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Summary of Clawback Policies Under Dodd-Frank Reform Act

By Deborah Lifshey

Compensation recovery policies, or "clawbacks," first came to the public's attention with the Sarbanes-Oxley Act in 2002, which required that in the event of any restatement based on executive misconduct, public companies must recoup incentives to the company's CEO and CFO that were paid out within 12 months preceding the restatement. Clawbacks made headlines again when public and private companies participating in the federal Troubled Assets Relief Program (TARP) were required to recover incentive payouts over a longer period to an even broader group of top executives, regardless of whether they had engaged in misconduct.

The Dodd-Frank Wall Street Reform and Consumer Protection Act signed on July 21 further expands the reach of mandatory recoupment policies. Under the Act, the SEC will direct the national securities exchanges and national securities associations to amend their listing standards to require that every listed company adopt a compensation recovery policy containing two key components:

- Disclosure: Companies must provide disclosure of clawback policies for any incentive-based compensation that was paid out based on erroneous financial information reported under securities laws. The rule does not specify if this is to be located on the company's website, in the proxy statement, or in another location.

- Adoption of Mandatory Recoupment Policies: Following an accounting restatement due to material noncompliance with any financial reporting requirements under securities laws, companies must seek repayment from any current or former executive officer of any incentive-based compensation (including stock options) paid during the three-year period preceding the "date that the company is required to prepare the accounting restatement" that was based on the erroneous data. The clawback is calculated as the excess amount paid on the basis of the restated results.

Significantly, there does not need to be executive wrongdoing involved to trigger the recoupment of pay. Moreover, neither the SEC nor the national securities exchanges may grant exemptions (such as to smaller reporting companies), as permitted for some other requirements under the Act. The penalty for non-compliance with these clawback requirements is possible de-listing from the exchange[s].

As with many other provisions of the Dodd-Frank Act, the clawback requirements are ambiguous and Congress deferred to more detailed rules that will be issued by the

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SEC. No deadline was given, but presumably regulators will have the rules in place for the 2011 proxy season.

Among the areas that will require clarification:

- Does the triggering period commence when a decision to file the restatement, the work on the restatement, or the restatement occurs?
- What is the definition of an “executive officer?” Without guidance, this presumably refers to individuals as defined by Exchange Act Rule 3b-7 (president, any VP in charge of a principal business unit, division or function and, any other officer who performs a policy making function), or Section 16 officers.
- How does the policy apply to an individual who became an executive officer after grant, but before the restatement?
- What is the definition of "incentive-based compensation"? Does it apply to short-term and long-term plans, and does it apply to other forms of equity besides stock options?
- How is the recouped compensation determined if it was not tied to specific performance metrics?
- Is the clawback based on the award or payment of compensation?
- How does the three-year look-back period apply to stock options granted, vested and/or exercised during the previous three-year period?

Numerous companies had previously and voluntarily adopted clawbacks that went beyond the minimum requirements of Sarbanes-Oxley, including recovery of compensation from executives who engage in activities that don’t necessitate financial restatements, but could be detrimental to the company. In adopting these policies, companies have struggled with establishing appropriate parameters for triggering events and look-back periods, and determining whether restatement should be tied to executive malfeasance. Whether some companies will be prompted to adopt even stricter clawbacks than required under the Dodd-Frank Act remains to be seen, as do the best practices that eventually emerge. Questions may also be raised about the enforceability of the Act under various state laws.

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