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20 Years in the Making: Do Executive Compensation Clawback Policies Have Claws?

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Do Executive Compensation Clawback Policies Have Claws?

by

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1. Introduction

The separation of ownership and control in public companies requires that shareholders monitor executives' behavior to ensure that the executives are acting in the shareholders' best interests. One setting in which such monitoring is important is in the realm of external financial reporting. While shareholders desire unbiased information about financial performance for use in capital allocation decisions, managers have incentives to report the highest profits in order to attract investment capital and increase stock prices. Moreover, managers often earn incentive pay that is based on reported performance (e.g., cash bonuses or equity compensation based on reported earnings-per-share). Such incentives can pressure management into engaging in forms of earnings management - using latitude in accounting standards to manipulate reported performance (i.e., by way of misconduct and/or noncompliance with authoritative accounting guidance). Following the high-profile accounting scandals of the late 1990s and early 2000s, investors, legislators, and regulators called for increased accountability within corporations to protect shareholder interests. One mechanism to deter aggressive financial reporting that emerged during this period is the compensation clawback policy. Compensation clawback policies allow shareholders to recoup any incentive compensation that executives earn based on reported financial performance metrics that are subsequently determined to be misstated. Clawback policies were introduced to encourage top executives to take increased responsibility for the financial statements, and to give shareholders increased security when designing compensation contracts for executives.

Clawback policies have existed in several different forms for the past 20 years. In this study, I review the history of clawbacks, and discuss the enforcement (or lack thereof) of such provisions by regulators and corporations. The goal of my study is to further the understanding of the usefulness of clawback policies and whether they are the effective deterrent that Congress intended them to be. My study may be of interest to regulators, legislators, investors, academic researchers, and other market participants. My findings may be of particular interest to the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ), as they pursue ongoing initiatives related to clawback provisions. The remainder of this study proceeds as follows. Section 2 discusses clawback provisions under Section 304 of the Sarbanes-Oxley Act of 2002. Section 3 discusses clawback provisions under Section 954 of the Dodd-Frank Act of 2010. Section 4 discusses clawback policies that were voluntarily adopted by corporations internally. Section 5 briefly concludes my study of clawback policies.

2. Section 304 of the Sarbanes Oxley Act

The Sarbanes Oxley Act (hereafter, SOX) was passed in 2002 in response to several high-profile accounting scandals that resulted in massive losses to shareholders. A main objective of SOX was to help investors regain confidence in the market, in part by requiring the SEC to set more rigorous standards regarding corporate governance. Section 304 (hereafter, SOX 304) states that if an accounting restatement occurs due to material noncompliance with reporting standards, as a result of misconduct, the Chief Executive Officer (CEO) and the Chief Financial Officer (CFO) of the corporation must forfeit any bonuses or incentive-based pay received, and any profits from the sale of any of the corporation's stock, within a twelve-month period following the initial release of the incorrect financial statements. The misconduct provision of SOX 304 has proven to be difficult to enforce, as Congress did not make any distinction of whose misconduct it must be; whether the CEO or the CFO must be personally involved in the misconduct, or if it can be any employee's misconduct as the CEO and the CFO are still responsible for certifying the financial statements under SOX Section 302 (Schwartz 2008). Although enforcement of SOX 304 has been limited, courts have established that the executive does not have to personally participate in the misconduct to be subject to SOX 304. Courts that have addressed SOX 304 have also ruled that only the SEC can enforce SOX 304, and the suit cannot be brought by any member or shareholder of the corporation (Schwartz 2008). Historically, the SEC has been very reluctant to enforce SOX 304, and when they have, the executive involved is usually first convicted of criminal fraud. In the period between July 1, 2002, and June 30, 2006, a total of 1,786 restatements were filed due to either financial reporting fraud or accounting errors, however, the first successful enforcement of SOX 304 occurred in 2007, nearly five years after the legislation was passed (List 2009). This incredible lack of enforcement of SOX 304 undermines the deterrent Congress meant it to be. In the fifth year after SOX was passed, the SEC had enforced SOX 304 only five times. In each of those five cases, the CEO or CFO knowingly and deliberately participated in some form of misconduct, and specifically, the CEO was complicit in the misconduct in each of those five cases (List 2009). There is evidence that in most cases where SOX 304 is enforced, the CEO or high-level officer of the corporation has some hand in the misconduct that triggers the restatement, although it is not a requirement for the enforcement of SOX 304. Although SOX 304 was originally meant as a deterrent to CEOs and CFOs, its limited enforcement in the past by the SEC suggests it has limited usefulness.

Recent enforcement of SOX 304 has been slightly more aggressive than in the first decade after SOX was passed. In a case against Granite Construction, an infrastructure company, filed on August 25, 2022, the SEC recouped more than 1.9 million dollars from the former CEO and CFOs, although none were charged directly with any misconduct. It was the former Senior Vice President, Dale Swanberg, who was charged with financial fraud regarding inflating profits (SEC 2022a). Gurbir S. Grewal, the Director of the SEC Enforcement division stated that "We are committed to using SOX 304 as Congress intended: to incentivize a culture of compliance at public companies by ensuring that senior executives are not rewarded when their firms violate core reporting requirements". This attitude towards the enforcement of SOX 304 is much more aggressive than what was seen with the SEC's prior enforcement. Another case filed in July of 2022 against software company Synchronoss Technologies follows a similar pattern. The SEC charged seven employees in connection with financial misconduct that occurred from 2013 to 2017. The SEC also enforced SOX 304 against the former CEO, recouping 1.3 million dollars, even though he was not charged with any form of misconduct connected to accounting fraud (SEC 2022b). Although the SEC uses SOX 304 in connection with some type of financial misconduct, it is clear that one does not need to have been personally involved in misconduct concerning SOX 304. This greatly differs from what was seen in the early enforcement of SOX 304, as the SEC used to be very hesitant to enforce SOX 304 in cases in which the executives had no personal involvement or knowledge of the misconduct. This new approach to the enforcement of SOX 304 could be due to increased political pressures, or to increased recent attention to clawback provisions related to the SEC's final rule regarding clawback policies under the Dodd-Frank Act that was finalized at the end of 2022 (see section 3).

3. Section 954 of the Dodd-Frank Act

3.1 Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in 2010 in response to the financial crisis in 2007 and 2008. The act included various corporate governance provisions, including Section 954. Section 954 of the Dodd-Frank Act (hereafter, DFA) went beyond the provisions of Section 304 of the Sarbanes-Oxley Act and required that the SEC develop rules requiring that all public companies adopt their own internal clawback policies that are enforceable by the Board of Directors. As discussed in greater detail in section 4 many firms voluntarily adopted their own clawback policies in the years following SOX, and the objective of Section 954 was to promulgate rules making internal clawback policies mandatory. Before the DFA was passed, less than 50% of S&P 500 firms had an internal clawback policy. Of those that did, 81% of the policies gave the directors discretion when recouping any excess compensation. Less than 2% of corporations adopted clawback policies that required executives to return excess compensation regardless of any misconduct (Fried et al. 2011). Section 954 requires that corporations adopt their own clawback policies and allows them to enforce them themselves, whereas previously only the SEC could invoke the clawback provision. DFA Section 954 directed the SEC to create a set of regulations that the new voluntary policies must follow, however, the rules were not finalized until 2022. Section 954 also changed the types of compensation allowed to be clawed back by the corporation, whereas previously under Section 304 all types of incentive pay were allowed to be clawed back, Section 954 specifies that only certain types of incentive pay will be clawed back, though it specifically states that this must include stock options. The types of incentive pay that can be clawed back will be decided by the final rule issued by the SEC. Section 954 also did away with the misconduct requirement, the voluntary clawback policies no longer needed to be triggered by any sort of financial fraud or misconduct. Now, all that is needed to occur to trigger a clawback provision is a restatement of earnings that results in any overcompensation of executive officers.

3.2 SEC Final Rule

The SEC published their final rule on the recovery of erroneously awarded compensation on October 26, 2022, nearly 12 years after Dodd-Frank instructed them to do so. The final rule was effective January 27, 2023 (SEC 2022c). The final rule includes several provisions that will cause many publicly traded firms to adopt new, stricter clawback policies. The new rule requires that clawback policies apply to any executive officer, regardless of whether they play a part in preparing the financial statements. Not only do these clawback policies include all executive officers, but they also include any executive officers who have served the firm in the past three years, due to the new look-back provision, which requires the firms to consider all compensation that may be affected by a restatement in the past three years. A contested part of the rule, the SEC states that both “Big R” and “little r” restatements must be evaluated for erroneously awarded compensation. Meaning that whether an error is “material to the previously issued financial statements” (a “Big R” restatement) or “would result in a material misstatement if the error were corrected in or left uncorrected in the current period” (a “little r” restatement), firms will have to evaluate if these errors contributed to compensation of any executive in the past 3 years (Guo et al. 2023). The types of compensation that would be subject to clawback provisions are defined as any incentive-based compensation that is “granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure”, this includes both cash and stock incentive-based compensation. The SEC does make the distinction in the final rule that any incentive compensation that is awarded based on non-financial measures will not be subject to any sort of clawback provision (Guo et al. 2023).

A long-awaited and discussed provision of the final rule is the discretion the Board of Directors or Compensation Committee will receive under the new rule when it comes to both the means and the decision on whether or not the Board will seek recovery of erroneously awarded compensation. The final rule significantly reduces the amount of discretion given to directors compared to many voluntarily adopted rules. In determining whether to seek recovery of excess compensation, the board must recoup the compensation except for under three circumstances: the cost of enforcing recovery would exceed the recoverable amount, the pursuit of recovery would violate home country law, or recovery would be likely to cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code. These are the only circumstances under which a board could exercise discretion when deciding to enforce a clawback policy on a case-by-case basis. If the Board exercises discretion and chooses not to recover the compensation, they must provide documentation proving their attempt to recover the compensation, and how it complied with one of the three circumstances detailed above (Guo et al. 2023). This provision of the final rule significantly limits the Board's ability to exercise discretion as they were able to with voluntarily adopted policies, and will hopefully combat any kind of corruption or personal motivations that the Board members may have when choosing not to recover excess pay. The final rule does give the Board discretion to choose the means for recovery, as long as they do not settle for less than the full amount, given that many firms have different processes and ways they may go about recovering excess compensation and the type of compensation. The recovery, however, must be "reasonably prompt". The final rule also requires firms to disclose the recovery of excess compensation in their proxy statements, including the means that they recovered the excess compensation, as well as if the Board exercised any discretion on the recoupment.

With regard to the final rule, Section 304 of the Sarbanes-Oxley Act will still be enforced by the SEC. Any amounts that the executive officer has already reimbursed the company per SOX 304 will offset any additional amounts required by the final rule. It is likely that with the final rule, we will see less enforcement of SOX 304 as firms begin to enforce their clawback policies in accordance with the final rule, however in cases of extreme misconduct, the SEC may step in.

4. Voluntary Clawback Policies

4.1 Background

As mentioned in Section 3, in the interim time between Dodd-Frank and the issuing of the new rule by the SEC, many corporations adopted their own clawback policies. A study conducted by PricewaterhouseCoopers (PwC 2013), 5 years after the DFA was passed, shows the variety and trends in the adopted voluntary clawback policies. 90% of the companies in the study required there to be a restatement of some kind in order to trigger a clawback policy, of that 90%, 76% required there to be evidence of misconduct on behalf of an employee (PwC 2013). This is interesting as although the final rule had not been proposed at this time, it is clear under the language used in Section 954 of the DFA that misconduct will not be a requirement for clawback policies. The three most common triggers of voluntarily adopted clawback policies were misconduct, restatements, or fraud, with many firms having multiple possible triggers for their clawback policies. Of the companies studied, 76% allowed for discretion when enforcing the clawback of excess pay (PwC 2013). This can be problematic as the damage that enforcing a clawback policy may incur on board members' personal relationships with executives most often outweighs the amount of personal gain that a board member would potentially get. Especially in cases where the board member and the executive in question would still work closely together, it is highly unlikely that board members will actually enforce clawback policies to their full extent, regardless of the financial harm to the firm (Schwartz 2008). The ability for discretion on a case-by-case basis allows for bias and corruption to make their way into corporations and undermines the very purpose of the clawback policies as Congress intended. The majority of companies allowed for the clawback of both cash and stock compensation. 57% of clawback policies did not disclose any sort of look-back period (PwC 2013), which is most likely due to there being no guidance in Section 954 on this subject. There is evidence that clawback policies improve financial reporting quality, as they give firms the incentive to design compensation contracts in a way that reduces the risk of financial restatements, thereby reducing the risk of misreported earnings due to misconduct of any employee. (Prescott and Vann 2018). It was found that executives' base pay and total compensation were more likely to increase in firms with voluntarily adopted policies than in firms with no clawback policy. The adoption of clawback policies is also associated with an increase in firm value, due to a positive market response and is especially effective in increasing firm value in firms with a history of restatements (Prescott and Vann 2018).

4.2 Enforcement of Voluntary Clawbacks

Despite extensive evidence that voluntarily adopted clawback policies are associated with improvements in financial reporting quality and increases in firm value, little is known about whether, or under what circumstances, firms enforce their internal clawback policies. To provide insight into the enforcement of such policies, I conduct a manual review of recent cases where entities restated financial statements. Specifically, I use data from Audit Analytics to identify all "Big R" restatements (i.e., restatements accompanied by an 8-K filing indicating that investors should not rely on previously issued financial statements) during 2017-2022. To limit my sample to restatements that are likely to involve executive misconduct, I focus on those involving financial statement fraud. These procedures result in a sample of 21 restatement events. I then manually reviewed 8-K, 10-K, and proxy filings surrounding the restatement events for disclosures indicating that the entity enforced its clawback policy in response to the restatement. Surprisingly, only one of these 21 firms disclosed having enforced its clawback policy following the restatement. This provides evidence that, like clawbacks under SOX 304, voluntarily adopted clawback policies have limited enforceability. This finding is important because it suggests that the limited discretion provided to directors under the SEC's final clawback rules pursuant to DFA 954 may be necessary to ensure that shareholders are able to recoup compensation from executives following financial restatements.

5. Conclusion

This study reviews the history of executive compensation clawback policies. Clawback policies were first popularized in the wake of the widely publicized accounting scandals of the early 2000s as a means of disincentivizing aggressive financial reporting choices that could lead to restatements. SOX 304 first gave the SEC latitude to recoup executive compensation on behalf of shareholders, but the SEC has only enforced clawbacks under SOX 304 in limited circumstances. The DFA instructed the SEC to promulgate a rule that would require companies to adopt their own clawback policies, which was just put into effect earlier this year. In the meantime, companies voluntarily adopted their own clawback policies. In my review of clawbacks in a historical context, clawback policies do not act as the mechanism of shareholder protection they were intended to be. However, with stricter rules under DFA 954 now in effect that limit directors' ability to opt not to enforce a clawback policy, and in light of the Department of Justice's new program incentivizing the enforcement of clawback provisions[1], clawback policies may finally have "claws".

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[1] A new pilot program is being launched by the Department of Justice on March 3, 2023, that incentivizes the enforcement of clawback policies. According to U.S. Deputy Attorney Lisa Monaco, this pilot program is a part of the DOJ's focus on individual accountability and will "shift the burden of corporate crime away from shareholders who frequently play no role in the misconduct and onto those who are directly responsible". This program will reward corporations by reducing criminal fines if the corporation attempts (in good faith) to claw back erroneously awarded compensation, even if they are unsuccessful (Department of Justice 2023). This pilot program is to last three years and is the first of its kind. It will be interesting to see how financial incentives will impact the effectiveness of clawback policies that corporations are already legally required to enforce.

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