Clawbacks and other Dodd-Frank governance updates

20 September 2012
Your presenters

► Bill Murphy
► Principal, Human Capital Performance & Reward
► (216) 583-2869
► william.murphy05@ey.com

► Mary McLaughlin
► Manager, Human Capital Performance & Reward
► (216) 583-2745
► mary.mclaughlin@ey.com
Agenda

► Introduction to clawbacks
► Current state
► Dodd-Frank §954 proposed regulations
► Regulatory uncertainties
► Regulatory issues
► Planning opportunities
► Administration considerations
► Other regulatory updates
Introduction to clawbacks

Notwithstanding potential Dodd-Frank final rules, clawbacks are contractual provisions allowing a company the opportunity to recover compensation erroneously awarded under specific circumstances; most typically:

- Financial Restatements
- Ethical misconduct
- Non-compete and non-solicitation agreements

Clawbacks can also be drafted in the form of a written policy to which executives and directors are subject as part of an overall corporate governance strategy.
Introduction to clawbacks

There is an increase in the number of companies publicly disclosing clawback policies as a result of the following regulations:

- SOX
- TARP
- Dodd-Frank (financial institutions)
- Dodd-Frank (public companies)

Currently 86.5% of Fortune 100 have publicly disclosed their current clawback policy up from 17.6% in 2006.

- Policies in place cover more than one element of compensation including cash and equity incentives (Equilar).
- Currently 76% of Fortune 100 companies clawback policies are triggered by both a restatement and unethical behavior (Equilar).
- As regulations are finalized we expect to see a number of changes to policies currently in place.
Current State

Prevalence of Fortune 100 Companies with Publicly Disclosed Clawback Policies

Equilar 2012 Clawback Policy Report
Introduction to clawbacks

Data from the Mercer Financial Services Executive Compensation finds 14% of global banks surveyed “clawed back” compensation in 2011

JP Morgan Chase

In July 2012, JP Morgan Chase restated its financial statements to include reflect losses of $5.8B

Individuals responsible were separated from the company with two years of compensation “clawed” back

Chief Investment Officer resigned forfeiting over $30M in compensation
Dodd-Frank §954 proposed regulations

Proposed clawback rules were included in the SEC’s timeline for completion by June 2012.

§954 – Clawbacks: Proposed rules regarding recovery of executive compensation

- SEC prohibits national exchanges from listing companies that fail to implement a clawback policy
  - Policy must include recovery of incentive based compensation,
    - Includes all annual and long-term incentive compensation including stock options
  - Policy to include current and former executives covering a three-year look back period preceding date company is required to prepare an accounting restatement (does not include rank and file employees)
- Requires companies disclose policy in the proxy statement
§954 – Clawbacks: Proposed rules regarding recovery of executive compensation (cont’d)

Upon finalization of the rules, Clawback policy must be applied if company issues an accounting restatement based on erroneous data due to material non-compliance with any financial reporting requirement under the securities laws.

It does not matter whether the executive was involved in the misconduct that led to the restatement.
The key elements of the proposed regulations include:

- Accounting restatement
- Incentive based compensation
- Current and former executives
- Three year look-back period
- Misconduct not required
Regulatory uncertainties

► How is material non-compliance defined?
► Which individuals are considered “current or former executive officers”?
► Is a financial restatement required or advisable?
► Which types of incentive compensation will be affected?
  ► e.g. annual incentive, stock options, restricted stock, performance shares
► 3 year look-back period:
  ► When are amounts considered awarded and at what point do they fall outside the look-back period
  ► Valuation of options both exercised and unexercised, what effect does restatement have on stock price?
  ► Gains on sale of equity compensation awarded and clawed back
In anticipation of the proposed regulations a number of questions regarding enforceability of clawback have been raised.

► Does the policy comply with state, local and international labor laws?
  ► Policy design should take into account state Labor and Employment laws which generally prohibit forfeiture of compensation considering compensation “earned wages”
  ► States and localities also differ in definition and treatment of compensation and wages including commissions, vacation pay, equity and bonus awards.
    ► In New York a discretionary cash bonus not predicated on recipients “personal productivity” is not wages. *Truelove v. N.E. Capital* (N.Y. 2000)

► Similar enforceability issues internationally
Regulatory issues
Enforceability

► Equity awards provide a unique set of concerns
  ► Is an equity award once vested considered “wages” and as a result non-forfeitable?
  ► For example:
    ► California equity compensation is considered wages when earned, it is unclear whether equity awards that vested based on financial metrics that were later restated are considered “wages” and, therefore, nonforfeitable
    ► New York equity awards (unvested options and RSUs) are not considered wages. Guiry v. Goldman, Sachs (N.Y. App. Div. 2006)
Regulatory issues
Repayment of compensation

► In year of payment
  ► If compensation payment and clawback occur in same year, the company will issue the employee a W-2 net of the clawback

► Later years
  ► “Claim of Right” prohibits amendment of original return
  ► Employer will report wages earned unaffected by clawback on employee’s W-2
  ► Employee will report clawback as a miscellaneous itemized deduction on his/her tax return in year of clawback
    ► Section 1341 allows the individual to avoid 2% floor and AMT, providing a deduction in the year of repayment (deduction must exceed $3K) or credit equal to additional tax in year of payment
Equity awards present unique issues:

- Employee will recognize a deduction equal to the FMV at vest
  - If appreciation has occurred §1341 applies
  - If stock has depreciated §1341 may be restricted

How will gains related to stock sales during period between award and restatement be handled?

Accounting considerations:
- Income and expense adjustment
- Balance sheet adjustment
- Impact on APIC pool

Company to recognize income in year of clawback as offset to prior year deduction
Regulatory issues
Unintended consequences

► As executives face risk of potential clawback will companies face pressure to allocate a larger portion of executive compensation from incentive based to guaranteed or discretionary compensation?

► Will management resist restating financial statements to avoid clawback?

► Proposed rules indicated Board will not have discretion in application of clawback provisions. Will an exception be granted for companies in which cost to recover is greater than amount clawed back
Planning opportunities

► In anticipation of final regulations, how can plan design alleviate repayment administration issues?
  ► Structure vesting, performance and transfer restrictions to cover clawback period
  ► Continue to hold vested/exercised equity, subject to clawback in a broker/trustee account
  ► Use of income “off-sets”
    ► If clawback “paid back” with (set-off) of nonqualified deferred compensation said compensation must have been scheduled to be paid in year of clawback
  ► Example
    ► Employee owes $100 clawback payment from FY11 in FY12. If EE is scheduled to receive deferred compensation ($250) in FY12 EE can use deferred compensation payment to offset clawback payment. EE’s W2 will recognize full deferred compensation ($250).
Administrative considerations

► Tracking
  ► Separately identify compensation susceptible to clawback for continued tracking from award through the look-back period

► Communications
  ► Methods to educate employees on clawback policies
  ► Raise awareness to compensation at risk of clawback

► Adjustments resulting from clawback and repayment
  ► Adjustment to previously reported compensation expense
  ► Adjustment to APIC pool
Dodd-Frank proposed regulations
Whistleblower Incentives and Protection

§922 – Securities whistleblower incentives and protection
- Final rules issued May 2011
- Requires payment of awards to whistleblowers
  - Individual voluntarily providing original information leading to a Commission enforcement action
  - Monetary penalties sanctioned by the Commission must exceed $1M
  - Awards range between 10-30% of the money collected

Will this incentive increase the number of financial restatements, and thus clawbacks?
Other governance/regulatory updates
Listing standards for compensation committees

On June 20, 2012, the SEC issued a final rule directing national security exchanges to adopt minimum listing standards related to compensation committees and their use of compensation consultants, independent legal counsel, and other advisers under Section 952 of Dodd-Frank.

The final rule is substantially consistent with the SEC’s March 2011 proposal and generally requires the following:

- A member of a listed company’s compensation committee must be an “independent” member of the BOD, as defined by the exchange.
- Listing standards must require that compensation committees have the authority to retain advisers and be responsible for their appointment, payment and oversight.
- Companies are required to provide new proxy disclosures about whether the use of compensation consultants raised any conflicts of interest.
Other governance /regulatory updates

Several Dodd-Frank Act rules continue to be delayed:

- The following final and proposed rules were included in the SEC’s timeline for completion by June 2012:

- Propose enhanced compensation disclosure rules for pay-for-performance, pay ratios, and hedging by employees and directors (§§ 953 and 955)
  - Relationship of compensation paid and the financial performance of the issuer
  - Ratio of compensation between CEO and median employee
  - Ability of directors or employees to hedge company securities
Questions