputational harm” where the company’s market capitalization declined by $61 billion, clawbacks were enforced.\textsuperscript{227} Enforcement discretion was therefore not tied to the underlying wrongdoing; otherwise, clawbacks would have been enforced on several occasions after 2002.

\textsuperscript{219} Id.
\textsuperscript{220} Id.
\textsuperscript{221} See Cowley & Kingston, supra note 211.
\textsuperscript{222} Wells Fargo Market Cap, supra note 218.
\textsuperscript{223} INDEPENDENT DIRECTORS OF THE BOARD OF WELLS FARGO & COMPANY, supra note 202, at 2.
\textsuperscript{224} Wells Fargo Market Cap, supra note 218.
\textsuperscript{226} Cowley & Kingston, supra note 211.
\textsuperscript{227} INDEPENDENT DIRECTORS OF THE BOARD OF WELLS FARGO & COMPANY, supra note 202, at 10.
ii. Walmart Foreign Bribery Scandal

Clawbacks were not enforced in connection with the Walmart foreign bribery scandal.\(^{228}\) Walmart has maintained a contractual policy permitting discretionary clawbacks if an executive “engaged in any act deemed inimical to the best interests of Wal-Mart.”\(^{229}\) In 2003, Walmart executives allegedly facilitated or failed to prevent bribery of Mexican government officials to change zoning laws for new Walmart stores.\(^{230}\) In 2005, Walmart’s internal compliance investigators found “clear confirmation that . . . top executives at Wal-Mart de Mexico were well aware of the [bribery] payments.\(^{231}\) In 2012, the New York Times publicly exposed the scandal, resulting in public outrage.\(^{232}\)

Walmart has never exercised discretion to enforce clawbacks for this “inimical” scandal, and although shareholders demanded Walmart amend its policy to include clawbacks triggered by unethical conduct, their demand was rejected in 2013.\(^{233}\) In addition, state litigation\(^{234}\) and federal litigation\(^{235}\) costing Walmart more than $820 million in legal expenses\(^{236}\) were eventually dismissed.\(^{237}\)

Walmart’s market capitalization was $207 billion in January 2003 when the foreign bribery began,\(^{238}\) which rose to $210 billion in January 2012 just before public discovery,\(^{239}\) which fell by $17 billion in April 2012 after public discovery\(^{240}\) but recovered back to $213 billion by the end of the same month.\(^{241}\) In April 2017, Walmart’s market capitalization reached $217 billion.

Walmart did not enforce clawbacks during periods of financial success. After “inimical acts” where market capitalization increased, Walmart did not enforce


\(^{229}\) Conor O’Brien, SHAREHOLDERS URGE WAL-MART TO DISCLOSE USE OF CLAWBACK POLICIES, WESTLAW CORPORATE GOVERNANCE DAILY BRIEFING (May 8, 2014), 2014 WL 1814196.

\(^{230}\) Barstow, supra note 228.

\(^{231}\) Id.


\(^{233}\) O’Brien, supra note 229.


\(^{235}\) Cottrell v. Duke, 829 F.3d 983 (8th Cir. 2016); Cottrell v. Duke, 737 F.3d 1238 (8th Cir. 2013).


\(^{237}\) Stempel, supra note 232.


\(^{239}\) Id.

\(^{240}\) Stempel, supra note 232.

\(^{241}\) Wal-Mart Stores Market Cap, supra note 238.
clawbacks. After “inimical acts” causing financial harm followed by quick recovery, Walmart did not enforce clawbacks either. Enforcement discretion was therefore not tied to executives’ bribery; otherwise, clawbacks would have been enforced on several occasions after 2003.

iii. Findings: Discretionary Clawbacks are Enforced in Relation to Financial Success Rather than the Underlying Wrongdoing

Effectively, Wells Fargo and Walmart utilized discretionary clawback enforcement as a public relations tool to maximize profits rather than as a deterrent for executive wrongdoing. Like Wells Fargo, which could have enforced contractual clawbacks several times after 2002 under its “reputational harm” policy, Walmart could have enforced clawbacks several times after 2003 under its “inimical acts” policy. Like Wells Fargo, which did not enforce clawbacks from 2002–2016 after a public scandal when market capitalization nevertheless increased, Walmart did not enforce clawbacks from 2003–2016 after a public scandal when market capitalization nevertheless increased. When Wells Fargo’s market capitalization failed to recover after negative publicity from 2016–2017, clawbacks were finally enforced; when Walmart’s market capitalization quickly recovered after negative publicity in April 2017, clawbacks were not enforced. Both companies apply discretionary enforcement in relation to the company’s financial success; neither company applies discretionary enforcement in relation to the underlying wrongdoing.

This phenomenon may be attributable to the inconsistent alignment of interests between statutory and contractual clawback mechanisms. Contractual clawbacks seek to align company interests with shareholders’ financial interests, while Sarbanes-Oxley, Dodd-Frank, and TARP all seek, on some level, to align company interests with public interests. This misalignment might explain a more fundamental problem with clawback provisions like Dodd-Frank § 956, which require companies to adopt clawback policies intended for the government’s interests, yet the policies are crafted to achieve the company’s interests. The Wells Fargo and Walmart scandals illustrate how discretionary clawbacks can be used as a strategic public relations tool.

3. Conclusion

Clawbacks likely increase agency costs by failing to prevent costly executive wrongdoing. The Comprehensive Clawback Coverage is too weak and disorganized to effectively deter executive wrongdoing. In addition, two case studies illustrate how discretionary clawbacks are enforced in relation to the financial success rather than the underlying wrongdoing: Wells Fargo only enforced clawbacks when the company failed to recover from financial harm; Walmart never
enforced clawbacks despite shareholder pressure. As a result, each company incurred expenses, including government fines, legal fees, and stock price decline, that negatively impacted shareholders.

B. Clawbacks May be Increasing Executive Compensation as a “Risk Premium”

Kevin Murphy identified the concept of a “risk premium” in the context of incentive-based compensation: executives demand higher compensation for uncertainty that compensation may never be realized.\textsuperscript{242} It logically follows that executives are incentivized to demand a risk premium for the risk of clawbacks. Moreover, it follows that all targeted companies pay this risk premium, even if the Comprehensive Clawback Coverage is too weak to justify the premium.

In theory, clawbacks incentivize executives to negotiate for higher compensation, particularly in the form of base salary, because base salary is not subject to clawbacks. Moreover, Managerial Power Theory suggests that executives are able to fulfill this incentive by influencing their compensation structures.\textsuperscript{243}

Several authorities suggest that the base salary has increased or will increase as a risk premium for clawbacks. The SEC expressed concerns that in response to Dodd-Frank clawbacks, “executive officers may demand that incentive-based compensation comprise a smaller portion of their pay packages, or that they receive a greater total amount of compensation, to account for the possibility that the awarded incentive-based compensation may be reduced due to future recovery.”\textsuperscript{244} The SEC also predicted that Dodd-Frank § 954 clawbacks impact not only “the magnitude of the expected compensation, but also to how an executive views and responds to the compensation.”\textsuperscript{245} For example, because of the increased uncertainty created by § 954’s no-fault mandatory clawback,

risk averse executives may lower the value that they attach to the incentive-based component of their pay and . . . demand an offset to bear the increased uncertainty . . . [either] in the form of a smaller portion of pay being comprised of incentive-based compensation . . . [or] an increase in expected total compensation, which would come at a greater cost to the issuer.\textsuperscript{246}

In addition, Steven Bank and George Georgiev point out that “[o]ne easy way to game the [clawback] rules would be to receive less in incentive compensation

\begin{itemize}
\item \textsuperscript{242} Murphy, \textit{supra} note 27 at 144.
\item \textsuperscript{243} Bechuk & Fried, \textit{supra} note 153.
\item \textsuperscript{244} Listing Standards, \textit{supra} note 62, at 41171.
\item \textsuperscript{245} \textit{Id.} at 41176.
\item \textsuperscript{246} \textit{Id.} at 41176.
\end{itemize}
and more in fixed salary.” **247** Others have argued that § 954’s disjointed three-part enforcement creates additional uncertainty for executives, **248** leading to further base pay increases. **249**

In addition, financial institutions targeted by TARP and Dodd-Frank appear to be increasing base salaries in response to clawback legislation. One American Bar Association publication explains that, “[i]n keeping with the government’s [legislation], numerous companies (especially financial institutions) are changing their compensation structures . . . A number of financial institutions recently increased employees’ base compensation . . . .” **250** Suggesting that base salary increases may be a response to clawbacks, another study found that,

> the Troubled Asset Relief Program . . . has affected not only the level of pay but [also] the structure of pay in a sense. . . . Budgets [for base salary] are inching up as companies begin to feel more comfortable with business performance and to address a pent up demand for base salary increases. **251**

Moreover, the Sarbanes-Oxley prohibition on clawback indemnification **252** likely increases base salaries for CEOs and CFOs in the form of disguised ex ante indemnification. Because traditional ex post indemnification is prohibited under § 304, **253** CEOs and CFOs are incentivized to negotiate up front for higher base salary to cover the risk of future clawbacks. Although the value of this risk premium cannot be quantified, it logically follows that the value would be the estimated value of future clawback liability that cannot be indemnified. Furthermore, companies are likely paying this risk premium even though § 304 clawbacks are statistically unlikely. Section 304 has only been enforced against twenty-five CEOs or CFOs, **254** so most never actually “use” their disguised indemnification.

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**248** Bachelder, *supra* note 84.

**249** See Listing Standards, *supra* note 62, at 41177.


**252** See generally Cohen v. Viray, 622 F.3d 188 (2d Cir. 2010).

**253** *Id.* at 192.

**254** See Fried, *supra* note 30, at tbls. 1, 2.
risk premium even though nearly 4,000 SEC-regulated companies incur the associated agency cost.

1. Empirical Study

To analyze the influence of the clawback provisions on compensation trends, this section presents an original empirical study of S&P 1500 CEO compensation over the past ten years. This study serves two main benefits: (1) it consolidates the year-to-year growth changes in components of executive compensation over time and (2) it reveals trends in the portion of base salary that constitutes total compensation. More specifically, this study seeks to answer whether executives have begun negotiating for higher base salary in response to the clawbacks that target incentive-based compensation.

Methodology. This study compiles data from the ExecuComp Database, using the S&P 1500 sample, which is most useful for analyzing the effects of Sarbanes-Oxley § 304 and Dodd-Frank § 954, which target publicly listed companies. This study analyzes three metrics: base pay, total compensation as reported in the SEC filings, and total grant-date compensation. While the SEC filings do not report total compensation prior to 2006, the ExecuComp Database includes data on base salary and grant-date compensation dating back to 2000, which has been included to examine trends related to Sarbanes-Oxley (2002). This study presents both averages and medians, which may be “more relevant [than averages] in describing compensation for a ‘typical’ CEO” by removing highly-paid outliers.

255 Listing Standards, supra note 62, at 41172.
256 This data covers the period 2006–2016. The data begins in 2006 because “target payouts” of base salary were not available prior to 2006. Target payouts were chosen instead of actual payouts to reflect the impact clawback provisions had on negotiated pay packages—i.e. how clawbacks changed executives’ strategy and incentives when negotiating base salaries.
259 Total grant-date compensation is measured by “TDC1” in the ExecuComp Database. The TDC1 valuation includes the following: Salary, Bonus, Other Annual, Total Value of Restricted Stock Granted, Total Value of Stock Options Granted (using Black-Scholes), Long-Term Incentive Payouts, and All Other Total. UNIV. OF PENN, supra note 257.
My study includes the TDC1 valuation to reveal trends that might not otherwise be revealed by the SEC total compensation valuation. Furthermore, I included this grant-date valuation (TDC1), instead of exercise-date valuation (TDC2), to uncover the impact of clawback provisions on expected compensation and negotiated pay packages—i.e. how clawback provisions changed executives’ strategy and incentives when negotiating salaries.
260 Id.
261 Murphy, supra note 27, at 10.
Findings. This study supports—or at least does not disprove—concerns that clawbacks incentivize increased executive compensation. This study finds a correlation, though not causation, between the implementation of clawback statutes and CEOs negotiating for larger base salaries. Sarbanes-Oxley was implemented in 2002; TARP in 2008; Dodd-Frank in 2010; and the Dodd-Frank § 956 Proposed Rules in 2016. Over that time frame, 1) base salaries have steadily increased, and 2) total compensation has increased at a slower rate than the rate at which base salary has increased.

Figure 1 below shows that base salary is increasing at an average of $12,444 and median of $11,619 per year. Another study also found that base salary has been steadily increasing, and company salary budgets have increased at a median of 3% per year from 2012–2016.

While the increase in total compensation and the increase in base salary are both slowing down, Figures 2 and 3 show that base salary is slowing down at a lower rate, which suggests that base salary is increasing relative to total compensation and total grant-date compensation. More specifically, the year-to-year

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262 See Discussion supra Section II.
263 Id.
265 See supra Figure 2.3
increase in base pay is slowing down at an average of -1.45% per year and a median of -0.31% per year.²⁶⁶ The year-to-year increase in total compensation, as reported on SEC filings, is slowing down at an average of -3.25% per year and median of -0.51% per year.²⁶⁷ The year-to-year increase in total grant-date compensation is slowing down at an average of -3.60% per year and median of -0.06% per year.²⁶⁸
On the other hand, Figure 4 below shows that the portion of base pay that constitutes total compensation is decreasing at an average rate of \(-1.1\%\) per year.
and median rate of -1.01% per year.\textsuperscript{269} Although S&P 1500 CEOs are undoubtedly negotiating for more base pay, they seem to bargain for slightly more compensation in other forms as well—likely bonuses.\textsuperscript{270} An S&P 500 study by Equilar however, found that, “base salary and awarded stock grants both increased in median value in each of the past five years [from 2011–2016], while stock option grants decreased in value at the median over that time period.”\textsuperscript{271} The S&P 500 dataset suggests that executives at larger companies are in fact bargaining for more base salary than equity compensation.\textsuperscript{272}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{s&p_1500_ceo_compensation.png}
\caption{S&P 1500 CEO Compensation: Percentage of Total Compensation that Constitutes Base Salary}
\end{figure}

In conclusion, Figures 1–4 illustrate the correlation between the implementation of the clawback provisions, beginning with Sarbanes-Oxley in 2002, and an increase in executive compensation over the same time period.\textsuperscript{273} While this study establishes a correlation between increased compensation and clawback provisions, several factors prevent the assertion of a causal link.\textsuperscript{274} Most notably, ex-

\begin{itemize}
\item \textsuperscript{269} See supra Figure 4.
\item \textsuperscript{270} Id.
\item \textsuperscript{272} Id.
\item \textsuperscript{273} See supra Figure 1-4
\item \textsuperscript{274} Id.
\end{itemize}
ecutive compensation was increasing before the implementation of the clawbacks, but comparable data is not available to expand the time frame of this study. In addition, increased base pay may be caused by various other factors, such as concerns that incentive stock compensation is not well correlated with performance, from which the influence of the clawback provisions cannot be clearly distinguished. Still, this study demonstrates that compensation trends are consistent with, and do not disprove, theories about executives’ logical incentive to increase compensation and base salary in response to the clawback provisions.

If base salary is in fact increasing in response to clawbacks, it is an unfavorable public policy. In addition to the cost of salaries, Managerial Power Theory suggests that increased compensation often leads to further increases in compensation, resembling a chain-reaction where executives’ cognitive dissonance leads them to expect and often receive continual salary increases. In 2015, the SEC also expressed concerns that increased base pay in response to clawbacks could “reduce pay-for-performance sensitivity and may reduce the correlation between the executive officer’s effort to enhance value [they provide to the company].” Investors may also suffer, because shifting from incentive-based compensation to base salary allows directors to privately determine base compensation instead of providing clear, publicly-disclosed performance metrics for stock-compensation.

C. Clawbacks Incentivize Costly Circumvention of Clawback Provisions

Because most clawbacks are triggered by some form of disclosure inaccuracy, executives may be incentivized to 1) forego valuable projects involving difficult accounting judgments that might result in accounting misstatements; 2) overinvest in financial reporting to protect themselves at a high cost to shareholders; and 3) attempt to reduce the effect of a clawback, resulting in a different penalty than shareholders initially believed they approved. Steven Bank and George Georgiev have also expressed concerns that in response to clawbacks, “executive . . . attention . . . will be wasted on developing strategies to make executive compensation clawback-proof and on technical compliance with the complex rules.” Clawbacks create incentives for unproductive and costly behavior.

276 Id.
277 Id.
278 Bebchuk & Fried, supra note 153.
279 Listing Standards, supra note 62, at 41179.
280 Fried, supra note 30, at 34.
281 Bank & Georgiev, supra note 247.
D. Clawbacks Drive Talented Employees Away from Companies Targeted by Clawback Provisions.

The Dodd-Frank § 956 Proposed Rules may drive talented employees to seek jobs where regulations do not apply. For example, over-inclusive clawback provisions may incentivize highly-compensated employees to leave Covered Institutions for smaller banks, hedge funds, or non-U.S. companies. As a result, systemic financial risks are not eliminated, but merely shuffled amongst new companies. In reference to Dodd-Frank clawbacks, the 2016 Republican CHOICE Act 1.0 explains that, “[f]ar from mitigating systemic risk, driving talented professionals out of the financial services sector only increases the likelihood of a future financial crisis.” More drastically, over-inclusive clawbacks may drive business out of the United States, creating agency costs due to sub-optimal, long-distance business management and international transaction costs. For example, foreign companies might delist from U.S. stock exchanges in response to Dodd-Frank clawbacks that target listed companies, because even though “U.S. listing confers advantages on non-U.S. companies . . . the burden from the [clawback] rules may well outweigh these advantages,” Not only are corporate relocation costs increased, but driving companies out of the country is contrary to Dodd-Frank’s purpose of ensuring financial stability in the United States.

VI. Solution

While this comment primarily sets out to clarify executive compensation clawbacks and highlight the major flaw that clawbacks increase agency costs, one solution follows logically: repealing or amending statutory clawback legislation may lower the agency costs associated with clawbacks. It is unlikely that clawbacks will be entirely repealed, but amendments appear likely in the near future. For example, the 2017 Republican-controlled House released a draft of the CHOICE Act 2.0 in April 2017, outlining an amendment to Dodd-Frank § 954, but not a total repeal. Amendment or repeal might prove to be difficult in the near future, given President Trump’s recent executive order that, “for every one new regulation issued, at least two prior regulations be identified for elimination.” Congressional action and legislative repeal may not be required to reduce clawback agency costs though; the Appropriate Federal Regulators can proscribe new rules under Dodd-Frank § 956 to minimize executives’ risk of clawbacks and thus decrease the associated risk premium. This route appears most likely, given

282 Coffee, supra note 155, at 1071–72.
283 Financial Choice Act 1.0, supra note 111, at 110.
285 Bank & Georgiev, supra note 247.
287 See Dodd-Frank, supra note 58.
that Trump’s Executive Order does not apply to independent federal regulators like the SEC.\textsuperscript{288}

Others argue that clawback provisions should be maintained or strengthened.\textsuperscript{289} Repealing clawback provisions may deprive shareholders of a tool for holding executives accountable. When Dodd-Frank was first enacted, one commentator speculated that “clawbacks . . . may arm shareholder plaintiffs and shareholder activists with a major new weapon.”\textsuperscript{290} In addition, maintaining clawbacks might ensure accounting compliance. One study found that, “big, ugly [material] earnings restatements aren’t as common as they used to be . . . the number of companies restating results peaked in 2006, at 1,550. By [2012] that figure had fallen to 713.”\textsuperscript{291} Fewer accounting restatements may suggest that clawback provisions encourage accounting compliance.

On the other hand, the rejection of shareholder demands in the Walmart foreign bribery scandal\textsuperscript{292} demonstrates that companies are able to dominate shareholders, and rare clawback enforcement could simply be the result of the weak Comprehensive Clawback Coverage.\textsuperscript{293} Furthermore, reducing statutory clawback provisions would not eliminate clawbacks all together. Most companies would likely retain contractual policies, because shareholders want and expect them now that contractual clawback policies have become commonplace.\textsuperscript{294} On balance, some form of legislative repeal, legislative amendment, or regulatory policy shift is necessary to reduce the burdensome agency costs associated with clawback provisions.

VII. CONCLUSION

Under U.S. law, there are five compensation clawback mechanisms. Three are statutory: Sarbanes-Oxley § 304, Dodd-Frank § 954, and 12 U.S.C. § 5221 (TARP). One is a proposed regulation pursuant to Dodd-Frank § 956. In addition, companies often maintain contractual clawback policies with coverage extending beyond statutory requirements. This paper analyzed the targets, triggers, penalties, enforcement bodies, and purposes of each clawback mechanism, then condensed that analysis to create the “Comprehensive Clawback Coverage.” The


\textsuperscript{289} See Senate Letter, \textit{supra} note 146.


\textsuperscript{291} Morgenson, \textit{supra} note 154.

\textsuperscript{292} See discussion \textit{supra} Section V.A.2.

\textsuperscript{293} See discussion \textit{supra} Section V.A.2.

\textsuperscript{294} See \textit{id}.
Comprehensive Clawback Coverage provides a clear synopsis of the current legal framework for executive compensation clawbacks.

Analysis of the Comprehensive Clawback Coverage reveals a major flaw in the current legal framework: clawbacks increase agency costs. First, clawbacks fail to prevent costly executive wrongdoing, because the Comprehensive Clawback Coverage is weak, and discretionary clawbacks are enforced in relation to a company’s financial success rather than the underlying wrongdoing, as illustrated by case studies of the Wells Fargo Fraudulent Account Scandal and the Walmart Foreign Bribery Scandal. Second, logical inferences from an original empirical study and supporting authorities suggest that the clawbacks may be increasing executive compensation, particularly base salary, in the form of a “risk premium.” Third, clawback provisions incentivize costly circumvention of clawback rules. Fourth, the clawbacks drive talented employees away from companies subject to clawbacks. The logical solution to reduce these agency costs involves a legislative repeal, legislative amendment, or regulatory policy shift with respect to executive compensation clawback provisions.
The following tables were used to calculate the empirical study of executive compensation trends in Section V.B.1 of this article (Figures 1–4). Further supporting data and calculations can also be provided upon request.

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<th>Average Total Compensation</th>
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The table above includes data for years 2001 to 2005.
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