

Clawbacks in Focus

How Companies Can Link Executive Compensation to Compliance

Despite enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act almost four years ago, final rules implementing Section 954, the clawback provision, remain a work in progress. The clawback provision will require public companies to disclose their policies on incentive-based compensation and to adopt policies for recovery of compensation, such as bonuses, from their executives in certain instances. Intended to discourage the types of excessive risk taking that contributed to the financial crisis, the provision has been hailed as a key linchpin of sweeping reforms aimed at improving corporate governance.

With that guidance still pending, many companies seeking to adopt executive compensation systems that would satisfy new US Securities and Exchange Commission (SEC) rules remain in a holding pattern. Nevertheless, research suggests that an increasing number of companies are opting to adopt policies on a voluntary basis. Given that development, there are important items for companies and their executives to consider, particularly as executive compensation returns to the forefront of the regulatory agenda.

The Rule and Its Origins

The clawback provision was first passed under the Sarbanes-Oxley Act of 2002. However, Dodd-Frank has given the SEC additional powers to claw back compensation, such as bonuses, from executives under certain circumstances. Specifically, the law will require the national securities exchanges and national securities associations to prohibit the listing of an issuer that does not comply with those clawback provisions. Once the SEC's rule is enacted, companies will

be required to recover certain monies from executive officers if an accounting restatement occurs as the result of a material noncompliance with financial-reporting requirements under securities laws.

The Dodd-Frank clawback provisions are significantly more expansive than is the clawback provision under Section 304(a) of Sarbanes-Oxley. For instance, under Sarbanes-Oxley, clawbacks of compensation were linked to restatements brought about "as a result of misconduct" and were limited to CEOs and chief financial officers of public companies. Under Dodd-Frank, however, compensation may be clawed back even if such misconduct has not occurred—and it would be clawed back for all current and former executive officers. Companies covered by the provision are also required to disclose their policies in their annual proxy statements. Executives will also be required to return excess incentive compensation earned over a period of three years prior to the erroneous previously filed financial results.

For companies and their executives to fully understand the scope and terms of the new rule, the SEC will need to address several areas. Chief among them are:

- ▶ Who will be considered an executive officer for purposes of the clawback provisions? Will the rule cover all executives in the C-suite, such as the chief compliance officer, chief information officer, and chief legal officer?
- ▶ What is the definition of a restatement? Is a company required to have filed an amended financial statement?
- ▶ Will every restatement be considered a result of “material noncompliance” with the financial-reporting requirements?
- ▶ Will profits from stock sales be subject to clawback similar to the current rules?

Approaching Clawback Policies

By adopting clawback policies, companies may improve accountability within both their executive ranks and their companies as a whole. With such policies in place, companies are encouraged to eliminate inaccuracies and errors associated with financial statements. Facing the possibility that they may have to return compensation, executives may want to take extra steps to provide adequate resources for their financial-reporting and compliance departments. And additional procedures and oversight mechanisms may be implemented to mitigate the risks associated with financial reporting.

Pending the adoption of SEC rules, companies should consider a number of factors when developing clawback policies. First, it is important that such policies align the goals of the company and its executives, shareholders, and stakeholders, including boards of directors. Other important factors that companies should consider include:

- ▶ Determining which employees will be covered by the policy (i.e., incentive based only, former executives, all employees)
- ▶ Identifying those events that would trigger a clawback policy
- ▶ Defining the forms of compensation to be covered

Another important consideration is the notion that the people responsible for determining whether a restatement is required may well be the same ones who could face a clawback of their compensation in the event of that restatement. Deciding whether errors exist and whether they are material enough to warrant restatement involves the exercise of professional judgment. Will the new rule, when enacted, cloud that judgment? Additionally, some restatements may result from changing views on the part of a public accounting firm or an audit partner. Will circumstances such as those also require executive officers to return prior earnings?

Companies may also consider best practices within the industry or any potential risks associated with a policy. Steps that companies could take as part of a risk assessment or in managing their clawback policies could include:

- ▶ Linking bonuses and incentives to the achievement of compliance objectives based on policies, processes, and controls as well as reported financial results
- ▶ Reporting on a regular basis to the audit committee and board members on the progress of implementation of compliance objectives

Conclusion

It remains unclear just when the clawback rules will be finalized, but a growing number of companies aren't taking a wait-and-see approach. In 2013, for example, 89% of Fortune 100 companies had policies in place, up from roughly 18% in 2006, according to Equilar, a provider of executive compensation data.¹ Meanwhile, leading financial services firms have announced plans to strengthen existing policies.²

The success of those new or improved policies will likely depend on whether or not they're broad enough to deal with the requirements of the new rules under Dodd-Frank. Some critics say the new policies that have been adopted since the enactment of Dodd-Frank don't go far enough. They argue that these policies limit misconduct solely to intentional actions—without regard for the degree of harm the actions may have. Another important factor will be the criteria used for determining when a clawback can be applied. For example, will funds be clawed back when theft or an earnings restatement occurs and it is determined to not be material?

For its part, the SEC appears willing to pursue clawbacks of executive compensation. Over the past few years, the commission has pursued such action related to alleged misconduct under Sarbanes-Oxley. Under Dodd-Frank, it will have much broader authority to ensure that companies are taking action against more officers in appropriate circumstances. We may also see the SEC probe the matter of whether clawback provisions existed and were complied with by its opening of enforcement investigations or its issuing comment letters to companies that restate financial statements. Once the SEC releases final rules regarding clawback requirements, companies will likely continue to review their policies and modify them accordingly, if needed, in order to comply with any mandates not sufficiently addressed.

¹ Equilar 2013 Clawback Policy Report.

² <http://money.cnn.com/2013/03/14/investing/bank-bonus-clawback/index.html>.

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