Have You Reviewed Your Clawback Policy Recently?

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ESG (Environmental, Social, Governance) dominates many executive compensation conversations these days. However, there are other important topics that compensation committees should revisit and review regularly. One such topic is the clawback policy, and now is a good time for companies to revisit their provisions.

Why Review Clawback Policies? Three Primary Reasons:

1. The SEC has indicated they will again take up this topic and revisit the 2010 Dodd-Frank rules that are yet to be finalized. Although Dodd-Frank rules for clawback policies are relatively narrow in scope, they have made their way back to the SEC's short-term agenda, signaling their importance to many stakeholders. (Technically, finalizing clawback rules has been on the SEC's short-term agenda since 2019, but the newly constituted SEC under Gary Gensler is more focused on executive compensation issues.)

2. Shareholder proposals that require adopting, examining, or expanding clawback policies are gathering strong support. Most shareholder proposals—formal requests submitted to a company advocating for a certain course of action—rarely garner above single-digit support from investors. However, proposals regarding clawback policies are getting significant minority support, and occasionally majority support,—another signal that clawback policies are important to investors.

3. The overall governance environment has shifted significantly in recent years. There are growing expectations from employees, investors, and the public at large. These new expectations are the same ones that keep ESG in the limelight. It behooves companies to take a fresh look at their clawback policies and proactively equip boards with the tools they might need if something goes awry.

The Dodd-Frank Impact

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, or Dodd-Frank for short. The Act aimed to "Promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."

One of the many provisions of the Dodd-Frank Act is a requirement for companies to adopt a clawback policy. This policy will require companies, in the event of a financial restatement, to claw back *any* excess compensation that was awarded to *any* current or former executive, regardless of fault. This policy will go further than the common bare-bones clawback policies of many organizations that call for the return of incentives only from executives whose misconduct caused a restatement.

The SEC is required to issue rules for implementing this clawback policy. While the SEC proposed rules in 2015, they were never finalized. Now the issue is back on the SEC's agenda. However, the process for finalizing rules can take time. After proposing new rules, there will be a comment period and time for further deliberations before anything is final.

However, companies that wait for final SEC rules before making any changes may find themselves in a precarious position. Some high-profile controversies have caught boards off guard, with clawback policies that were not robust enough to take action that investors or the public at large might have expected. These organizations provide cautionary tales—companies must act now to ensure their policies are robust enough to act if necessary. The time to think about changing the policy is before it is ever needed.

Framework for Reviewing Clawback Policies

Step 1: Take Inventory

Compensation committees must first understand what is in place today. While most provisions are included in formal clawback policies, clawback and forfeiture provisions can exist in many places, including:

- Formal clawback policies
- Bonus plan documents
- Equity plan documents
- Equity and long-term cash award agreements
- Individual employee contracts and agreements
- Offer letters
- Change-of-control plans

With a thorough inventory in hand, compensation committees can evaluate provisions for potential conflicts. This inventory also helps gauge whether a clawback policy might need to expand. Consider recent business controversy headlines. If your company were in that position, would current provisions enable your board to act? If not, it may be time to consider an update.

Step 2: Articulate Recoupment Triggers

Another reason not to wait for final SEC rules to inform your clawback policy is that they will focus only on financial restatements, which are relatively rare. This kind of trigger focuses on fairness, addressing receiving compensation not earned. Beyond the eventual SEC mandate for a restatement trigger, additional fairness triggers to consider include simple miscalculations or significant reductions in company performance.

These fairness triggers are important, but misconduct is what really draws investors' ire and public attention, and has the potential to cause significant harm. Potential misconduct triggers include:

- Criminal activity (e.g. fraud, embezzlement)
- Violations of company policy (e.g. codes of conduct, ethics policies, risk policies, sexual harassment policies)
- Negligence (e.g. failure to act, failure to supervise)
- Restrictive covenants (e.g. non-compete or non-solicitation provisions)

While violating company policies can include a wide range of minor issues (i.e. missed training), violations for triggering a clawback or forfeiture are often qualified by having caused, or potentially could have caused, financial, competitive, or reputational harm to the company.

Step 3: Consider Other Clawback Policy Provisions

In addition to deciding on potential triggers, there are several other provisions to consider as part of a complete clawback policy.

- Clawback or forfeiture? Companies can take back money that an executive has already been paid (a clawback) or require forfeiture of outstanding or unvested awards.
- Discretion? Most companies allow significant discretion to consider the unique facts and circumstances of any given situation, including intent and materiality.
- Who is covered by the policy? C-Suite only, or all incentive participants? Are former executives subject to the policy?
- What types of compensation are covered? Cash incentives, performance-based equity, time-based equity, and severance are all possibilities.
- What is the covered time frame? If executive pay is being clawed back, how many years into the past should the company go? Likewise, if the company is forfeiting future rewards, how far into the future does that forfeiture go?
- Termination? Must you terminate a good executive to allow for a forfeiture or clawback? Are there situations where it's appropriate to retain an executive, even if a clawback or forfeiture is appropriate?

These are all complicated questions that require thoughtful discussion between management and compensation committees. There is no one right way to draft a clawback policy that suits the needs of all stakeholders. The ideal outcome is a robust policy that deters misconduct and inspires confidence in stakeholders by virtue of never being used.