CORPORATE COUNSEL

Broader Clawback Policies, More Corporate Accountability

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Corporations should go far beyond the frameworks in Dodd-Frank and Sarbanes-Oxley in designing clawback and holdback policies. Broadly and properly constructed, these mechanisms, now encompassed under the term of art “compensation recovery policies” are essential for ensuring high performance with high integrity—for holding officers and employees accountable for operating objectives to achieve that broad goal.

Section 954 of the Dodd-Frank Act mandates clawback of compensation for all executive officers for *any* company listed on a U.S. securities exchange if it has material financial restatements—*regardless of individual fau*lt; Sarbanes-Oxley, enacted in 2002, requires clawbacks only from CEOs and CFOs if there was *misconduct* that led to a restatements But U.S. Securities and Exchange Commission regulations on Section 954 provision are not yet complete (almost four years after passage of Dodd-Frank), and, as noted recently in Corporate Counsel (["Compensation Clawbacks: Compliance First, Rules Later"]), some companies are not waiting for the SEC and are revising clawback policies that date back to SOX.

Now is, thus, a good time to review what are the essential components of a sound compensation recovery policy—and explicate how it differs from Dodd-Frank's Section 954. (See my more extended discussion of this subject here.)

- Covered individuals should be the executive officers (defined by the SEC as certain named officers and others with "policy-making" authority) but also other important, highly compensated employees who have the capacity to injure the corporation with regard to performance, risk or integrity, and who receive special compensation (options, RSUs, etc.) beyond base salary. Current and past holders of positions with the company should be covered to advance the goal of accountability.

- The clawbacks/holdbacks should cover both variable cash and variable equity earned in a particular year whenever they vest, as well as long-term incentive and executive deferral programs that vest years after grant.

- In any contract or other documents related to a covered executive's hiring or reception of particular benefits over time, there should be a section describing the board of directors' clawback and holdback powers. There should also be a clause stipulating that any disputes will be resolved in arbitration, which is far preferable for these sensitive matters. Such an explicit provision, when explained to covered individuals as a condition of their employment and in the context of an integrity culture, can serve as an important deterrent to future malfeasance.

- The act of malfeasance that can lead to a holdback or clawback should be far broader than a material misstatement of financials (which is the focus both of some existing corporate policies and Dodd Frank 954). It should be defined to include any serious breach of law or company ethics. For example, JPMorgan Chase and Co.'s compensation recovery policy—which was used to clawback pay from those involved in the "London Whale" trading losses—applies if, among other things: an employee is fired for cause; an employee causes the firm material financial or reputational harm; an award was based on the company's materially inaccurate performance metrics (regardless of fault) or on a material misrepresentation by the employee; or a subset of senior employees and officers fail to identify, raise or assess a material risk. (See more here [PDF].)

- Similarly, although actual intent or gross negligence/recklessness should generally be the behaviors that trigger compensation recovery policies, acts of omission on the part of an individual can give rise to sanctions. For example, senior business leaders can, especially when they have negligently or recklessly failed to create proper culture, be held responsible for problems in their units. Given the range of possible acts and the variety of standards (and circumstances) that could trigger clawbacks or holdbacks, greater sanctions (e.g., termination) or lesser ones (e.g., demotion, being denied promotion) may be appropriate, either in concert with or instead of clawbacks and holdbacks.

- In the "Squam Lake Report" (Princeton University Press 2010), 15 leading academics suggest a "collective" holdback for senior managers that would be forfeited in the event of bankruptcy or receipt of extraordinary government assistance. This provides incentives for the management team to prevent outsized and potentially catastrophic risk.

- The inevitable, real-world variation in possible circumstances supports giving the board discretion to find the facts and make appropriate individual holdback or clawback determinations (with advice and counsel of senior management if top business leaders are not implicated).

- This discretion should also be applied to the appropriate amount of damages—how much unvested variable cash or equity or other long-term awards should be held back; how much vested variable cash and equity and other long-term awards should be clawed back. Such judgments will, of course, turn on standard issues like the amount of harm and the nature and degree of culpability

- Employees should be subject to compensation recovery policies for events that occurred more than three years in the past (a typical look-back period) if serious enough. As to when a recovery action may be taken, there is no reason to set a limit on the time for holdbacks or clawbacks because discovery and disclosure of corporate malfeasance may be delayed. (Once there has been discovery, there should, however, be a specific time limit, written in company policy, during which a compensation recovery actions must be brought.)

I believe that this type of broad, flexible holdback/clawback approach is a powerful mechanism for holding senior leadership accountable to the fundamental mission of the corporation: proper risk taking balanced with proper risk management and the robust fusion of high performance with high integrity. It helps create—but also must take root in—a strong corporate integrity culture.

It is not a tail that wags the dog, but instead a systematic follow-on of the interrelated tasks of defining corporate mission; setting appropriate operational objectives across performance, risk and integrity dimensions; and tying compensation closely to those objectives—tasks that promote long-term growth and sustainability and reward balanced senior leadership. On the other hand, it is not a tool to be used lightly. Other traditional employment actions—cuts in pay, lack of raises, diminished equity grants, withholding the grant of deferred compensation, lack of promotion—also may serve the goals of holding employees accountable.

This voluntary approach to holdbacks/clawbacks is, in general, broader than many current voluntary corporate clawback policies. It is an approach that follows more clearly from necessary revisions in executive compensation that have emerged since the financial crisis of 2008 and which focus on deferral of significant percentage of annual pay, on more intense consideration of risk and on more detailed performance objectives (beyond stock price and total shareholder return). For example, compensation recovery policies in the financial services sector should go beyond the obvious causes of financial penalties—fraud, rogue trading and material misstatements. Holding people to account for other failures—such as failure to identify and assess material risk or causing material harm to reputation—is an essential element of a broad approach to risk management inside both financial services and industrial firms.

Such broad, flexible and context-based holdbacks/clawbacks do, however, require that government mandates be accommodated within a corporation's voluntary approach. For example, Dodd-Frank 's Section 954 is narrower than the approach described above (it applies only to financial restatements due to "material noncompliance"); removes discretion from the board (recovery must be sought); does not require fault of all individuals from whom monies are clawed back (both present and past employees); specifies and limits those individuals ("executive officers"); and, in general terms, specifies the amount of recovery (the percentage of incentive compensation, including equity awards, in excess of what would have been paid without the restated results).

But because the trigger to Dodd-Frank Section 954 is a financial restatement due to material noncompliance with reporting requirements, this is just one type of malfeasance within the broad framework suggested above. In any new or revised voluntary corporate holdback/clawback policy, such restatements will have to be addressed clearly due to regulatory requirements. But regulatory compliance does not prevent the corporation from adopting the broader approach outlined here.

Such a context-specific approach that covers both law and ethics is a necessary corporate governance framework to put around the legislative mandate of Dodd-Frank. If (and this is potentially a big "if") companies take seriously the design and implementation of their own compensation recovery policies, such holdbacks and clawbacks can be an important method of promoting balanced business leader and employee behavior—and of holding them accountable.

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