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Boston University School of Law
Research Paper Series No. 22-42

December 6, 2022

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ABSTRACT

The SEC has recently released final rules implementing the executive incentive compensation recovery or “clawback” provisions of the 2010 Dodd-Frank Act. These rules are aimed at recovering from executives incentive compensation determined to be excessive in light of a subsequent accounting restatement. Unfortunately, the SEC’s rules create a loophole by excluding purely time-vested stock and stock option grants from the reach of the new clawback regime. This aspect of the rulemaking seems inconsistent with the intent of Congress, and the result likely will be to distort executive pay practices in a perverse fashion, shifting compensation back in the direction of the time-vested stock option heyday of the late 1990s and early 2000s. As such, the SEC’s decision is also regrettable as a policy matter. In addition to exempting a large fraction of incentive compensation from the reach of the clawback, a renewed emphasis on time-vested options would reverse a salutary trend in executive compensation design in favor of more tightly performance-conditioned pay instruments that create incentives over a broader range of market conditions than time-vested options, often reward executives only when they outperform their peers, and minimize executives’ ability to use inside information to maximize their compensation. To be sure, institutional investors and proxy advisory firms that embrace serious linkage between pay and performance may resist firms backsliding into heavy usage of time-vested stock and options, but given the risks to executives and the cost to firms of issuing compensation instruments subject to the new clawback, I am not optimistic.

1 Professor of Law and Maurice Poch Faculty Research Scholar, Boston University School of Law. Acknowledgements to follow.
INTRODUCTION

On October 26, 2022, the SEC adopted final rules implementing the incentive compensation recovery (aka clawback) provisions of 2010’s Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). These rules require the stock exchanges to promulgate standards requiring listed companies to adopt and disclose procedures for recovering from current or former executives incentive compensation determined to be excessive in light of a subsequent accounting restatement. The new clawback regime is mandatory and “no fault.” It is mandatory in two senses: all listed companies must adopt clawback rules that are compliant with the SEC’s requirements, and boards of directors generally lack discretion to waive the application of the rules. The new regime is “no-fault” in the sense that the rules apply regardless of individual or even collective culpability. If a company restates its financial results downward and if previously granted incentive compensation included within the regime would have been lower had the accounting been correct in the first place, the company must recover the difference from covered executives. The idea behind this approach is that corporate executives should not retain erroneously conferred compensation.

In my view, the adoption of a broad, no-fault clawback mandate was an appropriate and long overdue step. Unfortunately, however, the SEC’s rules create a troubling loophole. While the new regime applies to performance-vested equity pay, that is, stock or option compensation that is tied directly to a firm’s financial or share-price performance, the SEC’s rules exempt purely time-vested stock and stock options, that is, stock or options that become owned outright by executives based solely on their remaining employed by the issuer for a certain number of years. The predictable result of this discrepancy, I fear, will be the distortion of executive pay design in a perverse fashion, a shift back in the direction of the time-vested stock option heyday of the late 1990s and early 2000s. The reasons for the distortion are obvious. If performance-vested equity is subject to a mandatory, no-fault clawback but time-vested options are exempted, executives will prefer and value the latter more greatly. Governance watchdogs like Institutional Shareholder Services (ISS) might bemoan the shift, but the tougher the clawback (and the new clawback regime is quite tough and appropriately so), the greater the discount executives will apply to clawback-able compensation. The distortion will be amplified by the possibility that taxes executives pay on compensation that is later clawed back might not be recoverable and by the cost and difficulty that firms will face in determining how much compensation must be clawed back, particularly when compensation subject to the clawback is tied to a company’s share price. Avoiding compensation instruments subject to the new clawback also minimizes the risk of shareholder litigation associated with valuation and other aspects of the new clawback regime.

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4 Exchange Act Release Nos. 33-11126, 34-96159, supra note 2, at 73,100 (adopting rules requiring issuers to “recover erroneously awarded compensation … except to the extent that pursuit of recovery would be impracticable”).
5 Id. at 73,077.
In its release, the SEC did not specifically discuss why it excluded time-vested equity compensation from the reach of new clawback regime. Perhaps it believed that including time-vested stock and options would be inconsistent with the language of the statute or that application of the clawback to time-vested equity was simply too difficult. I do not believe either reason justifies the decision. Exempting time-vested options seems inconsistent with congressional intent as the Dodd-Frank Act explicitly included “stock options awarded as compensation” as incentive compensation subject to the clawback.  

6 Dodd-Frank Wall Street Reform and Consumer Protection Act § 954.

It is unlikely that Congress was referring only to performance-vested options as the SEC has essentially concluded. Time-vested equity is incentive compensation, and the value of that compensation is inflated when an executive cashes out time-vested stock or options at inflated share prices due to misstated financial results. Of course, it is not trivial to estimate the impact of misstated financials on share price, but the SEC’s new rules already require firms to generate such estimates in clawing back performance-based pay tied to share price. It would not be difficult to extend these rules to reach time-vested equity pay.

Exemption of time-vested stock and options and a likely return to old school option-heavy compensation design are regrettable for several reasons. First, exempting time-vested stock and options undermines the efficacy of the new clawback regime. If the result of the rulemaking is a return to a world in which the bulk of executive incentive compensation consists of time-vested stock and options and only a small fraction of incentive pay is subject to the clawback, the clawback simply won’t catch the majority of unearned pay associated with financial misstatements. Second, a return to heavy emphasis on time-vested options would reverse a salutary trend in executive compensation design in favor of performance share plans that create incentives over a broader range of market conditions than time-vested options, often reward executives only when they outperform their peers, and minimize executives’ ability to use inside information to maximize their compensation.

To be sure, corporate governance has evolved considerably since the time-vested stock option heyday of the 1990s. Executive pay practices are under greater scrutiny than ever before, and investor advocacy groups such as ISS and Glass Lewis lean hard on companies to adopt performance-vested equity compensation. Perhaps the influence of these groups and of institutional investors will prevent companies from backsiding into pay packages heavy with time-vested stock and options, but I am not optimistic. I fear that a clawback regime that exempts time-vested equity may be worse for shareholders in the long run than no clawback regime at all.

I. THE DODD-FRANK CLAWBACK AND SEC RULEMAKING

Section 954 of the Dodd-Frank Act amended the Securities Exchange Act of 1934 to require the SEC to direct the national securities exchanges to promulgate listing standards requiring the adoption and disclosure of executive incentive compensation clawback procedures, specifically:

that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or
former executive officer of the issuer who received 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, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.\footnote{Id.}

The legislative history behind § 954 is almost non-existent. A very brief discussion is found in a short section of a Senate Banking Committee report which indicates that this no-fault clawback is aimed at preventing unjust enrichment of executives.\footnote{S. Rep. No. 111-176, at 135-36 (2010).} The report states that clawbacks are aimed at money executives were “not entitled to” and “would not have received if the accounting was done properly.”\footnote{Id.} The provision was intended to avoid adjudication of misconduct and address the unfairness to shareholders of executives’ retaining unearned compensation.\footnote{Id.}

The Dodd-Frank clawback regime differs in important ways from clawback provisions included in prior legislation. In 2002, the Sarbanes-Oxley Act gave the SEC the power to enforce clawbacks of any bonus, incentive-based pay, or stock sale profits received by a company’s CEO or CFO within twelve months of a financial statement filing in the event of material noncompliance with financial reporting requirements resulting from misconduct.\footnote{Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304(a), 116 Stat. 745 (2002).} This clawback was predicated on fault – misconduct by someone within the organization – and allowed for complete disgorgement of incentive pay, not just the incremental amount associated with the faulty accounting.\footnote{Id.}

Compared with the SOX clawback, the Dodd-Frank clawback is both broader and more surgical. The Dodd-Frank clawback applies regardless of fault and applies to a very broad class of financial misreporting – what the SEC refers to as both “little r” and “Big R” restatements.\footnote{As the SEC explains, “Big R” restatements “correct errors that are material to previously issued financial statements” while “little r” restatements “correct errors that are not material to previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period.” Exchange Act Release, supra note 2.} It also applies to a much broader set of executives, reaching essentially the same group of individuals who are required to report trades to the SEC and are subject to the “short-swing” insider trading prohibitions under SEA § 16.\footnote{Exchange Act Release, supra note 2, at 73,089 and 73,090.}

\footnote{The Troubled Asset Relief Program (TARP) enacted by Congress in the wake of the 2007/2008 financial crisis also imposed executive pay clawback requirements on the financial firms that were bailed out by the federal government, but these clawback obligations disappeared when the bailout funds were repaid. See David I. Walker, Executive Pay Clawbacks and Their Taxation, 24 FLA. TAX REV. 522, 530-31 (2021).}
excess compensation resulting from faulty financial reporting, not the entirety of contemporaneous incentive pay and not reaching at all profits from stock sales inflated by misstated financials.15

The Dodd-Frank clawback is easily applied to cash bonuses based on financial results, and if such bonuses comprised the whole of executive incentive compensation, much less SEC interpretation and rulemaking would have been required. Suppose, for example, that an executive has received a $1 million cash bonus based on her company achieving $10 of earnings per share in 2020. Suppose that earnings are restated downwards a year later, and that based on restated earnings the executive would have been entitled to a bonus of $700,000. To be compliant with the Dodd-Frank clawback, the company must have procedures in place to recover the $300,000 of excess compensation paid in 2020.

Clawbacks become more complicated when compensation is tied to firm equity or share price. In its final rule, the SEC defines “incentive-based compensation” to be “any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure,” where “financial reporting measure” is further defined to include, inter alia, a company’s stock price or total shareholder return (TSR).16 The SEC describes this as a principles-based approach to defining incentive compensation that “will capture new forms of compensation that are developed.”17 Importantly, stock and stock options that are granted under the discretion of the board or compensation committee and vest solely based on the passage of time are not included within this definition of incentive-based compensation.18

The SEC has ruled that the amount of compensation that must be disgorged under the Dodd-Frank clawback should not be adjusted for any taxes incurred by executives on the receipt of that compensation.19 Some commentators noted that this approach could lead to unfairness or inconsistency between executives, some of whom might not be able to recover taxes imposed on compensation that is subsequently returned to the company.20 The SEC reasoned, however, that excluding taxes from the calculation leads to full recovery by shareholders and relieves companies of the burden of determining individualized tax circumstances.21 Ultimately, the SEC ruled, the tax treatment of clawed back compensation is a tax policy matter outside the scope of its rulemaking.22

II. THE LOOHOLE AND THE DISTORTION IN EXECUTIVE PAY DESIGN

The loophole in the Dodd-Frank clawback regime as implemented by the SEC and the likely distortive effect are readily apparent from the description in Part I. Purely time-vested stock and options are excluded from the regime while incentive compensation that vests in part based

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15 Id. at 73,097.
16 Id. at 73,092.
17 Id. at 73,093.
18 Id. at 73,094.
19 Id. at 73,098.
20 Id. at 73,097. The tax treatment of disgorged compensation is complex and uncertain. See infra Part II.B.
21 Exchange Act Release, supra note 2, at 73,098.
22 Id.
on financial performance or share price, such as the currently popular performance share plans, are included. Executives will discount the latter relative to the former. Companies and executives wishing to avoid or minimize the impact of the clawback regime can focus compensation design on time-vested stock and options. Moreover, given the risk that tax paid on clawed back compensation may not be recoverable by executives in all circumstances, difficulties in determining the magnitude of clawed back compensation associated with sophisticated compensation instruments, and the risk of shareholder litigation related to clawback implementation, the incentive to minimize compensation subject to the new clawback regime is even greater. This Part develops these themes.

A. Executive Incentive Compensation and the Application of the Dodd-Frank Clawback

Executive incentive compensation has evolved considerably over the last 20 years. In 2020 stock options, which once dominated the executive pay landscape, accounted for only about 11% of total pay for the average S&P 500 senior executive. Stock grants accounted for about 52%, while annual bonuses and nonequity incentives accounted for about 17%. The remaining 20% of total pay consisted of non-incentive elements, principally salary. Under the SEC’s rulemaking, the Dodd-Frank clawback applies inconsistently to the incentive elements of these pay packages.

Annual Bonus. Annual bonus plans are quite heterogeneous. Bonuses may be tied to various financial metrics, such as earnings per share, or to non-financial attainments, such as improving safety or increasing diversity. Dodd-Frank clawbacks of annual bonuses are relatively straightforward. To the extent that a bonus is tied to a financial reporting measure that is subsequently restated downward, the incremental bonus amount must be recovered by the company. If a bonus is tied to the company’s share price in some fashion and the share price at the time of the bonus calculation is inflated due to misstated financials, the impact of the misstatement on share price must be estimated to calculate the clawback amount.

A number of commentators have pointed out the difficulty of determining compensation that must be clawed back when an award payout is based on share price or TSR, as share price is only indirectly related to overstated financial metrics. Overstated financials are likely to lead to an inflation in share price, but by how much? The SEC’s final rules require companies to

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24 2020 compensation figures reflect author’s calculations based on Compustat ExecuComp data.
25 See, e.g., ANNE BUSHMAN, RSM, EXECUTIVE COMPENSATION STRUCTURES IN A COMPETITIVE MARKET (Aug. 1, 2018), at 3 (providing examples of financial and non-financial performance metrics frequently used in annual bonus plans).
26 Exchange Act Release, supra note 2, at 73,098.
27 TSR over a period includes dividends received in addition to changes in the share price. Absolute TSR and TSR relative to that of a peer group of companies are common incentive pay metrics. FW COOK, 2020 TOP 250 REPORT, 7 (2020) (reporting that in 2020 TSR was employed as a performance share metric by 67% of companies issuing performance shares).
28 Exchange Act Release, supra note 2, at 73,097.
estimate the impact but do not dictate a methodology. Presumably, estimation will be based on event studies or similar methodologies.

**Options.** The large majority of the options granted to U.S. senior executives are purely time-vested options. Almost uniformly, a corporation’s board or compensation committee will grant an executive an option to purchase a fixed number of shares at a predetermined price on a future date. The exercise or strike price of the option is the fair market value of the shares on the date of the grant; the options typically become exercisable or vest in tranches over several years; and most options expire ten years following grant. Upon exercise, the executive receives the underlying shares. These shares may be held indefinitely, but typically most or all of the shares are sold immediately. These time-vested options represent incentive compensation because the value of the underlying shares depends on firm performance. However, because grant and vesting are not a direct function of the attainment of financial reporting measures or of share price, these options are excluded from the Dodd-Frank clawback regime.

A small number of companies issue performance-vested stock options that vest based on time and some measure or measures of company performance. If one or more of the performance measures is a financial reporting measure or is related to share price, these options are subject to the Dodd-Frank clawback. If a performance metric incorporated the company’s share price in some fashion, the impact of the misstated financials on share price would have to be estimated to determine the compensation to be clawed back.

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29 Id. at 73,098 (requiring companies to base recoveries on a “reasonable estimate” of the impact of misstated financials on share price).

30 Id. at 146 (discussing the use of event studies to estimate the impact of financial misstatements on stock price but emphasizing that the use of event studies is not required).

31 Although the data is somewhat dated, Bettis, Bizjak, Coles, and Kalpathy find that only 5% of sample firms issued a performance-vested stock option to a senior executive in 2012, versus 58% of firms that issued at least one time-vested option that year. J. Carr Bettis et al, *Performance-Vesting Provisions in Executive Compensation*, 66 J. ACCT. & ECON. 194, 199 (2018).

32 See, e.g., David Aboody et al, *Are Executive Stock Option Exercises Driven by Private Information?*, 13 REV. ACCT. STUD. 551 (2008) (analyzing all option exercise transactions reported to the SEC by corporate insiders between 1985 and 2003 and finding that in 50% of exercises all shares received were sold within 30 days and in 21% of exercises some but not all shares received were sold within 30 days).


34 Bettis et al, *supra* note 31, at 199 (reporting that 5% of sample firms issued at least one performance-vested option to a senior executive in 2012).

35 Exchange Act Release, *supra* note 2, at 73,094. The SEC briefly, but I think somewhat erroneously, addressed the determination of clawed back compensation arising from performance-vested options. According to the release, if options “are still held at the time of recovery, the erroneously awarded compensation is the number of [options] received in excess of the number that should have been received [but] if the options ... have been exercised [and] the underlying shares have not been sold, the erroneously awarded compensation is the number of shares underlying the excess options.” Id. at 73,098. Recovering excess option shares is appropriate, but if the options have been exercised, the excess compensation should be the value of the excess shares less the aggregate exercise price paid by the executive for the excess shares.
Stock. Stock grants made to U.S. corporate executives are more heterogeneous than options. A minority of these grants today are solely time vested: after a certain number of years an executive who remains with the company receives a fixed, pre-determined number of shares that she can hold or sell.36 These solely time-vested stock grants are not subject to the Dodd-Frank clawback regime.37

However, the majority of current stock grants made to executives today are tied to firm performance in a way that brings them within the ambit of the Dodd-Frank clawback.38 One typical design is referred to as performance shares. In a typical performance share plan, an executive is promised a variable number of shares after a three-year period. The exact number of shares delivered will be a function of one or more metrics such as earnings per share or TSR.39 As I have explained elsewhere, because the ultimate value of performance shares is a function of both the number of shares delivered and the value of these shares at payout, these plans mimic the incentive features of time-vested stock options.40 But in the typical case in which the number of shares that ultimately vests is a function of financial reporting measures (including share price), these awards clearly are subject to the new clawback regime.41 Presumably, in the event of a restatement, an executive would be required to return the excess number of shares received at vesting or, if already sold, their cash equivalent.

Nonequity Incentives. Nonequity incentive plans are heterogeneous, but most are multiyear programs similar to performance share plans, but are paid in cash.42 To the extent that financial or share price-based metrics are employed, these plans fall within the Dodd-Frank clawback regime.43 Recovery in the event of a restatement will mirror that of performance share plans but will obviously consist of cash.

B. Inconsistent Clawback Application Is Likely to Distort Incentive Pay Design

I predict that inconsistent application of the Dodd-Frank clawback regime to time-vested and performance-vested equity pay will lead to significant changes in the design of executive pay packages. Corporations have faced a somewhat similar situation before. In the late 1990’s inconsistent, and very favorable, accounting treatment of stock options led to an explosion in their use.44 By the year 2000, over 60% of aggregate senior executive pay at large public companies...
consisted of time-vested options.\textsuperscript{45} After the option accounting treatment was rationalized, their use plummeted to today’s level of just over 10% of aggregate pay.\textsuperscript{46} Of course accounting rules and clawback rules are different, but they are similar in that they each encourage companies to adopt executive compensation designs for reasons other than optimizing executive incentives, managing risk-taking, and the like. Given the new clawback rules, we will almost certainly see renewed reliance on time-vested stock and options.

The new clawback rules will distort executive pay design for several reasons. Most obviously, executives would prefer not to have their compensation subjected to the Dodd-Frank regime and will discount compensation subject to a risk of clawback. The degree of discount is a function of how rigorous and comprehensive the clawback regime is, and the Dodd-Frank regime as implemented by the SEC is both rigorous and comprehensive. As noted above, this is a mandatory, no-fault clawback regime applicable to a broad set of accounting restatements. Current and even retired executives who have received performance-vested equity pay within the prior three years could lose a portion or all of that incentive pay in the event of a restatement through no fault of their own.

Of course, discounting performance-vested compensation for clawback risk is only meaningful if there is an alternative pay vehicle that 1) is a reasonably close substitute and 2) is not subject to the clawback. Economically, time-vested options and performance share plans are reasonably close substitutes.\textsuperscript{47} And, of course, shifting to time-based equity that is excluded from the new clawback regime completely eliminates the clawback risk.

It is noteworthy that clawback procedures that companies have adopted voluntarily are generally much less onerous than the Dodd-Frank regime.\textsuperscript{48} Many of these voluntary plans dictate recovery only from executives who played some role in or had oversight over the faulty accounting that led to the restatement,\textsuperscript{49} and boards typically have discretion whether to pursue clawbacks under most voluntarily adopted plans.\textsuperscript{50} To the extent that companies replace performance-vested equity with time-vested stock or options, their less onerous, voluntarily adopted clawback rules will apply, not the new SEC rules promulgated under Dodd-Frank.

Moreover, in addition to facing a risk under Dodd-Frank that they may have to return compensation even though blameless, executives may also face a risk of being unable to recover

\begin{itemize}
\item \textsuperscript{45} Walker, \textit{ supra} note 23, at 633.
\item \textsuperscript{46} \textit{ Supra} note 24 and accompanying text.
\item \textsuperscript{47} Both time-vested options and performance-based equity link executive pay to firm performance and create compensation “convexity” which encourages risk taking by otherwise potentially risk averse executives. Bettis, Bizjak, Coles, and Kalpathy find that the widespread replacement of time-vested options with performance-based equity pay following the rationalization of the equity compensation accounting rules in 2006 did not result in a substantial reduction in the aggregate convexity of equity compensation granted to the executives of large U.S. corporations. Bettis et al, \textit{ supra} note 31, at 218.
\item \textsuperscript{49} \textit{Id}. at 42 (reporting that 69% of voluntarily adopted clawback provisions limit application to persons directly responsible for a triggering event).
\item \textsuperscript{50} \textit{Id}. at 43 (reporting that the plan overseer, which is typically the board, has discretion to invoke the clawback provision in 57% of cases and to determine the amount to be recovered in 52% of cases).
\end{itemize}
income taxes that they paid when they received the later disgorged compensation. As I have
described elsewhere, given that combined marginal federal and state income tax rates can exceed
50% for high income individuals, this is a very significant issue. In the worst case, an executive
who received a $1 million performance-based bonus and paid taxes of $500,000 could find herself
forced to return the $1 million without being able to recover the $500,000 in taxes.

The tax issues involved are complicated. I have written about them at length and will not
rehash them extensively here. The problem, in short, is that the federal income tax deduction for
disgorged compensation is a miscellaneous itemized deduction (MID) and MIDs are not deductible
through 2025. There is a tax provision (IRC § 1341) that essentially provides a tax credit for
taxes previously paid on amounts received under “claim of right.” The difficulty lies in
determining whether clawed back compensation is held under a claim of right. In cases in which
an executive is blameless, I think the better view is that §1341 applies; in other cases, it most likely
does not.

In theory, companies could eliminate the tax concern for their executives by promising to
indemnify their executives for taxes paid and not recovered on clawed back compensation.
However, there are two problems with this approach. First, it is unclear whether indemnification
would be permissible. The SEC’s rules “prohibit issuers from insuring or indemnifying any
executive officer or former executive officer against the loss of erroneously awarded
compensation.” To be sure, taxes on clawed back compensation are really a separate issue from
the clawed back compensation itself, and the rules do not specifically address indemnification for
taxes associated with clawed back compensation, so a company’s ability to indemnify executives
for clawback-related tax losses is unclear. Second, even if indemnification for unrecovered taxes
would be permissible, it would be very expensive for shareholders. Payment of taxes by a
corporation would be considered additional compensation, which would result in additional taxes,

51 Walker, supra note 12, at 540.
52 Id.
53 Id. at 561. The disallowance of MIDs was a product of the Tax Cuts and Jobs Act. As with
many TCJA provisions, the disallowance expires at the end of 2025. Without further congressional action,
2026 will see the return of the prior treatment under which MIDs were allowed to itemizers to the extent
that they exceeded 2% of adjusted gross income. Under pre-TCJA law, MIDs also were disallowed for
purposes of the alternative minimum tax and like other itemized deductions were phased out for high
income taxpayers. The fate of these provisions post-TCJA is uncertain. Id. at 561-62.
54 Id. at 563-72.
55 Exchange Act Release, supra note 2, at 73,110.
which would have to be covered by the company to make an executive whole.\textsuperscript{56} Such “gross ups” for taxes are understandably anathema to investor advocacy groups.\textsuperscript{57}

In any event, the point here is not that executives necessarily face a tax penalty in addition to a risk of having compensation clawed back. The point is that the issue can be totally avoided by substituting time-vested equity compensation for performance-based pay.\textsuperscript{58}

But even assuming that executives would prefer to avoid the onerous no-fault Dodd-Frank clawback regime, will corporate boards and compensation committees agree? In this case, I think the answer is likely to be yes. While some directors might prefer a rigorous, universal no-fault regime, what the SEC has provided is a very leaky regime. It will be difficult for some companies to force their executives to accept performance-based compensation, subjecting them to the potentially costly Dodd-Frank regime, while other companies are issuing time-vested stock and options, bypassing that regime. At the very least, companies would expect to pay more for subjecting their executives to these risks.

Directors, moreover, have other reasons to support pay designs that bypass the Dodd-Frank regime, and that avoid, in particular, currently popular performance share plans that incorporate TSR or relative TSR as a metric. As discussed, even estimating the number of shares that should be clawed back when performance-vested compensation is tied to share price or TSR return will be difficult and costly. One could also imagine these determinations exposing companies to investor litigation.\textsuperscript{59}

There are, to be sure, other players at the table, namely institutional investors and proxy advisory firms, that could potentially derail plans to return to heavy reliance on time-vested executive compensation. Their perspective will be considered in Part IV below after the problematic aspects of the SEC’s rule making are explored in somewhat greater detail.

\textsuperscript{56} Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 729 (1929) (holding that an employee’s taxes paid by his employer constituted additional taxable income for the employee). The formula for determining the gross amount that must be paid to make an employee whole for taxes is gross amount = net amount/(1 – marginal tax rate). See, e.g., MICHAEL GRAETZ & ANNE ALSTOTT, FEDERAL INCOME TAXATION, PRINCIPLES AND POLICIES (Foundation Press 9th ed. 2022). Assume, for example, that a company wishes to gross up an executive on a $100,000 of tax that was incurred but not recovered on clawed back compensation. Assume that the executive is subject to a combined marginal tax rate of 50%. In this case the company would need to pay the executive $200,000 to make the executive whole. See Walker, supra note 12, at 558-59.

\textsuperscript{57} See ISS, UNITED STATES PROXY VOTING GUIDELINES 44 (Dec. 13, 2021) (listing tax gross-ups as a "problematic" pay practice); GLASS LEWIS, 2022 POLICY GUIDELINES – UNITED STATES 58 (voicing opposition to the adoption of new executive excise tax gross-ups).

\textsuperscript{58} As I discuss elsewhere, the tax issue also can be avoided by structuring compensation in such a way that tax is not incurred until after the clawback window has closed. But again, these complications can be avoided by replacing performance-based equity with time-vested stock and options. See Walker, supra note 12, at 556-57.

\textsuperscript{59} Exchange Act Release, supra note 2, at 73,092 (noting concern of some commentators that defining incentive compensation to include share price-based metrics could lead to litigation over clawback determinations).
III. WHY THE SEC’S RULE MAKING AND THE CONCOMITANT DISTORTION IN PAY DESIGN ARE PARTICULARLY TROUBLING

The SEC’s rulemaking – essentially exempting time-vested equity from the Dodd-Frank clawback regime – will likely distort executive pay practices. The rulemaking and concomitant distortion are troubling for several reasons.

A. Rulemaking Undermines the Clawback Provision

Executives should not be permitted to retain unearned compensation. This simple proposition underlies the Dodd-Frank clawback provision. In my view, it is exactly right. It is both unfair and inefficient for executives to retain compensation tied to faulty financials. Unfair since the money is unearned. Inefficient because of the temptation to fudge the accounts, or at least to take questionable accounting positions, in order to boost one’s compensation.60

By exempting time-vested equity from the Dodd-Frank clawback regime, the SEC undermines its stated intent. Executives who receive time-vested stock and options as compensation and receive and sell the underlying shares at inflated prices reflecting faulty accounting will not be subjected to the new clawback. The clawback provision simply will not apply. The inflated portion of the proceeds is as unearned as shares erroneously issued under performance share plans or excessive bonuses tied explicitly to financials. The fact that time-vested equity is not granted or vested based in part on financials is irrelevant. The inflated portion of stock or option compensation is ill gotten and results directly from faulty financial reporting.

Interestingly, the SEC recognized the risk of inconsistent application undermining the effectiveness of the Dodd-Frank clawback and distorting pay practices in a similar context. Because of the difficulty of estimation, some commentators asked the SEC to exclude share price and TSR from the definition of “financial reporting measure,” essentially excluding share price based equity awards from the reach of the new clawback.61 The SEC declined to do so, responding that “stock price and TSR are frequently used incentive-based performance metrics for executive compensation, such that excluding them could lead issuers to alter their executive compensation arrangements in ways that would avoid application of the mandatory recovery policy, undermining the objectives of the rule, as well as impacting efficient incentive alignment.”62 The SEC should have been concerned that excluding time-vested stock and options from the reach of Dodd-Frank will produce the same unintended consequences.

B. Exclusion of Time-Vested Equity Likely Inconsistent with Congressional Intent

Although we lack any extensive legislative history on Dodd-Frank § 954, Congress likely intended the provision to reach time-vested options. To be sure, the language of the section is awkward and ungrammatical. It states: “the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer

61 Exchange Act Release, supra note 2, at 73,092.
62 Id. at 73,093.
is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement."\(^{63}\)

It appears that the drafter had a performance-based bonus in mind in crafting this provision. Thus, the reference to compensation “in excess of what would have been paid...”. But in defining “incentive-based compensation” subject to the clawback, the provision explicitly includes “stock options awarded as compensation.” The SEC has essentially determined that this phrase only applies to performance-based stock options, that is, stock options that are granted or vest based on firm performance.\(^{64}\) But this seems an improbable interpretation. In 2010, the large majority of compensatory stock options being issued were traditional time-vested options; performance-vested options were very rare.\(^{65}\) It is highly likely that the term “stock options” without further elucidation would have referred to, and have been understood to refer to, time-vested options. Moreover, it was well understood that unscrupulous executives could increase the payouts on traditional time-vested options by fudging the financials and boosting share prices.\(^{66}\) This was exactly the type of behavior that was alleged at Enron and WorldCom and other corporate malefactors around the turn of the century.\(^{67}\) It certainly made sense for Congress to include time-vested options in drafting Dodd-Frank § 954.

C. The Distortion in Executive Compensation Design is Particularly Perverse

The SEC’s decision to exclude time-vested stock and options from the reach of the Dodd-Frank clawback regime could set executive compensation design back twenty years. Since the accounting treatment of time-vested stock options was rationalized in 2006, we have seen a steady trend away from purely time-vested to performance-vested equity compensation. As noted, the share of aggregate senior executive pay delivered through time-vested options has declined from an all-time high of about 60% in 2000 to just over 10% today.\(^{68}\) Commentators generally view this trend away from time-vested options as a positive development.

Time-vested options are disfavored by corporate governance commentators and performance-based equity, such as performance share plans, favored for several reasons. First, the payout on time-vested options is uniformly based on the absolute increase in a firm’s share price. There is no adjustment for rises or dips in the economy, the stock market, or the sector. As a result, in a rising market time-vested options generally pay off for executives even if their share price underperforms the surging market, while in a down market, stock options provide little incentive

\(^{63}\) Dodd-Frank Wall Street Reform and Consumer Protection Act, § 954.
\(^{64}\) Exchange Act Release, \textit{supra} note 2, at 73,094.
\(^{65}\) In FW Cook’s 2010 survey of executive pay practices at the 250 largest members of the S&P 500, only 3% of the companies that issued options to executives issued performance-vested options. The remaining 97% issued time-vested options only. FW COOK, 2010 \textit{TOP 250 REPORT}, 7 (2010).
\(^{66}\) See, \textit{e.g.}, John C. Coffee Jr., \textit{What Caused Enron? A Capsule Social and Economic History of the 1990s}, 89 CORNELL L. REV. 269, 298 (2004) (noting that executives holding stock options can inflate share prices through, \textit{e.g.}, premature revenue recognition and cash out immediately leaving shareholders bearing the cost when the artificially inflated share price subsequently tumbled).
\(^{67}\) \textit{Id.}
\(^{68}\) \textit{Supra} note 24 and accompanying text.
even for high performing firm executives. By contrast, many performance share plans introduce relative performance evaluation into the equation. The metrics for determining the number of shares an executive receives are often based on firm performance relative to the broad market or relative to industry peers, eliminating or reducing windfalls as well as unjustified losses.

Second, and relatedly, because time-vested options that become far “underwater” in a bear market no longer create effective incentives, boards have been tempted to reduce or “reprice” the exercise price of these options or otherwise adjust programs to recreate incentives. Interestingly, no one seems to consider adjustments in a bull market. This asymmetry in treatment ex post is troubling as the mere possibility of repricing undermines ex ante incentives. These sorts of ex post adjustment do not arise with performance share plans which are designed to create and maintain incentives across a broader zone of performance outcomes.

Third, with respect to time-vested options (but not stock) executives universally have discretion as to the timing of exercise. This discretion leads to concerns about exercise being timed to take advantage of temporary upticks in stock price. The payout on performance shares, by contrast, is based on performance over a predetermined period. Executives might manipulate the release of news around the measurement date to boost payouts but at least they cannot game the measurement date on inside information.

D. It is Possible and Appropriate to Apply the Dodd-Frank Clawback to Time-Vested Equity

Although the SEC did not say so, perhaps it concluded that it is simply too difficult to apply the Dodd-Frank clawback to time-vested equity. To be sure, including inflated gains realized on time-vested stock and options within the Dodd-Frank clawback regime would require a different approach, but it is feasible and perhaps not much more onerous than estimating the impact of restated financials on share price, a process that the SEC has embraced in its clawback rules.

Suppose, for example, that 1000 shares of purely time-vested stock vested in an executive prior to an accounting restatement. Suppose that on the date the shares vested and were sold by the executive the share price was $100 yielding proceeds of $100,000. Suppose also that it is estimated that absent the falsely stated financials the shares would have traded at $80 on that date. (The share price but for the misstated financials would be estimated using the same methodology that a company would use to value shares when clawing back performance-based equity tied to

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70 Walker, supra note 40. Theoretically, stock options can be designed to incorporate relative performance evaluation by indexing the exercise price to a broad market, such as the S&P 500, or to the price of a basket of competitor stocks. However, option indexing was once discouraged by accounting rules and today is effectively precluded by federal income tax rules. Id.
71 Core et al, supra note 69, at 40.
72 Id.
73 Walker, supra note 40.
share price.) The amount that should be clawed back from the executive in this hypothetical is $20 per share times 1000 shares or $20,000.

One could object that this is a very different approach than the SEC has applied to performance-vested equity. With performance-vested equity, what presumably is being clawed back is the excess number of options or shares (or their cash equivalent) that have been mistakenly issued, not the excess value of equity that was rightfully issued. In the case of time-vested stock or options we would be clawing back excess proceeds from the sale of compensatory equity at inflated price. Consistent with that approach, if an executive vests in stock or options and holds the equity through the date of the restatement, there should be nothing to claw back.

While the approaches to clawing back performance- and time-vested equity pay would be somewhat different, it is important to emphasize that time-vested stock and options are forms of incentive compensation and that when these instruments are cashed out at artificially inflated prices the result is excessive compensation that should be subject to clawback like any other form of incentive pay. It is difficult, moreover, to perfectly align the clawback treatment of executive pay. If there must be an inconsistency, wouldn’t it have been preferable to apply an arguably more onerous approach to more problematic time-vested equity than to exempt such equity pay from the clawback regime entirely, thus placing a large thumb on the scale in its favor?

IV. COUNTERVAILING PRESSURE TO MAINTAIN PERFORMANCE-BASED INCENTIVE COMPENSATION

One might argue that the concerns expressed in this essay are overblown, that corporate governance practices have improved over the last twenty years and that the proxy advisory services and large institutional investors will prevent companies from abandoning performance-vested equity pay in favor of time-vested “pay for pulse.” Institutional investors and their advocates might push back on companies reverting to time-vested equity for two reasons. First, they might prefer that the pay of their executives be subject to the Dodd-Frank clawback. Second, even if ambivalent or even hostile to the Dodd-Frank clawback, these parties might want to avoid the pathologies associated with time-vested equity and retain the benefits of pay instruments more directly tied to corporate performance. Of course, investors today have greater ability to express

75 Arguably this is a mistake. The value of performance shares depends on both the number of shares that vest and the market value of those shares. Each may be artificially inflated by misstated financials and contribute to excess pay. As far as I can determine, the SEC is applying the Dodd-Frank clawback only to the former. I would go further in the case of performance-vested equity but would have been content with the SEC’s approach if time-vested equity had not been totally excluded.

76 The exclusion of time-vested options from the clawback regime is reminiscent of the position once held by the SEC that stock option compensation did not constitute a cost for financial accounting purposes. That position distorted executive compensation design for years. Exclusion of time-vested stock and options from the Dodd-Frank clawback regime is really no different.

77 See, e.g., Joann S. Lublin, Boards Tie CEO Pay More Tightly to Performance; Options Grants May Depend on Meeting Financial Goals; Moving Beyond a 'Pulse', WALL ST. J., Feb. 21, 2006, at A1 (describing time-vested equity as “pay for pulse” since the restrictions disappear over time and provide large rewards “even if the executive does little more than just show up for work”).
their preferences on pay matters given another Dodd-Frank innovation, advisory shareholder voting on executive pay.\textsuperscript{78}

The proxy advisory firms and largest institutional investors certainly care about executive pay design and implementation. The questions are how much they care and how they would respond to a shift from performance-based pay to time-vested stock and options.

The two largest proxy advisory firms – ISS and Glass Lewis – promulgate what are essentially executive compensation best practice guidelines that inform their voting recommendations on various corporate matters. Increasingly, the two services have pushed companies to tie equity pay to specific corporate performance metrics. ISS focuses in part on the “ratio of performance- to time-based incentive awards” in executive pay packages\textsuperscript{79} and does not consider purely time-vested equity to be “performance conditioned.”\textsuperscript{80} In detailing the elements of a “well-structured” equity compensation plan, Glass Lewis includes incorporating multiple performance metrics and ensuring that at least one metric incorporates relative performance evaluation.\textsuperscript{81} These features are common to performance share plans but inconsistent with purely time-vested stock and options.

On the other hand, while the three largest U.S. institutional investors also stress the importance of tying executive pay to performance, only Vanguard specifically discourages time-based equity, and Vanguard does so indirectly by stressing the importance of relative performance evaluation, which again is not a feature of purely time-vested equity.\textsuperscript{82} BlackRock and State Street each profess agnosticism regarding the use of time- and performance-vested compensation elements.\textsuperscript{83} While one could imagine these investors joining the proxy advisory firms in pushing back against significant reversion to solely time-vested equity compensation in the wake of the new clawback regime, I fear that the incentives to avoid performance-vested equity and the reach of the Dodd-Frank clawback outlined in Part III will in many instances be too great.

V. CONCLUSION

By excluding time-vested equity compensation from the reach of the Dodd-Frank clawback provision, the SEC has created a loophole. Companies and their executives can avoid the clawback provision with relative ease, as evidenced by the recent clawback cases.

\textsuperscript{78} See, e.g., Denton Collins et al, \textit{Equity-Based Incentives and Shareholder Say-on-Pay}, 46 J. BUS. FIN. ACCT. 739, 740 (2019) (documenting a statistically significant positive relationship between positive say-on-pay voting and the sensitivity of CEO pay to firm performance).

\textsuperscript{79} ISS, \textit{UNITED STATES PROXY VOTING GUIDELINES}, supra note 57, at 43.

\textsuperscript{80} More precisely, ISS does not consider purely time-vested options that are issued “at the money” to be performance conditioned. ISS, \textit{UNITED STATES EQUITY COMPENSATION PLANS, FAQs} 22 (Dec. 17, 2021). Virtually all options are issued at the money, i.e., with exercise price set equal to the market price of the company’s stock on the grant date. See, e.g., FW COOK. 2013 Top 250 Report, 21 (2013) (noting that variations from at-the-money options are “no longer widely used in practice”).

\textsuperscript{81} GLASS LEWIS, supra note 57, at 54.

\textsuperscript{82} VANGUARD INVESTMENT STEWARDSHIP POLICY INSIGHTS, HIGHLIGHTING VANGUARD’S VIEWS ON EXECUTIVE COMPENSATION 3 (May 2022).

\textsuperscript{83} BLACKROCK, COMMENTARY, INVESTMENT STEWARDSHIP’S APPROACH TO EXECUTIVE COMPENSATION 2 (Jan. 2020); STATE STREET GLOBAL ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES (Mar. 2022).
by replacing currently popular performance share plans with purely time-vested stock and options. Doing so will not only reduce the reach of the new clawback regime, it will also reverse the salutary trend away from purely time-vested equity pay to performance-vested equity pay that we have witnessed over the last twenty years.

It is tempting to view the exclusion of time-vested equity from the Dodd-Frank clawback regime as a natural experiment testing the quality of contemporary corporate governance. Will companies backslide into executive pay packages heavy with time-vested stock and options, as executives would prefer, or will investor pressure cause companies to retain performance-based pay subject to the reach of the Dodd-Frank clawback? But it is not so simple. Avoiding the clawback regime may primarily benefit executives in the first instance, but investors benefit indirectly by reducing the riskiness of executive pay and benefit directly by reducing the cost and litigation risk associated with the Dodd-Frank clawback regime. If firms backslide towards purely time-vested equity pay, as I predict, it will be difficult to pin the blame on poor corporate governance.