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Paying High for Low Performance

Steven A. Bank

George S. Georgiev

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This Essay argues that regulatory reforms in the area of executive compensation introduced by the Dodd-Frank Act of 2010 have not yet achieved their purpose of linking executive pay with company performance. The rule on shareholder say-on-pay appears to have had limited success over the five proxy seasons since its adoption. The rule on pay ratio disclosure, adopted in August 2015, and the rules on pay-versus-performance disclosure and the clawback of certain incentive compensation, proposed in April 2015 and July 2015, respectively, are also unlikely to succeed. For the most part, the rules are intuitive and well-intentioned, but a closer look reveals that they are easy to manipulate, counterproductive, and often interact with one another, and with other regulatory goals, in unintended ways. As a result, five years after the passage of Dodd-Frank, the decades-old goal of aligning pay with performance remains elusive.

INTRODUCTION

The heads of CBS, Discovery Communications, and Viacom had the distinction of being the three highest-paid American CEOs in 2014.[1] At a cool $255 million, the media CEOs' combined payout looks impressive even when compared to Hollywood's top-paid stars, Robert Downey, Jr., Dwayne Johnson, and Bradley Cooper, who together took in $172 million over a similar twelve-month period.[2] These high figures might cause

† Paul Hastings Professor of Business Law, UCLA School of Law.

†† Visiting Assistant Professor and Lowell Milken Institute for Business Law & Policy Fellow, UCLA School of Law.

1. Associated Press, *Top 10 Highest-Paid CEOs in US*, BOS. GLOBE (May 26, 2015), https://www.bostonglobe.com/business/2015/05/26/top-highest-paid-ceos/uyTpy7DgYeXFYR7uKCh3LN/story.html (covering data for the year ending December 31, 2014).

2. Dorothy Pomerantz, *Robert Downey Jr. Tops Forbes' List of Top Earning Actors with $75m Take*, FORBES (July 21, 2014), http://www.forbes

even Iron Man's jaw to drop, but the real problem lies elsewhere. While the actors are guaranteed to draw crowds to the box office, the stock of all three companies lagged behind the overall market by a large margin and even lost value for the year.

Most would agree that CEOs should not receive outsized pay when their companies underperform. And yet, company boards, shareholders, and policymakers have been trying—and largely failing—to put this simple principle into effect for decades. After the recent financial crisis, the Dodd-Frank Act of 2010 aimed to embed the "pay for performance" mantra firmly into federal law.[3] Five years on, we find that the main result has been a thicker executive compensation rulebook, more complex pay structures, and a heavy compliance burden that is only set to increase as a result of major recent Securities and Exchange Commission (SEC) initiatives. These include the controversial pay ratio disclosure rule adopted by the SEC on August 5, 2015,[4] as well as proposed rules requiring additional pay-for-performance disclosure[5] and the clawback of certain incentive-based executive compensation,[6] which were released in April and July 2015, respectively.

Unfortunately, the link between pay and performance is as elusive as ever. Turning back to Hollywood, the median pay of the CEOs of the eleven major media companies was $32.9 million in 2014, by far the highest of any industry group in the S&P 500 index.[7] At the same time, the median total return of those companies was only 10.8%—more than 20% lower than the S&P 500 average of 13.7%.[8] The problem is not confined to the entertainment industry. A recent study found that firms

.com/sites/dorothypomerantz/2014/07/21/robert-downey-jr-once-again-tops -forbes-list-of-top-earning-actors/ (covering data for the year ending June 1, 2014).

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

4. *See SEC Adopts Rule for Pay Ratio Disclosure*, U.S. SEC. & EXCH. COMM'N (Aug. 5, 2015), http://www.sec.gov/news/pressrelease/2015-160.html.

5. *See SEC Proposes Rules To Require Companies To Disclose the Relationship Between Executive Pay and a Company's Financial Performance*, U.S. SEC. & EXCH. COMM'N (Apr. 29, 2015), http://www.sec.gov/news/pressrelease/2015-78.html.

6. *See SEC Proposes Rules Requiring Companies To Adopt Clawback Policies on Executive Compensation*, U.S. SEC. & EXCH. COMM'N (July 1, 2015), http://www.sec.gov/news/pressrelease/2015-136.html

7. *See* Ross Kerber, *U.S. Media CEOs Are Top Paid Even in Year When Stock Prices Lagged*, REUTERS (May 12, 2015), http://www.reuters.com/article/2015/05/12/us-ceo-compensation-media-insight-idUSKBN0NX0AV20150512.

8. *Id.*

headed by CEOs whose pay is in the top 10% in a given year subsequently suffer an 8% drop in stock value in each of the following three years.[9] Indeed, an examination of the most recent developments relating to Dodd-Frank's four most consequential executive compensation reforms—Say-on-Pay, Pay-Versus-Performance disclosure, Pay Ratio disclosure, and Clawbacks—reveals that the Act is proving to be just as ineffectual, counterproductive, and easy to manipulate as prior efforts in this area.

To be sure, Dodd-Frank's reforms may be well-intentioned and even logical when viewed in isolation. But when implemented within the complex regulatory domains of corporate governance and taxation, where economic actors have strong pecuniary incentives to find ways to undercut or evade the rules, the reforms add extra layers of complexity and expense for public companies, without getting us much closer to implementing the pay for performance paradigm in practice.

SHAREHOLDER SAY-ON-PAY

After decades of attempting to align pay with performance chiefly via enhanced corporate disclosure requirements, Congress and the SEC changed tack in 2010 and sought help from firms' shareholders via the new say-on-pay regime.[10] The say-on-pay requirement is Dodd-Frank's most visible and innovative pay-related provision. It requires companies to hold a shareholder vote on executive compensation and golden parachutes at least once every three years.[11] The concept is intuitive enough. Shareholders stand to gain the most from strong corporate performance, and they also stand to lose the most from oversized pay or poor performance. In theory, therefore, shareholders should have a strong incentive to monitor executive compensation and corporate performance, and, if dissatisfied,

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9. *See* Michael J. Cooper et al., Performance for Pay? The Relation Between CEO Incentive Compensation and Future Stock Price Performance 3–6, 28 (Oct. 1, 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572085 (concluding that the results are consistent with the hypothesis that (1) highly-paid CEOs are overconfident and therefore engage in suboptimal behavior and empire building, and (2) investors overreact to the incentive pay and then are subsequently disappointed by the company's underperformance).

10. *See* Dodd-Frank Act § 951, 15 U.S.C. § 78n-1 (2012) (setting out the say-on-pay requirement); Shareholder Approval of Executive Compensation, Dodd-Frank Act Release No. 33-9178 (Jan. 25, 2011), 76 Fed. Reg. 6010 (Feb. 2, 2011), https://www.gpo.gov/fdsys/pkg/FR-2011-02-02/pdf/2011-1971.pdf (establishing the say-on-pay regime).

11. 15 U.S.C. § 78n-1(a)(1)–(2).

to vote pay practices down. In reality, however, say-on-pay has not lived up to its promise. Shareholders are almost guaranteed to support existing pay arrangements: in each of the five proxy seasons between 2011 and 2015, less than 3% of all shareholder votes at Russell 3000 companies resulted in a rejection of current executive compensation arrangements.[12] This outcome is even more striking when considered alongside the fact that the largest proxy adviser, Institutional Shareholder Services, recommended a negative say-on-pay vote for 12–14% of the companies holding votes during these five years.[13]

Even the rare rejection of a pay package can have little or no consequence, since Dodd-Frank made the shareholder votes merely advisory and non-binding; as such, boards are not required to abide by or even respond to them.[14] Shareholder rejection of executive pay packages is not a factor in derivative litigation either: courts have held that a negative say-on-pay vote does not help overcome the business judgment presumption attached to a board's decision on executive compensation.[15] If anything, the real impact of the say-on-pay regime has been contrary to the intent of regulators. According to one study, although companies reduce some aspects of pay in anticipation of the say-on-pay vote, they offset this by increasing other components of the compensation package with the net effect of increased overall pay.[16] It is of no surprise, then, that even five years after say-on-pay was adopted, only one-fifth of investors believe CEO compensation is appropriate in size and structure.[17] A similarly low percentage of investors have confidence that CEO pay is clearly linked to performance.[18] Say-on-pay may have focused attention on the optics of compensation, but at the cost of increasing the complexity of pay packages and

12. *See* SEMLER BROSSY, 2015 SAY ON PAY RESULTS 2 (2015), http://www.semlerbrossy.com/wp-content/uploads/SBCG-2015-SOP-Report-2015-09-28.pdf.

13. *Id*. at 3.

14. *See* Dodd-Frank Act, § 951(c), 15 U.S.C. § 78n-1(c).

15. *See* Michael C. Holmes & Alithea Z. Sullivan, *Say-on-Pay Lawsuits Losing Steam*, LAW360 (July 10, 2012), http://www.law360.com/articles/355799/say-on-pay-lawsuits-losing-steam.

16. Mathias Kronlund & Shastri Sandy, Does Shareholder Scrutiny Affect Executive Compensation? 36 (Nov. 20, 2015) (unpublished manuscript), http://papers.ssrn.com/sol3/ papers.cfm?abstract_id=2358696.

17. DAVID F. LARCKER ET AL., 2015 INVESTOR SURVEY: DECONSTRUCTING PROXY STATEMENTS – WHAT MATTERS TO INVESTORS 2 (2015), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survyey-2015-deconstructing-proxy-statements_0.pdf.

18. *Id.*

with little evidence that it has done anything to align pay and performance in meaningful ways.

"PAY-VERSUS-PERFORMANCE" DISCLOSURE PROPOSAL

The SEC has been expanding the public company disclosure requirements in the area of executive compensation at a steady, incremental rate since the 1990s.[19] The goal of aligning executive pay with firm performance carries an enviable intellectual pedigree[20] and has been a constant thread in this wave of federal rulemaking. The proliferation of executive compensation disclosure rules and the attendant complexity in pay practices are illustrated by the length of the executive compensation section in the proxy statements of S&P 500 companies, which, by one estimate, has grown from an average of 5–10 pages to 40–50 pages over this time period.[21] The SEC's rule proposal on "pay-versus-performance" disclosure, released in April 2015 pursuant to the requirements of Section 953(a) of Dodd-Frank, represents the latest and most explicit effort yet to establish observable and measurable links between executive pay and firm performance.[22]

The pay-versus-performance disclosure rule would require companies to show the historical relationship between compensation actually paid (CAP)[23] to the CEO and to certain other senior executives, on the one hand, and total shareholder return (TSR)[24] on the other. In addition, companies will be re-

19. *See, e.g.*, Kevin J. Murphy, *The Politics of Pay: A Legislative History of Executive Compensation*, *in* RESEARCH HANDBOOK ON EXECUTIVE PAY 14–17 (Randall S. Thomas & Jennifer G. Hill eds., 2012).

20. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (discussing board oversight of executive compensation and making recommendations for how to improve compensation practices and corporate governance).

21. Joseph E. Bachelder, III, *"Pay Versus Performance" Rule Proposed by SEC Under Dodd-Frank*, HARV. F. ON CORP. GOVERNANCE & FIN. REG. (July 20, 2015), http://corpgov.law.harvard.edu/2015/07/20/pay-versus-performance-rule-proposed-by-sec-under-dodd-frank/.

22. *See* Pay Versus Performance, Dodd-Frank Act Release No. 34-74835 (proposed Apr. 29, 2015), 80 Fed. Reg. 26330 (May 7, 2015), https://www.gpo.gov/ fdsys/pkg/FR-2015-05-07/pdf/2015-10429.pdf.

23. The SEC proposed to define "executive compensation actually paid" as "total compensation as reported in the Summary Compensation Table modified to adjust the amounts included for pension benefits and equity awards." *Id.* at 26337.

24. Under Item 201(e) of Regulation S-K, "total shareholder return" is "measured by dividing the sum of the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and the difference be-

quired to compare their TSR with the average TSR of a peer group of companies.[25] The SEC would require this information to be reported in a rigid tabular format, which is intended to increase transparency and comparability among companies.[26] The uniform presentation of the data, however, masks the fact that these metrics can be easily distorted by one-off events and that they incorporate decisions from different time periods. This could render historical and peer group comparisons useless or, even worse, misleading.

For example, annual CAP for the CEO would be "doubled up" if a company changes CEOs midway through the year: the figure reported in the pay-versus-performance table would include additional one-off contractual payments such as severance to the departing CEO and a sign-on award to the new CEO. A company's board may be replacing the CEO in an effort to align pay with performance, but the pay-versus-performance table would suggest the opposite—that the link between pay (CAP) and performance (TSR) is broken. In addition, the SEC's methodology introduces a mismatch in time horizons. TSR is, by definition, measured over a one-year period; the CAP for the same year, however, includes compensation that was awarded in prior years for performance in those years, but was paid in the current year.[27] This is a function of the unavoidable complexity of modern pay practices, and capturing this complexity in a single figure such as CAP is impossible.

What is more, TSR is a backwards-looking measure and is not useful in assessing how well a company is performing in areas that will determine its long-term value and success.[28] It presupposes that all companies manage their affairs with a fo-

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tween the registrant's share price at the end and the beginning of the measurement period; by the share price at the beginning of the measurement period." 17 C.F.R. § 229.201 (2015).

25. *See id.* § 229.201(e)(i)–(ii).

26. *See id.* Of course, companies can choose to provide additional narrative information clarifying the disclosures, so long as the additional disclosure is not presented with greater prominence than the required disclosure. Pay Versus Performance, 80 Fed. Reg. at 26334, 26355. While this could prevent misleading information, it does little to nothing to promote the comparability of information across companies.

27. *See* Ira Kay & Blaine Martin, *Does the SEC's New "Compensation Actually Paid" Help Shareholders?*, HARV. F. ON CORP. GOVERNANCE & FIN. REG. (July 2, 2015), http://corpgov.law.harvard.edu/2015/07/02/does-the-secs-new-compensation-actually-paid-help-shareholders/.

28. *See, e.g.*, Joseph E. Bachelder, III, *Targeting Total Shareholder Return Versus Creating Long-Term Value*, N.Y. L. J. (Sept. 27, 2012), http://www.newyorklawjournal.com/id=1202572707769/Targeting-Total-Shareholder-Return-Versus-Creating-LongTerm-Value.

cus on TSR and, indeed, it encourages them to do so.[29] As a result, the pay-versus-performance rule disregards corporate strategy diversity and the fact that some boards may prioritize the interests of long-term shareholders over short-term shareholders or that they may choose to take into account the interests of non-shareholder constituencies such as employees. Ultimately, both the "pay" and "performance" in "pay-versus-performance" are simply too complex as concepts to fit comfortably within the table required by the SEC's proposed disclosure rule.

PAY RATIO DISCLOSURE RULE

The desire to reduce complex concepts and relationships to single data points is also on display in the new pay ratio disclosure rule adopted by the SEC on August 5, 2015.[30] The rule, required under Section 953(b) of Dodd-Frank, calls for companies to calculate and disclose the ratio between the CEO's total compensation and the median total compensation for all other company employees. It appears that, at least in part, the animating force behind the rule was a concern about growing income inequality: by one estimate, the average ratio of CEO pay to median worker pay in American companies has risen from an average of 20:1 in 1965 to 303:1 in 2014.[31] Congress, however, inserted the rule in Dodd-Frank, a statute seeking to address the root causes of the 2008 financial crisis, and—as shown below—the SEC ultimately justified the rule as part of its pay-for-performance regulatory scheme.

Dodd-Frank's provision requiring pay ratio disclosure became controversial shortly after the Act's inception. The provision was a last-minute addition to the law that was not examined by the relevant congressional committees.[32] The SEC's proposing release, issued in September 2013, expressed initial

29. *See id.*

30. Pay Ratio Disclosure, Dodd-Frank Act Release No. 33-9877 (Aug. 4, 2015), 80 Fed. Reg. 50104 (Aug. 18, 2015), https://www.gpo.gov/fdsys/pkg/FR-2015-08-18/pdf/2015-19600.pdf; *see SEC Adopts Rule for Pay Ratio Disclosure*, U.S. SEC. & EXCH. COMM'N (Aug. 5, 2015), http://www.sec.gov/news/pressrelease/2015-160.html.

31. Lawrence Mishel & Alyssa Davis, *Top CEOs Make 300 Times More than Typical Workers*, ECON. POL'Y INST. (June 21, 2015), http://www.epi.org/publication/top-ceos-make-300-times-more-than-workers-pay-growth-surpasses-market-gains-and-the-rest-of-the-0-1-percent.

32. *See* Steven Davidoff Solomon, *A Simple Solution That Made a Hard Problem More Difficult*, N.Y. TIMES (Aug. 27, 2013), http://dealbook.nytimes.com/2013/08/27/a-simple-solution-that-made-a-hard-problem-more-difficult/.

skepticism about the rule's rationale under the federal securities laws.[33] Industry lobby groups raised multiple concerns about the feasibility of the rule and estimated annual compliance costs at $710 million.[34] Interestingly, this number was topped by the SEC's own estimate for initial compliance costs in the adopting release, which came at up to $1.1 billion.[35] Popular support for adopting the rule was high, however, and the SEC received more than 287,000 comment letters.[36] The vast majority were supportive of the rule, even though a number came from form letter campaigns organized by the AFL-CIO and other labor organizations.[37] The SEC was caught in a political crossfire, with one side pushing for a repeal of the rule as part of a Dodd-Frank "fixer" bill,[38] while the other advocated for its speedy adoption.[39] The repeal efforts continue even after adoption and there have also been calls for challenging the rule in court.[40]

Whatever the future fate of the rule, it represents yet another case study of the limited effectiveness and the substantial evasion potential of legislation in this area. Retreating somewhat from its earlier skepticism about the rule's place under

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33. Pay Ratio Disclosure, Dodd-Frank Act Release No. 33-9452 (proposed Sept. 18, 2013), 78 Fed. Reg. 60560, 60582 (Oct. 1, 2013), https://www.gpo.gov/fdsys/pkg/FR-2013-10-01/pdf/2013-23073.pdf ("[N]either the statute nor the related legislative history directly states the objectives or intended benefits of the provision or a specific market failure, if any, that is intended to be remedied.").

34. CTR. FOR CAPITAL MKT. COMPETITIVENESS, THE EGREGIOUS COST OF THE SEC'S PAY RATIO DISCLOSURE REGULATION 8 (May, 2014), http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Egregious-Cost-of-Pay-Ratio-5.14.pdf (reporting that, based on a survey of covered companies, the annual compliance cost for the rule is estimated to be $710.9 million).

35. *See* Pay Ratio Disclosure, 80 Fed. Reg. at 50156.

36. *See Comments on Pay Ratio Disclosure*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/comments/s7-07-13/s70713.shtml (last modified Aug. 5, 2015).

37. *See id.*; *see also* Richard Trumka, *Investors Should Know Pay Gap Between C.E.O.s and Workers*, N.Y. TIMES (Feb. 9, 2015), http://dealbook.nytimes.com/2015/02/09/investors-should-know-pay-gap-between-c-e-o-s-and-workers/ (explaining the AFL-CIO's position on the regulation).

38. *See* Burdensome Data Collection Relief Act, H.R. 414, 114th Cong. (2015), https://www.congress.gov/bill/114th-congress/house-bill/414.

39. *See, e.g.*, Kim Chipman, *Clinton Says 'No Excuse' Dodd-Frank Pay Rules Not Out Yet*, BLOOMBERG (July 24, 2015), http://www.bloomberg.com/politics/articles/2015-07-24/clinton-says-no-excuse-dodd-frank-pay-rules-not-out-yet.

40. *See, e.g.*, Victoria McGrane & Joann S. Lublin, *SEC Approval of Pay-Gap Rule Sparks Concerns*, WALL ST. J. (Aug. 5, 2015), http://www.wsj.com/articles/sec-set-to-approve-final-ceo-pay-ratio-rule-1438783961.

the securities laws,[41] the SEC emphasized the rule's relevance for pay-for-performance policies. Under this view, the information provided by the rule would serve to inform shareholders when casting say-on-pay votes.[42] Given shareholders' limited interest in challenging executive compensation practices through say-on-pay, however, it seems unlikely that this additional data point will cause the majority of shareholders to become more involved. What is more, the rule could be gamed in particularly damaging ways. For example, companies can make their pay ratio look better by cutting the lowest-paid workers from the payroll via outsourcing, without making any changes to CEO pay.[43]

Many of the original concerns about the rule centered around the arithmetic and logistical difficulties in making calculations about "median worker pay" by multinational corporations with thousands of employees and far-flung operations. In formulating the final rule, the SEC went to some lengths to provide companies with methodological flexibility in calculating the ratio, and also allowed companies to exempt a limited number of workers from the calculation.[44] Although "carefully tailored to address implementation concerns,"[45] this flexibility comes at a direct cost to data comparability. If each company is allowed to use its own methodology and exclude certain workers when calculating the rule, comparing ratios among companies would convey little meaningful information, and could be misleading. This concern is further compounded by the fact

41. *See supra* note 33 and accompanying text.

42. *See* Pay Ratio Disclosure, Dodd-Frank Act Release No. 33-9877 (Aug. 4, 2015), 80 Fed. Reg. 50104, 50106 (Aug. 18, 2015) (stating that the rule fits with the general purpose of other Dodd-Frank executive compensation provisions intended to further facilitate "shareholder engagement with executive compensation," that Congress intended for the rule to "supplement the executive compensation information available to shareholders," and that the rule "provides new data points that shareholders may find relevant and useful when exercising their [say-on-pay] voting rights").

43. Andrew Ross Sorkin, *S.E.C. Has Yet To Set Rule on Tricky Ratio of C.E.O.'s Pay to Workers'*, N.Y. TIMES (Jan. 26, 2015), http://dealbook.nytimes.com/2015/01/26/tricky-ratio-of-chief-executives-pay-to-workers/.

44. For example, companies can (1) select their methodology for identifying median employees and their compensation, including through statistical sampling of the employee population or other reasonable methods; (2) make the median employee determination only once every three years; (3) exclude non-U.S. employees from countries where data privacy laws or regulations make them unable to comply with the rule; and (4) exclude up to 5% of all non-U.S. employees. *See* Pay Ratio Disclosure, 80 Fed. Reg. at 50107.

45. Kara M. Stein, Comm'r, U.S. Sec. & Exch. Comm'n, Statement on Pay Ratio Disclosure (Aug. 5, 2015), http://www.sec.gov/news/statement/statement-on-pay-ratio-disclosure.html.

that the ratio does not take into account the varied timing of deferred compensation payments, or the accrued value of pensions and other retirement assets.[46]

In light of the methodological issues with making the ratio comparable across firms and the scope for gaming the rule, pay ratio disclosures would appear to have limited utility within the federal corporate governance system. These same concerns would caution against initiatives, already underway, to use firms' pay ratio data for other regulatory purposes, including granting preferences in state contracting or taxation to firms with low CEO-to-median worker pay ratios.[47]

PROPOSAL ON THE CLAWBACK OF INCENTIVE-BASED COMPENSATION

The SEC's rule on the clawback of incentive-based compensation, proposed on July 1, 2015,[48] represents yet another recent federal intervention in the area of executive compensation. Perhaps recognizing the limits of disclosure as a regulatory strategy, this rule turns to much more aggressive legal approaches such as restitution and the use of strict liability. Just like say-on-pay votes, pay-versus-performance disclosure, and pay ratio disclosure, the clawback rule is unlikely to align executive pay with corporate performance; even worse, however, the clawback rule may actually undermine the very foundations of the executive compensation regulatory edifice that the SEC has been designing since the 1990s.

Under the proposed rule, which is mandated by Section 954 of Dodd-Frank,[49] companies would be required to adopt policies for the clawback of "erroneously awarded" incentive-based compensation when there has been an accounting restatement

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46. *See* Pay Ratio Disclosure, 80 Fed. Reg. at 50104.

47. In Rhode Island, a proposed bill would give preference in state contracts to companies where the CEO's pay is no more than 25 times the median worker pay. *See* Gretchen Morgenson, *Why Putting a Number to C.E.O. Pay Might Bring Change*, N.Y. TIMES (Aug. 6, 2015), http://www.nytimes.com/2015/08/09/business/why-putting-a-number-to-ceo-pay-might-bring-change.html (citing S. 257, 2015 Gen. Assemb., Reg. Sess. (R.I. 2015)). In California, a proposed bill would require that firms with higher CEO-worker pay gaps pay state corporate tax at a higher rate. *See id.* (citing S. 1372, 2013–2014 Leg., Reg. Sess. (Ca. 2014)).

48. *See* Listing Standards for Recovery of Erroneously Awarded Compensation, Dodd-Frank Act Release No. 33-9861 (July 1, 2015), 80 Fed. Reg. 41144 (proposed July 14, 2015) [hereinafter "SEC Clawback Proposing Release"], https://www.gpo.gov/fdsys/pkg/FR-2015-07-14/pdf/2015-16613.pdf.

49. *See* 15 U.S.C. § 78j-4 (2015).

to correct a material error.[50] "Erroneously awarded" is a reference to the fact that only compensation that was in some way linked to the restated financial statements would be subject to clawback.[51] This seems logical enough, but the rule is overbroad in a number of other ways. It covers payments not just to the CEO and CFO, but to a large class of executives, including the principal accounting officer, any vice-president in charge of a principal business unit, division or function, and any other person who "performs a policy-making function for the [company]."[52] Moreover, the rule covers compensation paid over a three-year period to both current and former executives.[53] And, once triggered by a restatement, clawbacks are automatic for all covered payments to all covered executives, irrespective of whether fraud occurred or who was at fault.[54] To fully illustrate the expansive nature of the new clawback rule, it is useful to contrast it with the existing clawback rule under the Sarbanes-Oxley Act of 2002: the latter is enforced only by the SEC and on a discretionary basis, can only be triggered by actual wrongdoing or corporate fraud (as opposed to merely a restatement), and only covers compensation paid to a company's CEO and CFO.[55]

The far-reaching new clawback requirements will certainly capture the attention of executives, boards, legal advisers, and executive compensation consultants. But this attention is unlikely to result in better company management. The best case scenario is that the requirements will lead executives to spend large amounts of money ensuring technical compliance with the complex accounting rules. To be sure, restatements are evidence of earnings manipulation, and earnings manipulation

50. SEC Clawback Proposing Release, 80 Fed. Reg. at 41147 *passim*.

51. *Id.* at 41154.

52. *Id.* at 41153, 41193.

53. *Id.* at 41145 *passim*; *see also* 15 U.S.C. § 78j-4(b)(2) (providing that recovery of incentive-based compensation applies to compensation received during a "3-year period preceding the date on which the issuer is required to prepare an accounting restatement").

54. The proposal contains a very limited "impracticability" exception. SEC Clawback Proposing Release, 80 Fed. Reg. at 41192 ("Recovery would be impracticable only if the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered, or if recovery would violate home country law."). Before concluding that recovery would be impracticable, firms must first attempt recovery or, in the case of foreign companies, obtain a legal opinion that recovery would result in a violation of home country laws. *Id*.

55. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 778 (2002) (codified at 15 U.S.C. § 7243 (2012)).

remains a pervasive problem.[56] There is little to suggest, however, that the proposed clawback rule will address this problem; instead it is likely to have a variety of undesirable effects.

For example, the clawback rule may actually motivate executives to push for opportunistic changes in their compensation or in the operation of the company. One easy way to game the rules would be to restructure pay packages, so they contain more fixed salary and less incentive compensation. Even if fixed salary turns out to be unattractive for tax reasons or because the company wants to retain some form of incentives to motivate employees,[57] executives could avoid clawbacks if their incentive pay is determined by the board based on a general assessment of performance,[58] or if it is tied to metrics not found in the company's financial statements, such as opening a specified number of stores, obtaining regulatory approvals, or completing a merger, divestiture, restructuring, or financing transaction.[59] These performance metrics may be less clearly connected to the financial performance of the company or its stock than current incentive pay. Stated simply, if boards want to circumvent the rules, or if executives have enough bargaining power to require clawback-free compensation, the clawback rule can be evaded in its entirety by decoupling pay and performance. Therefore, instead of strengthening the link between the two by limiting manipulation designed to achieve performance goals, the clawback provisions—however well-intentioned—might actually serve to sever the link altogether.

The new SEC clawback rule may be counterproductive in other ways too. One study of firms that had voluntarily adopted clawbacks after the Enron and WorldCom scandals in the early 2000s found that the provisions induced companies to make opportunistic operational changes and focus on the short term

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56. *See* Simi Kedia et al., *Evidence on Contagion in Earnings Management*, 90 ACCT. REV. 2337, 2368 (2015) (documenting earnings management by firms and associated earnings restatements).

57. Executive compensation for any "covered employee" (defined as the chief executive officer and/or any of the next four most highly compensated employees) beyond $1 million is non-deductible, if it is not performance-based. 26 U.S.C. § 162(m) (2012).

58. This would apply to those executives who are not covered employees under Section 162(m) or who earn less than $1 million in compensation.

59. The SEC itself has acknowledged that compensation tied solely to such metrics would not lead to clawbacks. *See* SEC Clawback Proposing Release, Dodd-Frank Act Release No. 33-9861 (July 1, 2015), 80 Fed. Reg. 41144, 41156 (July 14, 2015), https:// www.gpo.gov/fdsys/pkg/FR-2015-07-14/pdf/2015-16613.pdf.

at the expense of research and development.[60] This study found that any spike in profitability from such measures was reversed within three years, suggesting that the changes were just a big suboptimal shell game designed to evade the clawbacks.[61] Given that there is little evidence that voluntary clawback plans have done much to align pay with performance or stem the tide of rising executive compensation,[62] it hardly seems worth it to mandate them. Moreover, the new mandatory rules are likely to escalate the cost of errors in financial statements which might lead companies to seek additional assurances when faced with difficult accounting judgments. Because of executives' desire for certainty, audits may thus become lengthier which would delay the flow of information to investors and markets. Contributing to the compliance burden even further, in order to ensure that clawbacks are legal and enforceable under the terms of their corporate contracts and foundational documents, companies would need to review and potentially amend their bylaw provisions, indemnification provisions, compensation committee charters, and other relevant policies.[63]

In addition to pay for performance, the clawback rules may interfere with other regulatory goals, such as the promotion of capital formation. The rules would apply to all companies listed on U.S. exchanges, including foreign companies (known as "foreign private issuers") as well as two categories of small public U.S. companies ("emerging growth companies" and "smaller reporting companies").[64] The SEC has traditionally allowed foreign private issuers to follow their home country rules on executive compensation and corporate governance in lieu of the U.S. federal rules.[65] The fairly exceptional application of claw-

60. Lilian H. Chan et al., *Substitution Between Real and Accruals-Based Earnings Management After Voluntary Adoption of Compensation Clawback Provisions*, 90 ACCT. REV. 147, 169–70 (2015).

61. *Id.*

62. *See, e.g.*, Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721, 737–42 (2011).

63. G. William Tysse et al., *SEC Proposes Broadened Executive Compensation "Clawback" Rules*, MCGUIREWOODS (July 2, 2015), https://www.mcguirewoods.com/Client-Resources/Alerts/2015/7/SEC-Proposes-Broadened-Executive-Compensation-Clawback-Rules.aspx.

64. SEC Clawback Proposing Release, Dodd-Frank Act Release No. 33-9861 (July 1, 2015), 80 Fed. Reg. 41144, 41172, 41185 (July 14, 2015).

65. *See, e.g.*, *Assessing the U.S. Capital Markets—A Brief Overview for Foreign Private Issuers*, U.S. SEC. & EXCH. COMM'N (Feb. 13, 2013), https://www.sec.gov/divisions/corpfin/internatl/foreign-private-issuers-overview.shtml.

backs to foreign private issuers may create incentives for these companies to delist from U.S. exchanges and rely solely on their home market listing, or to decide against listing in the U.S. in the first place.[66] In fact, many non-U.S. companies did just that when they were faced with complex new corporate governance rules under the Sarbanes-Oxley Act in the wake of the Enron and WorldCom scandals.[67] Studies show that a U.S. listing confers advantages on non-U.S. companies,[68] but the burden from the new clawback rules may well outweigh these advantages, especially at a time when international markets are becoming increasingly competitive.[69] Similar to foreign companies, small public U.S. companies have also traditionally benefitted from certain exemptions from executive compensation and corporate governance regulation. The application of the clawback rules to small public companies raises their compliance costs and could discourage them from going public in the first place. This, in turn, could have a negative effect on capital formation, one of the core goals of the federal securities laws.[70]

CONCLUSION

Over the past twenty-five years, the domains of executive compensation and corporate governance have provided numerous targets for regulation due to largely legitimate concerns over cases of inflated pay packages, corporate underperformance, and corporate malfeasance. The track record of these regulations, however, is mixed at best, and, five years on, the reforms required under Dodd-Frank look like no exception. By introducing substantial additional complexity into the system, Dodd-Frank's requirements not only create opportunities for evasion but also interact with one another, and with other reg-

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66. Foreign private issuers can avoid the requirement only if it violates their home country laws. *See supra* note 54.

67. Xi Li, An Examination of the Impact of the Sarbanes-Oxley Act on Cross-Listed Foreign Private Issuers and the Legal Bonding Hypothesis 28–33 (Mar. 5, 2011) (2d Conference on Empirical Legal Studies Paper), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952433 (documenting the negative long-term impact of Sarbanes-Oxley on U.S. listings by foreign private issuers).

68. *See, e.g.*, John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1779–98 (2002) (discussing reasons for foreign firms cross-listing on a U.S. exchange).

69. *See id.* at 1800–28 (exploring competition among international exchanges).

70. *See* 15 U.S.C. § 78c(f) (2012).

ulatory goals, in unintended and counterproductive ways. We've been here before: In 1993, the IRS adopted regulations limiting the tax deductibility of CEO salaries to $1 million, which was intended to stymie the growth in fixed executive compensation and encourage incentive-based compensation.[71] To regulators' chagrin, however, the $1 million salary ceiling quickly became the salary floor, while bonus payments to CEOs took off via complex stock option plans and other devices. Instead of providing a fix, this exacerbated then-existing tensions and precipitated many of the problems we are trying to solve today.[72]

Upon signing Dodd-Frank five years ago, President Obama expressed confidence that the Act would ensure that executives "are rewarded based on how well they perform, not how well they evade accountability."[73] Despite all the complex rules and over eleven thousand say-on-pay votes,[74] we clearly are not there yet. Just ask the shareholders of CBS, Discovery Communications, and Viacom, who collectively saw $22.7 billion of market capitalization evaporate in 2014, all while making eye-wateringly high payments to their CEOs. This is not what pay for performance was supposed to look like.

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71. *See* 26 U.S.C. § 162(m) (2012).

72. *See, e.g.*, Steven A. Bank, *Devaluing Reform: The Derivatives Market and Executive Compensation*, 7 DEPAUL BUS. L.J. 301, 332 (1995); *see also* STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS 118–37 (2012) (discussing the effects of federal reforms aimed at addressing executive pay since the 1990s).

73. *Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act*, WHITE HOUSE (July 21, 2010), https://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act.

74. *See* SEMLER BROSSY, *supra* note 12.