The Consumer Finance Podcast: December 1st Deadline to Adopt Executive Compensation Clawback Policies
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Guest: Sheri Adler
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Chris Willis:

Welcome to *The Consumer Finance Podcast*. I'm Chris Willis, the co-leader of Troutman Pepper's Consumer Financial Services Regulatory Practice, and I'm really glad you've joined us today for a special podcast episode in which we're going to be talking about executive compensation clawback rules under Dodd-Frank, which is of interest to a lot of financial institutions. But before we jump into that very interesting topic, let me remind you to visit and subscribe to our blogs. We have TroutmanPepperFinancialServices.com, where we cover legal development spanning the entirety of the financial services industry, and of course, our old standby ConsumerFinancialServicesLawMonitor.com, where we cover the consumer finance industry.

And don't forget our other podcasts, we have lots of them. We have the *FCRA Focus* all about credit reporting. We have *The Crypto Exchange* about everything related to crypto. We have *Unauthorized Access*, which is our privacy and data security podcast. And finally, our newest podcast *Payments Pros*, which is all about the payments industries. All of those are available on all popular podcast platforms, so check them out if you're interested. And speaking of those podcast platforms, if you like this podcast, let us know. Leave us a review on your podcast platform of choice and let us know how we're doing.

Now, as I said, today we're going to be doing something special. You know that one of the things I love to do is to introduce our listeners to the very broad variety of services that our firm can provide to financial institutions, and one of those is executive compensation and employee benefits. And to do that, I'm joined by my partner Sheri Adler, today. Sheri specializes in executive compensation and employee benefits issues for public companies in a wide variety of industries, including specifically financial institutions. So, she's joined me to talk today about the special clawback rules that are about to come into play. So, Sheri, thanks for being on the podcast today.

Sheri Adler:

Thank you so much, Chris. It's a pleasure to join and I'm looking forward to speaking with you today.

Chris Willis:

So, our listeners know all about Dodd-Frank, but when they know about Dodd-Frank, what they really know about is Title X of Dodd-Frank, which is the part that created the CFPB. That's the piece of Dodd-Frank that probably our listeners are most familiar with. But there's another part of Dodd-Frank and another Title that created these so-called clawback rules. So, could you just give the audience a little bit of background about what those are and what they say?

Sheri Adler:

Sure. So, Section 954 of the Dodd-Frank Act directed the SEC to implement rules directing the national securities exchanges, so the New York Stock Exchange and NASDAQ, to require listed companies to adopt and disclose a clawback policy. And the goals of the clawback policy are really to encourage accurate financial reporting and to prohibit windfalls to executives as a result of misstated financials, irrespective of whether the executive was at fault for the misstatement. The SEC published final clawback rules under Dodd-Frank in 2022. And since then, the New York Stock Exchange and NASDAQ has approved listing standards implementing the rules in 2023.

The listing standards are going to become effective October 2, 2023, and companies have 60 days or until December 1st to put into place clawback policies that comply with the rules. One other item I wanted to note, Chris, for the listeners to this podcast is there also exists in other Dodd-Frank provision Section 956, which directs financial institution regulators to jointly prescribe rules prohibiting incentive-based compensation arrangements that encourage inappropriate risk-taking for financial institutions with more than a billion dollar in assets. There are no final rules here yet, so this is TBD, but just wanted to keep this on everyone's radar.

Chris Willis:

Got it. So, we do have an important deadline coming up on December 1st for financial institutions who are going to be covered by these clawback rules. So which companies do these rules apply to? Who has to comply with this December 1st deadline that you just told us about?

Sheri Adler:

It's very broad. It is virtually all listed issuers. So, we're talking about public companies, big and small. We're talking about smaller reporting companies, emerging growth companies, foreign private issuers are included too. There really are very, very limited exceptions to the rule.

Chris Willis:

So basically, if you're a financial services company and you're publicly traded, you're going to be covered by the rule. Is that right?

Sheri Adler:

Exactly.

Chris Willis:

So now that we know who the universe of covered companies is, which executives within the company need to be covered by the clawback policies that the institution is required to adopt?

Sheri Adler:

This is going to be your Section 16 officers, so your president, your CFO, your chief accounting officer, if you have vice presidents in charge of principal business units and others who have

policymaking functions. It's anyone who you've already classified as a Section 16 officer. And one question that's been coming up is, wait, is it all of our Section 16 officers or just our top five named executive officers in our proxy statement? And the answer is, it is all your Section 16 Officers. So, it goes deeper than just your NEOs.

Chris Willis:

Understood. And so we know that it covers all those Section 16 officers. What parts of their compensation need to be covered by these clawback rules?

Sheri Adler:

This is incentive-based compensation. So, incentive-based compensation that is granted, earned, or vested based in whole or in part on the attainment of a financial performance measure. So in plain English, what are we talking about here? We're talking about bonuses, cash bonuses. We're talking about equity awards that are tied in some ways to the achievement of a financial measure, whether that's net income or perhaps it's a non-GAAP measure, perhaps EBITDA. Also, stock price and TSR for these purposes, total shareholder return, are considered by the SEC to be a financial performance measure. In terms of figuring out which types of arrangements are in and which are out, the SEC and the listing standards, there's no set rule. It is really a principles-based approach where you have to analyze arrangements based on the facts and circumstances. So you can't just say every option is out and every performance-based RSU is in. You have to look at the nature of those awards.

So let's take a few examples. If you have a performance-based restricted stock unit, a PRSU, that vests based on relative TSR, a very common design, that's going to be in. An annual bonus tied to a clear financial measure, that's going to be in. But let's say you have a time-based vesting RSU or an option that was not granted based on the achievement of certain financial measures and it just vests over time based on your continued employment, that's going to be out, that's not included in the clawback rules. Also, as far as timing, the compensation must have been received within the meaning of the rules on or after October 2nd. Now received is not exactly defined in the way that one might think. You may have been granted or awarded that award prior to October 2nd, but it's considered received on or after October 2nd if the relevant financial metric is achieved after that date. So, it's not necessarily intuitive which awards are in, and which awards are out.

Chris Willis:

And when you say October 2, you mean October 2, 2023, right?

Sheri Adler:

Exactly.

Chris Willis:

Got it.

Sheri Adler:

So, it's coming up.

Chris Willis:

Now we at least have a sense for what kind of compensation arrangements would be needing to be covered by these clawback policies that financial institutions need to adopt. What amount is supposed to be recoverable or clawed backable from the executives involved?

Sheri Adler:

So that is the inflated amount that the executive erroneously received as a result of the compensation being calculated based on misstated financials. So, let's say compensation was calculated based on a performance metric and the executive got a $100,000. There was a restatement of the financials, it was recalculated based on those financial results, and it was clear that the executive only should have gotten $50,000 under the bonus formula. In that event, the executive owes back the $50,000. It's computed on a pre-tax basis, keep in mind. So even if the executive already paid taxes on those $50,000, he or she still owes the full amount back.

There's also a lookback period of three years. It's essentially three completed fiscal years before the year in which the restatement is required. And there's a bit of a transitional period now as we start with October 2nd. It applies not only to current executives but also to former executives. So, if someone served as an executive at any time during their performance period for that incentive-based compensation, even if they're gone at this point, if they were erroneously awarded an amount, the company has to go after that amount.

Chris Willis:

That sounds a little bit scary if you're a executive of a publicly traded financial services company. Certainly something that you'd have to budget for, I think in your own personal finances. You hinted at this a little bit in your previous answer, but can you tell our listeners what would trigger a clawback? In other words, what will the event be that will require an executive to have this recalculation of their incentive compensation done and pay some of it back or maybe all of it back?

Sheri Adler:

Both a big R and a little r restatement of financials. So, a big R restatement, a restatement to correct errors that are material to previously issued financials. There's a big announcement to investors. You have to promptly amend your filings to restate your financials. People know what big R restatements are, but the addition here is also little r restatements. These are less serious and sometimes go under the radar. They don't generally require alerting investors. Generally, you can make the corrections the next time the issuer files the prior year financials. And so these get included too. So the universe of what might trigger the clawback is larger.

That said, there's not necessarily going to be a clawback every single time there's a restatement. It's only if the restatement causes some form of performance-based compensation to have been granted or awarded at an inflated level. And a very important part of this piece too

is these are on a no-fault basis. So if there's a big R or a little r restatement, the company has to look into whether a clawback is triggered, irregardless of whether the executive did anything wrong or there was any misconduct. It's sort of a strict liability regime.

Chris Willis:

And speaking of strict liability, are the clawback rules that companies are required to adopt again by December 1st of this year, do they give the company, like the board, the compensation committee, anybody associated with the company discretion as to whether or not to pursue a clawback if there's one of these triggering events?

Sheri Adler:

Well, Chris, there's not a lot of discretion as to whether or not to pursue the clawback. The clawback really is mandatory in the event that it's triggered. There are really a very few narrow situations where the compensation committee can forego recoupment. Very remote. Direct expenses to enforce the policy exceed the amount recoverable, and the company has tried and made reasonable attempts, or there's a violation of home country law, and there's an opinion of counsel or tax qualified plan would fail to meet the IRS requirements. We're talking very high level. So, for the most part, these are going to be mandatory. Where there is discretion though is something that you alluded to earlier, which is the executive doesn't necessarily have to turn around and write a check. Let's say that $50,000 hypo we talked about before. They don't necessarily need to go write a check for $50,000 and give that back to the company.

The comp committee can have a lot of discretion as to how to recoup, how to fulfill that $50,000 debt. So it may be that the comp committee says you have an outstanding equity award which is worth $50,000. So, in fulfillment of that clawback debt, we are going to cancel that outstanding equity award, and then you have fulfilled your debt. The comp committee will want to think about things like Section 409A of the code and when they're thinking about canceling or offsetting obligations against various debts. But that is an alternative that's open to the comp committee. Where we see this getting more difficult is for former executives. For current executives, they're going to have at many companies, annual grants, annual cash bonuses, and there will be a means by which to offset the clawback debt. On the other hand, a former executive may not really have much left at the company, and the company may really have to go out and truly recoup that amount.

Chris Willis:

Now, one question that's bound to come up is whether the company can indemnify an executive for the loss of a later determined to be erroneously awarded incentive compensation on the idea that it's not the executive's fault. Is there any indemnification possible here?

Sheri Adler:

There is not. The rules are very clear on this. The company can't indemnify the executive for the loss of the erroneously awarded compensation, and it can't reimburse the executive for insurance premiums that he or she might buy to guard against this. And the idea is that it shouldn't come out of shareholders' pockets, right? You erroneously got, let's call it a clerical

error, right? The financials were wrong and you erroneously got too much. That is not money that you earned, and the shareholders shouldn't bear the cost of that.

Chris Willis:

Got it. So, what if a company doesn't do this correctly? In other words, they don't comply with the requirement to either adopt or adhere to the kind of clawback policies that you've been talking about. What bad thing can happen to the company if that occurs?

Sheri Adler:

It's very dire. The company can get de-listed from the New York Stock Exchange or NASDAQ. So there are procedures that each of the exchanges have in place for what happens if a company fails to comply, but essentially true failure to comply and secure it would result in de-listing.

Chris Willis:

Yeah, that seems quite severe. So, we know we have a deadline coming up that has significant obligations associated with it, and we know there are significant consequences for not doing it. So, Sheri, using your experience, can you just share with the readers some practical considerations for complying with this new set of requirements?

Sheri Adler:

Absolutely, Chris. A lot of companies out there already have clawback policies. These proposed rules were kicking around for a long time. There were other shareholder friendly reasons to have policies out there. But to start, there are certainly some companies that don't. So, if you are a company that doesn't have a clawback policy, clearly now is the time to put one into place. You're starting with a clean slate, so you'll want to adopt a Dodd-Frank compliant policy, and there might be reasons to adopt some supplemental policies, which we'll get to in a minute. A lot of companies already have a clawback policy. For those companies, the steps that they should be taking now is they should review their existing policy with counsel. Virtually every single existing policy will need to be updated due to the nuances in the final rules. So, you can expect that no matter what, you're going to have some updates to your existing policy or receive a new policy and amend and restate your old one.

But let's just say your company does have some supplemental clawbacks. So, what do I mean by that? Let's say irrespective of financial restatements, your company has the right to clawback amounts if an executive engaged in misconduct. If you have that, you have to be very careful that you don't simply remove those because your shareholders, proxy advisory firms, perhaps the board, the comp committee, other stakeholders don't necessarily want to move backwards, right? Just because these new Dodd-Frank rules only require clawbacks in certain scenarios, that doesn't mean that if you've gone above and beyond in the past, that folks will expect you to move backwards. Many companies are being careful to maintain their preexisting supplemental clawbacks. They have a different purpose, they disincentivize different behavior than the ones that the Dodd-Frank rules are focused on.

One question that's come up is how do we do that? How do we maintain these supplemental clawbacks and also put into place the Dodd-Frank rules? Should they be combined in one policy? Should they be in different policies? There's no one set way to do this. A lot of what we've been seeing is bifurcating the policies just so that the Dodd-Frank policy stands on its own. It has limited board discretion in terms of recovery. There are a lot of disclosure requirements that apply and to keep it clean and just keep the supplemental one separate so that you're not subjecting yourself necessarily to the additional disclosure requirements, the board can still retain discretion in that supplemental policy. That said, there's no one way to do it and we've seen different companies handle it in many different ways. If a company does not currently have supplemental clawbacks, something else that they should about now is it something that the comp committee or the board believes it's desirable to put into place now? Who should it apply to?

So, do you want to have a clawback policy that goes deeper than just the Section 16 officers and goes deeper into the organization? Which compensation should be recoverable? Does it make sense to only make it be incentive-based compensation, or are there other types of compensation that the comp committee believes should be recoverable in the event of certain triggering events? Should the triggers be expanded? Even if there's no financial restatement, should the company be able to recover from an executive if the executive engages in misconduct or a really bad act? As another consideration just to add to the mix, over the last year, the Department of Justice has indicated that it will assess the company's clawback policy in the context of criminal investigation and resolution. So, the focus there is on disincentivizing misconduct, it's not on financial restatements. We'll have to see whether and to what extent the DOJ's guidance will impact company and industry approaches to clawback policies, but it's just another thing that comp committees are thinking about when they're looking at the whole spectrum and landscape for different clawbacks and what makes sense for that company.

Chris Willis:

Sheri, it occurs to me that there may be quite a few contractual agreements between executives and companies that are subject to these clawback rules. And so, what's the interplay between those, say, employment or incentive compensation agreements and the new policies that have to be adopted pursuant to this rule?

Sheri Adler:

That's a great question, Chris, because a lot of companies are thinking about how are the executives going to be contractually bound by this new policy? So, for many years, many companies have already put into executive employment agreements or offer letters or equity award agreements, a provision saying, I agree to be bound by the company's clawback policies, whether now in effect or in effect in the future. So that's a great provision and we continue and advise our clients to continue to put that into new employment agreements and continue to put that into annual equity awards. Another question is, should other documentation be signed up now? Many companies are considering also having executive sign up an acknowledgement form when they receive the policy, acknowledging that they have received and read the policy and understand that they need to abide by the rules. It's really a multilayered approach, and I think that companies will want to make sure that they feel comfortable that their executives are bound by the new policy, and also take a look at different documents and ensure that there aren't conflicting provisions in those documents.

So, for example, if you have a historical change in control or severance arrangement that says that under no event will any amounts paid thereunder be subject to offset or recoupment, but then you've got an equity award agreement that says, I, executive, agree to be bound by the clawback policy, what happens there? What rules? And we think that it's a good idea to go through and try and figure out how to refine or supersede any provisions and existing agreements that really seem to potentially conflict head on with the new rules so as not to get into those contractual debates later.

Chris Willis:

That sounds like a very complicated process that involves not just a review of any current agreements, but potentially historical agreements that might be within a lookback period. Right, Sheri?

Sheri Adler:

You know, Chris? I think for the most part, it's a couple of hour exercise. It depends on the company and it depends on how much counsel has been involved in the past in their compensation arrangements. But we're talking about Section 16 officers. The compensatory arrangements should be filed with the SEC as an exhibit to the 10-K. So, we're really talking about looking at forms of employment agreement, equity award agreements, severance or change in control plans or agreements that are out there, perhaps buffering up an incentive bonus plan if they have one for next year just to add some protective language saying that clawbacks are possible. Also looking at indemnification and corporate documents to make sure that there's nothing impermissible in those indemnifying the executive in a way that is not allowed as we discussed earlier.

So, I think there is more to do than just put a policy into place. I think it's prudent for companies to also do a review of their high-level executive agreements and arrangements just to make sure that there's nothing in there that's contrary to the rules. But at least so far, I haven't seen an approach taken where every single document that's out there is being amended to comport with the new rules. It's really a big picture approach of how little can we change? What can we effectuate with this new policy with perhaps an acknowledgement form buffering up the language and annual equity award agreements. And then is there anything out there which really is just potentially contradictory, which we should address up front.

Chris Willis:

Okay, got it. And finally, are there any sort of internal control changes, improvements, considerations associated with these clawback rules?

Sheri Adler:

There are. There are new disclosure requirements. So, for those internal professionals who work on 10-Ks and who work on proxies, they should be aware that there are requirements to file the policy. And in the event there is a restatement, in the event there is a clawback, there's going to be additional disclosure requirements. One thing that's helpful for companies to do now is to just look at their process, what happens in the event of a restatement, and make sure that there is an appropriate process in place. If there is a restatement, if there is a clawback trigger,

there's likely going to involve the audit committee, the compensation committee, outside advisors like counsel among others. So start to think about what that process would look like in the event that a restatement, a clawback, came up. I think it's prudent for companies to start thinking about that now. But certainly, as a first step, we're really focusing on getting a policy into place in the right timeline.

Chris Willis:

Sheri, this has been a very interesting discussion for me because I've learned a lot of new things and I'm sure our listeners have as well. And it's really been a treat for me because one of the things I love most is using the podcast to introduce the outside world to all the different kinds of expertise that our firm has that's applicable to financial institutions. And your executive compensation and employee benefits group is just one of those. And so obviously if a financial institution client who's publicly traded wants help with this issue, we have a whole crew of people, including Sheri, who can help with that, who are experts, not just in the clawback rules, but in how they're applied to compensation arrangements that are common in the financial services industry. So, thanks Sheri, for being on the podcast today.

Sheri Adler:

Thank you so much for having me, Chris. It was a pleasure.

Chris Willis:

And of course, thanks to our audience for tuning in as well. Don't forget to visit and subscribe to our blogs, TroutmanPepperFinancialServices.com and ConsumerFinancialServicesLawMonitor.com. And while you're at it, why don't you head on over to Troutman.com and add yourself to our Consumer Financial Services email list. That way you'll get copies of the alerts that we send out as well as invitations to our industry only webinars. And of course, stay tuned for a great new episode of this podcast every Thursday afternoon. Thank you all for listening.

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