

Strategic, Behavioral Compliance, and Economic Considerations Regarding DOJ's Pilot Program

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What Can Compliance Learn From Building Legos?



Do we look at gains differently from losses?

Problem 1: Which do you choose?

Get \$900 for sure or 90% chance to lose \$1,000

Problem 2: Which do you choose?

Lose \$900 for sure or 90% chance to lose \$1,000

The DOJ is not the first government entity to institute a clawback program.

	SOX	Dodd-Frank	DOJ
Covered Employees	CEO, CFO	All Executive officers-current and former	Company policy or discretion – may include supervisors
Source of Claim/Misconduct; Kind of Company Applicable	Statute/Financial restatement; no-fault as to CEO or CFO; applies to all (but only) public companies	Exchange listing requirement/Financial restatement; no-fault as to any officer; applies to all (but only) public companies	Clawback policy or program design; may include violations of any company code or policy; may include private companies
Prerogative to Enforce	SEC	Company – mandatory	Company - discretionary
Mandated	No	Yes, Company must enforce with limited exceptions	No – an incentive to reduce fine amounts
Recoverable Pay and Lookback Period	12 months of incentive-or-equity-based profits realized from stock sales	Incentive or equity granted, earned or vested based on restatement up to 3 fiscal years prior to restatement	Company design
Public Disclosures	No	Yes; must disclose clawback policy and applications	Discretion of the Company

The DOJ has provided rationale for instituting a clawback program

DOJ Clawback Pilot Program

- Under the three-year pilot program, companies will be able to reduce criminal fines by claw back of compensation from individual wrongdoers, if attempted in good faith.
- Criminal fines could be reduced even if those efforts are unsuccessful.
- The companies will be able to retain any recovered funds.

DOJ Rationale for the Clawback Pilot Program

- Discourage recidivism
- DOJ's goal of shifting the burden away from uninvolved shareholders and onto those more directly responsible.
- Better align the executive compensation of an organization with its corporate compliance function.

Companies will need to consider multiple factors when designing and instituting a clawback policy



Strategic Considerations



Human Resources and Employment Considerations



Economic Considerations

Behavioral economics considers irrational thinking and choices made by individuals

Traditional Economics

People are Rational

- People have Perfect Knowledge
- People make decisions based on self-interest
- People's thoughts and beliefs change with new information

Behavioral Economics

People do not always make rational choices

- Individuals and organizations make decisions based on influence from multiple factors:
 - Psychological
 - Social
 - Emotional

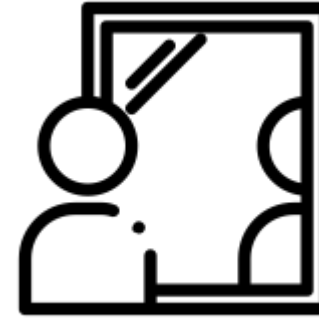
Behavioral economics distinguishes between two types of thinking; automatic and reflective

System 1 – Automatic Thinking



- Driving somewhere for the 100th time
- Requires minimal mental energy
- System 2 thoughts can become System 1

System 2 – Reflective Thinking



- Driving somewhere for the first time
- Requires significant mental energy
- Over exertion creates undue cognitive burdens

Goals for Compliance

Integrate compliant behavior into System 1.

Nudge employees to influence System 2 thinking.

Behavioral economics offers theories and tools that can be used for compliance

Behavioral Economics Theories



Framing



Anchoring



Time Preferences



Loss Aversion

Behavioral Economics Tools



Framing



Nudging & Default Options



Feedback & Monitoring



Cognitive Behaviorism



Social Norms & Peer Influences

Executive alignment is crucial to the success of a compliance program

Given the continued focus by DOJ, SEC, and OIG regarding compensation clawbacks, you are trying to move the company towards any needed changes and are about to have a conversation with the company's CFO.

What are steps you would follow in connection with this meeting?



Framing



Social Norms



Nudging



Loss Aversion

Compliance Pillars and Behavioral Psychology Tools

Compliance Pillar	Behavioral Psychology Theories			Behavioral Psychology Tools					
	Framing & Anchoring	Time Preference	Loss Aversion	Social Norms & Social Preferences	Nudging & Default Options	Incentives & Rewards	Feedback & Monitoring	Training & Education	Irrational Exuberance
CCO & Executive Oversight	X			X		X			
Due Diligence	X			X	X				
Education & Communication	X		X		X	X	X	X	
Monitoring & Auditing		X		X		X	X		X
Disciplinary Procedures & Incentives			X			X			

Appendix

How a question is framed can change the impression of the result

In a study among undergraduate students, respondents were presented with the following medical decision-making problem, described with both a positive and a negative frame and asked the same question “How would you evaluate the drug’s effect?”

Positive: 100 patients took the medicine, and 70 patients got better.

Negative: 100 patients took the medicine, and 30 patients didn’t get better.

Potential losses can be motivational for employees

The company is launching a compliance champion program and wants people to participate. This involves extra work and will require activities after hours or on weekends.

Positive: "Think about all of the opportunities you'll gain."

Negative: "Think about all the recognition, promotions, and raises you'll miss out on if you don't participate."

Strategic, Employment, and Economic Considerations Involving Compensation Clawbacks

Strategic Considerations

- Given that this is a pilot program, does the company proactively adopt and implement changes to the corporate compliance program now or wait and see how the Pilot Program develops?
- What is the behavioral impact of implementing incentives for actions individuals should be performing anyway?
- What type of compensation would be subject to clawback – salary, bonus, stock awards, deferred compensation, non-stock awards, increase in pension values, other?

Human Resources and Employment Considerations

- From a talent acquisition perspective, would certain candidates refuse employment contract provisions containing clawback provisions and would companies lose access to talent who select employers that do not require such provisions in their contracts?
- How do companies balance negligence, indemnification, and Directors and Officers (“D&O”) insurance provisions in employment agreements?
- For the relevant employees, do employment contracts need to be modified to include provisions for the potential clawback of compensation?

Economic Considerations

- If the company decides to proactively change its corporate compliance program now, what are the total anticipated internal and external costs for implementation?
- How does the amount of the fine levied by the Division compare to the amount of profit disgorgement or other amounts to be paid by the company?
- To the extent litigation is required to affect the clawback of compensation, would the number of years of litigation need to be less than, or proximate to, the duration of the corporate resolution?

Behavioral Economics Theories



Framing – Whether a given outcome is viewed as a loss or a gain depends on the decision maker's reference point outcome (i.e., avoiding death or saving lives). Presenting policies, controls, and procedures in a positive light or emphasizing the benefit.



Anchoring – The subconscious use of irrelevant information for making a subsequent decision.



Time Preferences – Valuation of current benefit from receiving a good or service is higher at an earlier date compared to receiving it later.



Loss Aversion – People become more risk preferring when faced with the threatened loss of what they have, compared to the opportunity to gain something of equal value. People hate losses more than they love gains.

Behavioral Economics Tools



Incentives and Rewards – Positive reinforcements to ensure adherence and influence behavior.



Nudging and Default Options – Subtle changes to the environment involving decision-making to guide individuals towards desired behaviors and outcomes.



Feedback and Monitoring - Review and oversight of individual's activities and inform the individual of the results on a regular frequency



Cognitive Behaviorism - behavior is impacted by thoughts and emotions, reinforcement schedules, acquisition and extinction, to encourage desired behaviors and discourage undesired behaviors.



Social Norms and Peer Influence/Social Preferences – Conforming to the norms of a social group or setting.