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The SEC's Clawback Proposal: Our Recommendations from a Value Management Perspective

Overview

We have been following the developments in clawback policies in compensation very closely over the last several years. In this article we introduce the SEC's latest proposal on clawbacks (Proposed Rule 10D-1) and provide recommendations to affected companies. Our recommendations are based on our expertise in value based management and look to strengthen the alignment of company management and shareholders. But first, we share a brief introduction to clawbacks for our readers who may not be familiar with them.

What are clawbacks?

In short, a clawback is the act of a company retrieving or "clawing back" previously earned or paid compensation. Many companies have policies to govern when and how clawbacks are used, as they can be an effective tool in corporate governance.

Clawbacks came into the spotlight in the 2000s following a number of accounting scandals by companies such as Enron and WorldCom. As a result of the scandals, the Sarbanes-Oxley Act was enacted to protect investors from fraudulent accounting by companies. Section 304 of Sarbanes-Oxley addresses accounting restatements that result from material noncompliance with financial reporting requirements. In the event that the noncompliance is the result of misconduct, the CEO and CFO must return any bonus and incentive compensation (IC) received as a result of the noncompliance.

So what's new?

The Dodd-Frank Act, passed in 2010, requires the SEC to create a new clawback rule concerning executive compensation that expands on the Sarbanes-Oxley measures. The SEC announced its proposed new clawback rule (Proposed Rule 10D-1) on July 1, 2015, and the period for public comment on the proposal ended on September 14th. The SEC may clarify or revise its proposal based on the comments it has received and is expected to publish the final rule later this year. The information below refers to the proposal in its present form.

- **Who:** All companies with publicly-traded securities listed on national exchanges in the U.S. This includes domestic and foreign firms.

- **What:** The proposal mandates that all companies that have securities listed on a national securities exchange in the U.S. adopt and enforce the new clawback rule.

  - If a company determines that it must issue an accounting restatement to correct a material error published in the last three fiscal years, then the company would have to claw back any excess IC paid to executive officers[A] that would not have been received based on the accounting restatement[B]. This new proposed rule would apply to IC that is tied to accounting-related metrics, stock price, and total shareholder return.

  - Each company would be required to disclose its clawback policy as an exhibit in its annual report. If during the last fiscal year the company either restated financials that triggered a clawback or had an outstanding balance of excess IC related to a prior restatement, it would be required to disclose information related to the clawback (such as the aggregate dollar amount of the excess IC paid attributable to the restatement) in its proxy statement and annual report.

  - Failure to adopt and enforce the new clawback rule would result in a delisting.

[A] The term "executive officers" includes the company's president; principal financial officer; principal accounting officer; any vice-president in charge of a principal business unit, division or function; and any other person who performs policy-making functions for the company.

[B] Exceptions: Companies would not be required to recover excess IC if the expense of enforcing recovery exceeds the amount to be recovered, or if the recovery violates home country laws (for foreign firms).

- **When:** Once the SEC publishes the final rule, securities exchanges will have 90 days to file their proposed listing rules that integrate the clawback rule. Companies will have 60 days to adopt their clawback policy once the securities exchanges' rules become effective.

So what does this mean from a value based management perspective?

We recommend that companies to which the proposal applies consider the items listed below, based on the proposal as it stands. These recommendations stem from our principles in the EVA®-based management system, which is the most powerful way of aligning company management with shareholders to create value.

(1) Ensure that the weighted-average risk of executive compensation packages remains the same, all else being equal.

If the new clawback rule is implemented as proposed, executives may feel that their IC is becoming riskier since there would be a 3-year period during which their bonuses could be clawed back. Of course, this sentiment would only arise if a company's IC policy did not have a 3-year clawback period prior to the new SEC rule. Under this scenario, executives may want to mitigate this increased risk by having a larger percentage of their compensation fixed as opposed to variable.

It is imperative that boards of directors ensure that the weighted-average risk of executive compensation packages remains the same pre- vs. post-implementation of the new rule, all else being equal. That is, we strongly recommend that a significant portion of total compensation for executives continue to be variable as opposed to fixed. The variable compensation earned should be objectively calculated using performance vs. targets based upon shareholder expectations. This is the key link between shareholder expectations and execution by company leaders; this is the key to have executives think and act like owners.

(2) Make sure that the financial vs. non-financial split in total IC remain the same, all else being equal.

One concern is that executives may want more of their IC to be based on non-financial goals, since the non-financial portion of IC would not change in the case of an accounting restatement. We are opposed to this type of change in IC plans. Shareholders invest in companies and they expect results[C]. The share price tells us about the financial performance that shareholders expect from the company in the future. We strongly believe that executives should be held accountable for delivering on those expectations. While non-financial goals do play a role in performance management and IC, the primary concern of shareholders is to see the company responsibly deliver on financials. As a result, boards of directors should ensure that the percentage of total IC that is determined by financial performance does not decrease, all else being equal.

[C] Shareholders expect a return on investment greater than or equal to the equity cost of capital on an annual basis.

(3) Next step: Consider implementing a bonus reserve.

As previously stated, one of our key principles is to award bonuses objectively based on performance vs. goals. The SEC's proposal accomplishes this mission by ensuring that companies reward their executives for true performance – even if it means taking back any portion of bonuses that were awarded as a result of material accounting mistakes. In other words, if the company makes a mistake in over-paying bonuses, the shareholders should not foot the bill. This is right in principle and is a step towards greater alignment between shareholders and company executives. However, we do not think that companies should stop there: we believe that they should adopt the bonus reserve (a.k.a. bonus bank).

A bonus reserve can be a feature of an annual IC plan. In short, it is a tool to defer the payment of earned bonuses to future years. For example, assume that a company uses a bonus reserve and pays out 1/3[D] every year. Say that in the year 1, an executive earns $100 in IC. At the end of the year, since the payout is 1/3, the executive gets $33 in his pocket. The remaining $67 of earned bonus is put in the bonus reserve. In year 2, the executive earns $200 in IC. At the end of the year, the executive would get $89 (1/3 of $67+$200) in his pocket. In future years, the bonus reserve continues to operate and the balance in the bonus reserve is always held at risk, while future bonus payments are dependent upon sustained improvements in performance.

We advocate the use of the bonus reserve for several reasons. First, the bonus reserve is a key tool in aligning executives with shareholders. This occurs in two ways. (i) As shown in the numerical example above, the fact that executives are not paid their earned bonus entirely in one year promotes a long-term view. By putting less emphasis on the short term, executives will feel less incentivized to engage in behaviors to "make a quick buck" and more incentivized to do what is in the long-term interest of the company. (ii) The bonus reserve has a powerful clawback feature that cultivates a strong sense of ownership. That is, the bonus reserve promotes sustained improvements in performance over time. If executives don't execute on shareholder growth expectations, they could carry a negative earned bonus into their bonus reserve[E]. In this case, bonuses would not be paid until the executive is able to regain a positive balance in the bonus reserve by delivering on expectations in future years. In essence, having to earn one's way out of a negative bonus reserve balance is a clawback feature because any positive bonus earned while "digging oneself out of the hole" is not paid: in this case, the earned positive bonus is clawed back. The same function occurs in the bonus reserve when there is a positive balance but performance is not sustained in the future. That is, positive balances can be clawed back: the balance in the bonus reserve is always held at risk. This makes the bonus reserve a powerful tool to create an ownership mindset in the company, aligning executives with shareholders.

[D] For illustrative purposes only. The company establishes the payout percentage of the bonus reserve in its IC policy.
[E] If an executive earns a negative bonus in one year, the bonus paid to the executive in that year is $0. The negative bonus earned gets added to the bonus reserve.

Second, the bonus reserve can benefit IC plan participants by helping to smooth out the volatility of bonuses during business cycles. If an executive does not earn a bonus in one year but has a positive balance in his bonus reserve, then he would still receive bonus money in his pocket. This feature is attractive to executives, particularly in bad times. From the company's standpoint, the bonus reserve mitigates the risk of losing good people during a downturn. This benefits shareholders since they want the most talented people to work at the company.

The third reason is particularly interesting in light of the new clawback: the bonus reserve could alleviate the stress of the SEC's new clawback rule. If there is a clawback on an executive's bonus and his bonus reserve has a sufficiently positive balance, then the bonus could be paid back to the company from the bonus reserve and not from the pockets of the executive. Assuming the above conditions, shareholders would be satisfied because executives would pay back any portion of bonuses they did not earn from true performance, and executives would be better off than without the bonus reserve because they wouldn't pay back the company from their pockets. In short, the bonus reserve could alleviate the stress of the new clawback rule on executives.

Companies must remember that the purpose of IC is to motivate company leaders to deliver on shareholder expectations. The three recommendations above will help companies maintain a strong culture of accountability. The principles embedded in our recommendations form a part of our best-in-class value management system which we have helped our clients successfully implement throughout our 35+ years of experience.

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References:

- SEC Proposed Rule 10D-1
- Sarbanes-Oxley Act of 2002

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