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Embracing a Global Clawback Policy

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Why clawback regulations should be a practice for global organizations.

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One of the key lessons from the global financial meltdown of 2008-2009 is the need for companies to put in place effective mechanisms for curtailing excessive risk taking and pursuit of short-term results at the expense of long-term value creation and sustainability. Executives, out of desperation to create a false impression of strong performance, made decisions that in the long run came back to haunt businesses. Stakeholders were shocked to discover that financial statements earlier presented as healthy did not give a true reflection of reality. The responsible executives got away scot-free, often with huge severance payments and bonuses that should never have been paid in the first place.

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Because there were no provisions to recoup such erroneous payments, there was nothing the boards of directors of such companies could do to recover the erroneous payment, except through the courts, which could turn out to be costly.

To address those issues, different jurisdictions have put in place measures to strengthen the regulatory framework for managing executive compensation and excessive risk taking. In the United States, the Sarbanes-Oxley Act of 2002 requires CEOs and CFOs to reimburse a company for any incentive or equity-based pay and profits obtained from disposing company shares in the year issuance of misstated accounts. Also, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, among other requirements, provides a mechanism for recovering erroneously paid executive incentives. In the United Kingdom, the Corporate Governance Code of 2014 requires that executive remuneration plans include provisions that would enable companies to recover or withhold payment of any sums made or to be made to executives.

Many countries currently do not have any regulations with clawback provisions. The various corporate governance codes available provide only broad guidelines on executive compensation without mandatory clawback requirements. Compliance with the various codes is usually low because enforcement may be ineffective. However, the absence of a regulation on clawbacks should not deter board remuneration committees (RemCos) from incorporating clawback provisions in their policies.

The benefits of such provisions are enormous and have the potential of significantly enhancing accountability among executives.

The Scope of a Clawback Policy

In implementing a clawback policy, a RemCo should consider the following factors, which are based on the U.S. Securities and Exchange Commission (SEC) guidelines:

1 Compensation elements that will be covered.

The clawback provisions should cover all incentive-based compensation granted, earned or vested, wholly or partly based on achievement of financial reporting (performance) measures, including share price and total shareholder return (TSR). However, incentive payouts tied to nonfinancial measures such as quality, innovation, customer and employee satisfaction should be exempted. Examples of the incentives to be covered are stock options, share appreciation payouts, phantom shares, incentives paid from a broad company incentive pool, proceeds from sale of stock acquired from an incentive plan tied to financial parameters, etc.

Therefore, the following types of fixed pay or guaranteed executive compensation should not be covered: salary, one-off discretionary bonuses (except those paid out from an incentive pool determined based on achievement of financial measures), retention bonuses, bonuses based on subjective nonfinancial measures, nonequity incentives based on nonfinancial measures, time-based equity awards and equity awards based on nonfinancial measures.

2 Length of the look-back period.

The look-back period is the timeframe, from the date of restatement, over which recoupment of incentive payment is required. The look-back period should normally be defined in a regulatory provision or legislation. According to SEC guidelines, a period of three to five years from the date of a restatement can be considered for this purpose.

3 Executives covered by clawbacks.

Clawbacks should apply to all executives and senior management (covered persons). However, those executives and senior managers must have served during the look-back period for them to be covered and their incentive pay must have been tied to a financial parameter.

Clawbacks also should apply irrespective of whether the covered executives and senior managers are responsible for or involved in any way in the preparation of the underlying financial statements.

4 Restatements that will trigger clawbacks.

Any restatement required to correct a material error in a previously issued financial statement should trigger a clawback. Care should be taken, however, to ensure that some type of retrospective changes are not taken as trigger events. Those include changes in accounting principles, the reporting entity and a prior business combination as well as discontinued operations. The look-back period should commence from when the board of directors, regulators or the court determines that a restatement is required, rather than when the restatement or restated accounts are issued. Clawbacks should not be limited to financial misstatements. They also should be triggered by any violation of noncompete provisions or inappropriate use of trade secrets.

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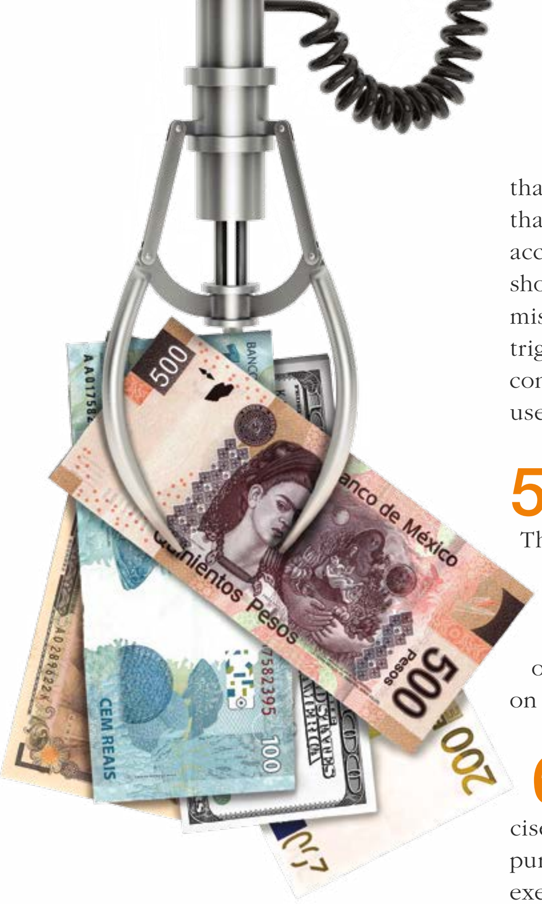

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5 Amount of compensation eligible for recovery.

The amount of incentive-based compensation to be recovered should be the excess received above the payout that should ordinarily have been made, based on the restated accounts.

6 Pursuit of the recovery.

Each company should exercise discretion about how best to pursue recovery of any excessive executive pay. Recovery could be made all at once or in phases, via direct payment from the employee or reduction in future pay. The company must act in good faith and without undue delay so the objective of the clawbacks is not defeated. To facilitate timely and easy recovery, RemCos may implement a mandatory deferral of a portion of annual bonus over the same timeframe as the look-back period.

7 Disclosure requirements.

Companies should disclose in their annual reports any account restatement cases requiring recovery from past fiscal year(s) so that investors are well informed. Also, information about any outstanding excess pay from prior restatements should be reported with appropriate explanations.

A Global Practice

Adopting a clawback policy is good practice that all companies should embrace. It will contribute to greater corporate effectiveness and governance, especially with respect to executive compensation. It also will help align remuneration practices in countries yet to adopt clawback regulations with global best practices while helping to shape appropriate executive behavior. Any company that desires to compete successfully in the global market would need to adopt a much broader perspective to its remuneration, which should include principles such as proper alignment with strategy and market practices, incentives to spur optimal resource utilization and good corporate governance. However, the implementation of the policy should take into consideration the specific circumstances of each company and its local environment. Also, it is important that shareholders approve the policy before implementation.

The global community has taken advanced steps toward addressing the issue of excessive risk taking and executive compensation. Regulators in countries yet to embrace clawback regulations cannot afford to be left behind. Therefore, there is an urgent need to update all the various codes of corporate governance to make it mandatory for covered companies to implement clawback provisions for their executives and senior management. ws

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