Executive Compensation: Clawbacks

2014 Proxy Disclosure Study

January 2015

pwc

Dear clients and friends

PwC is pleased to share with you our second annual **Executive Compensation: Clawbacks — Proxy Disclosure Study**. This study presents our analysis of the compensation recoupment or "clawback" policies of 100 large public companies as disclosed between 2009 and 2013 in their year-end proxies. We hope this study will be helpful to those of you preparing proxies as well as those responsible for compensation strategy and financial reporting.

Clawback policies, although not new, are top of mind for the C-suite and Boards and in compensation committee and annual shareholder meetings. And clawbacks continue to be discussed in the news and in the courts. CEO's and CFO's have been "on the hook" to return awards after a financial restatement, if earned as a result of misconduct, since passage of the Sarbanes-Oxley Act of 2002. More recently, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") directed the SEC to craft new rules for additional clawbacks. As a result, we continue to see companies modifying their clawback policies in anticipation of the new SEC rules, which have yet to be issued. In fact, 40% of the companies reviewed made some type of change to their plan during 2013.

Clawbacks are a way for employers to both incentivize certain behaviors and to hold employees accountable for their actions. They have also been adopted to address the increased scrutiny on executive compensation policies by investors, shareholder advisory firms, regulators, and the media. The number of companies that disclose clawbacks has significantly increased in the years since the 2008 financial crisis.

While more and more clawback provisions are being added to compensation arrangements, it remains relatively uncommon to see them exercised. There have only been a few high profile cases in recent years. It is not clear whether this is due to a lack of enforcement (by choice or due to of the difficulties with enforcement by the company) or the absence of conduct that would trigger a clawback.

In preparing this study, we looked at the proxy filings of the Fortune 100 and other large or established companies for 2009 through 2013. In certain cases, we used additional information available in other filings or on the company's website to clarify our understanding of their policy.

We hope you find this study useful and we look forward to working with you as your compensation programs continue to evolve. Please don't hesitate to reach out to your local PwC team or one of the authors if you would like to continue the conversation.

Best Regards,

Ken Stoler

HR Accounting Advisory Leader

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Introduction

When providing employees with bonuses, stock options, or other incentive awards, companies often establish provisions that allow them to recoup all or a portion of the award under certain circumstances. These provisions are referred to as clawbacks or otherwise described as compensation repayment or recoupment policies and are described by most public companies in their annual proxy statement.

Clawbacks are nothing new. Companies often adopt clawback provisions voluntarily to encourage or deter certain actions or behaviors. These provisions may also be included to comply with various laws and regulations. The Sarbanes-Oxley Act of 2002 requires public companies to claw back CEO and CFO awards earned in the one-year period prior to a financial restatement as a result of their misconduct.

The more stringent requirements for companies receiving assistance under the Troubled Asset Relief Program of 2008 (TARP) expanded the clawback requirements to the top twenty most highly-paid executives and eliminated the need to prove misconduct by the executive. Dodd-Frank will significantly expand repayment provisions by requiring clawbacks from all executive officers (current or former) of any erroneously awarded compensation in the three-year period prior to a restatement, without consideration of their misconduct.

The SEC is charged with writing the clawback rules mandated by Dodd-Frank, and initially announced an expected rulemaking timeframe of mid-2011. Though many expected a proposed rule sometime in 2014, the timing remains unclear. Without final rulemaking, questions of how the new provisions will apply abound:

- Will a clawback be required if financial results contained an error, but a restatement was not required?
- Will the clawback apply if the incentive compensation was not based on financial results (but instead was based on a non-financial operational performance metric)?
- Will the clawback policy apply to both cash and share-based compensation?
- Who will be considered an "executive" for purposes of the clawback provision?
- Does the three-year period start when the error originated, the date it was discovered, the date the restated financial statements were filed or something different?

Notwithstanding the lack of final rules on the Dodd-Frank clawbacks, we have seen many companies developing new types of clawbacks over the last few years. For example, a few companies in the pharmaceutical sector established a clawback based on failure to follow company policies or protocols. In response to banking regulators, some

companies in the financial services industry have implemented more stringent recoupment provisions in cases where executives were found to have taken excessive risk.

Overall, the companies sampled featured a wide range of clawback triggers in their clawback policies, but the most common reason companies seek to clawback is when there is a restatement, either with or without employee involvement or misconduct. Restatement and misconduct remain the most common clawback triggers in each of the industries studied. This is not surprising given the Sarbanes-Oxley Act requirements and pending Dodd-Frank-related regulations. However, as discussed above and described in this study, we saw many other triggers for clawbacks in our sampled companies.

Accounting considerations

Many companies have modified their clawback policies since enactment of the Sarbanes-Oxley and Dodd-Frank Acts, and others have indicated that their clawback policies will likely change once the SEC issues its clawback rules. As companies consider adding or changing clawback policies, it is important to consider the potential financial reporting implications.

Under existing accounting rules, a "traditional" clawback feature does not impact the equity award's value and expense pattern. If the clawback were ever invoked, accounting recognition would only be needed at that time to reflect the recoupment of the cash or shares.[1]

As companies develop new types of clawbacks to address a variety of risks, some may wish to add performance metrics that affect vesting or retention of the award (e.g., requiring an employee to return outstanding awards if there is a loss on their trading desk or in their division). Depending on how the provisions are structured, these performance requirements may not be considered clawbacks at all, but could instead be considered performance conditions of the award. In that case, the accounting implications could be significant.

Another consideration is whether the clawback includes flexibility or discretion, such as determining when or if a clawback has been triggered and the amount to be recouped. In some cases, this discretion may result in an assessment that the key terms and conditions of the arrangement are not established and understood. As a result, the award may fail to meet the criteria for a grant date and would need to be marked to market.[2] This is a complex area and significant judgment is often required.

Please note: This study was focused on disclosure only, and did not include an assessment of the accounting treatments applied by any of the companies in our study.

1 FASB Accounting Standards Codification 718-10-30-23 through 30-24 and 718-20-35-2

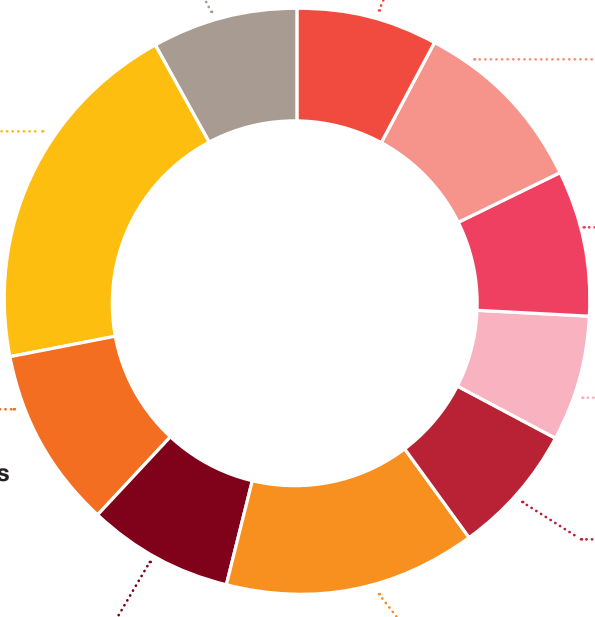
2 For more on the accounting treatment for clawbacks, readers may refer to PwC's HRS Insight 10/36 *"Accounting for Clawbacks in Stock Compensation Arrangements, Including the Dodd-Frank Act's Provision on Recovery of Erroneously Awarded Compensation"*.

Industry representation

Our 2014 study evaluated the various features of clawback policies along with other related data for 100 large U.S. public companies. We performed our analysis of the disclosures made by these companies based on published annual reports and other publicly available information.

Data has been compiled for all 100 companies that disclosed clawback policies by industry sector. Below is a description of these groupings and the percentage each industry sector represents of the total.

Sector representation



8%
Technology
Electronics, computer, and digital equipment

20 %
Retail and Consumer
Retail chains and consumer goods

10%
Pharmaceutical and Life Services
Health equipment and supply, and pharmaceuticals

8%
Insurance
Life insurance products and services

8%
Auto and Airlines
Automotive and parts manufacturers and airline services

10%
Banking and Capital Markets
Banks, capital markets, and financial services

8%
EMC
Entertainment, media, and communications

7%
Energy
Utilities and energy companies

7%
Healthcare Payers
Health insurance providers

14%
Industrial Products
Industrial products, manufacturing, and construction

Clawback triggers

Of the companies in our study, 90% have policies to recoup compensation if there's a restatement of financial results. However, of those that claw back upon a restatement, 73% require evidence that the employee caused or contributed to false or incorrect financial reporting, while 27% require repayment in the event of a restatement even without any personal accountability. In many cases, the clawback amount is only the excess of the amount paid over the payment determined based on the financial results after applying the restatement.

Below is an example of a clawback provision that considers the employee's involvement with a restatement:

"Pursuant to this policy, in the event our Board or an appropriate committee thereof determines that any fraud, negligence or intentional misconduct by an executive officer was a significant contributing factor to the Company having to restate all or a portion of its financial statements, the Board or committee will take, in its discretion, such action as it deems necessary to remedy the misconduct and prevent its recurrence. Such actions may include requiring reimbursement of bonuses or incentive compensation paid to the officer…"

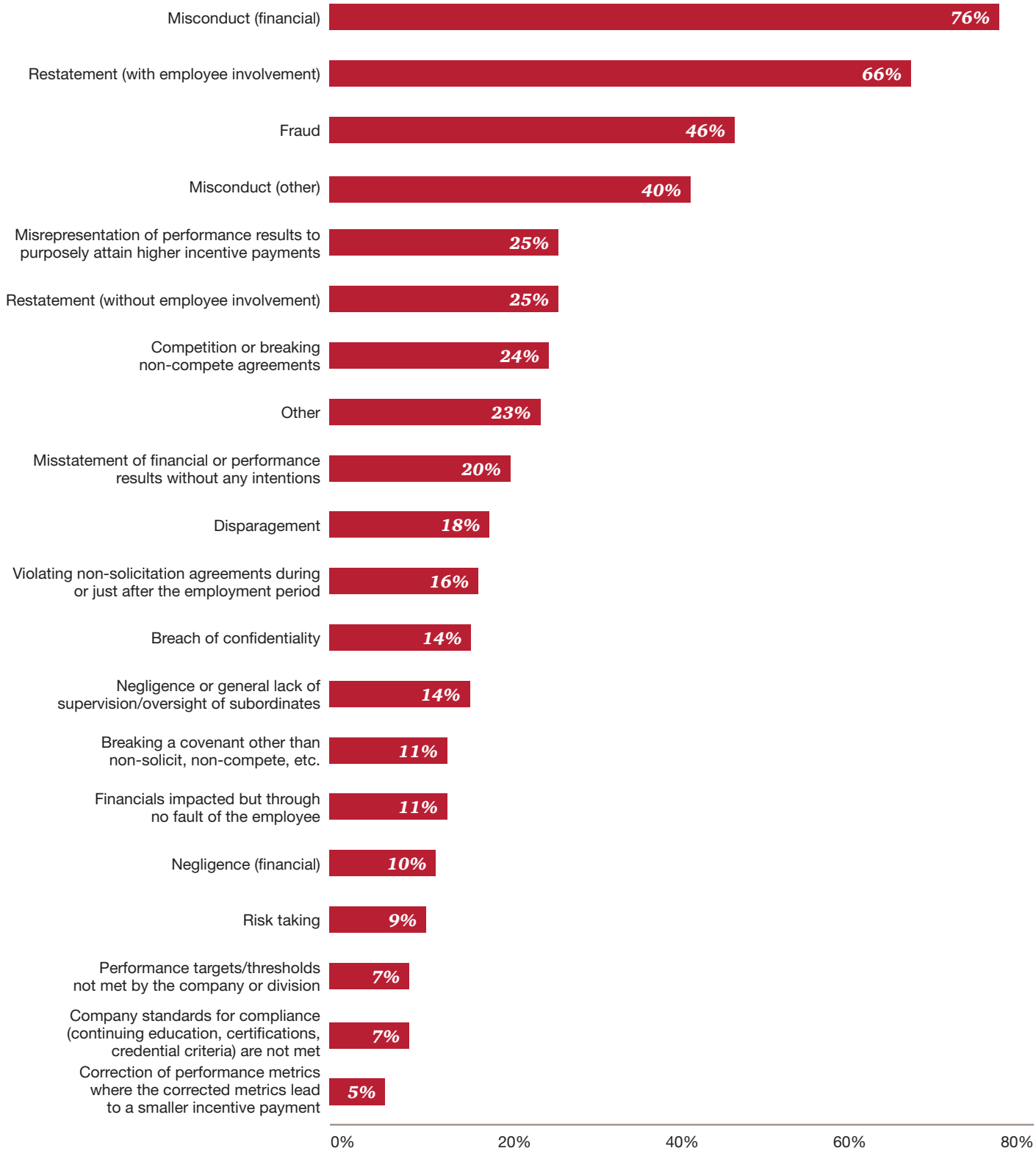
Another prevalent reason for recoupment of incentives was misconduct (83%), which includes breaking a company's code of conduct or ethics policies, being convicted of a criminal offense, or other transgressions and includes both financial misconduct and other types of misconduct.

Below is an example of a clawback provision with misconduct as a trigger, separate from a restatement clawback trigger:

"Under the policy, in the event of a financial restatement, material incorrect calculations of performance metrics, or misconduct, the Committee is authorized to recover compensation based on its analysis of the relevant facts and circumstances. In January 2013, the policy was updated to provide an expanded definition of misconduct to include serious violations of the Code of Conduct and violations of law within the scope of employment at the company."

The bar graph below reflects the percentage of companies that disclosed a particular clawback trigger (many companies disclosed more than one trigger).

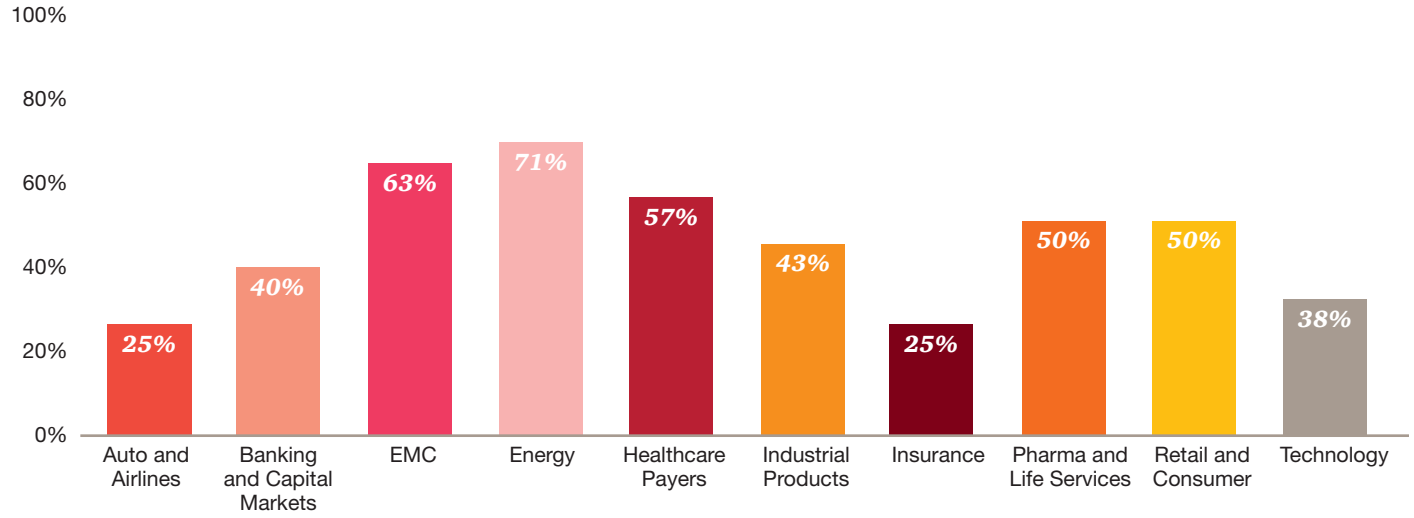
Clawback trigger prevalence



As one might expect, industry results generally followed overall results, but there were a few variances. The sectors indicating clawbacks for restatements with employee involvement ranged from 25% of the Insurance companies included in our study, to 100% of the Healthcare Payers sector studied. When we include restatement for any reason, three additional sectors (Auto and Airlines, Banking and Capital Markets, and Energy) hit the 100% mark (meaning that all of the studied companies in that sector included a restatement trigger of some kind).

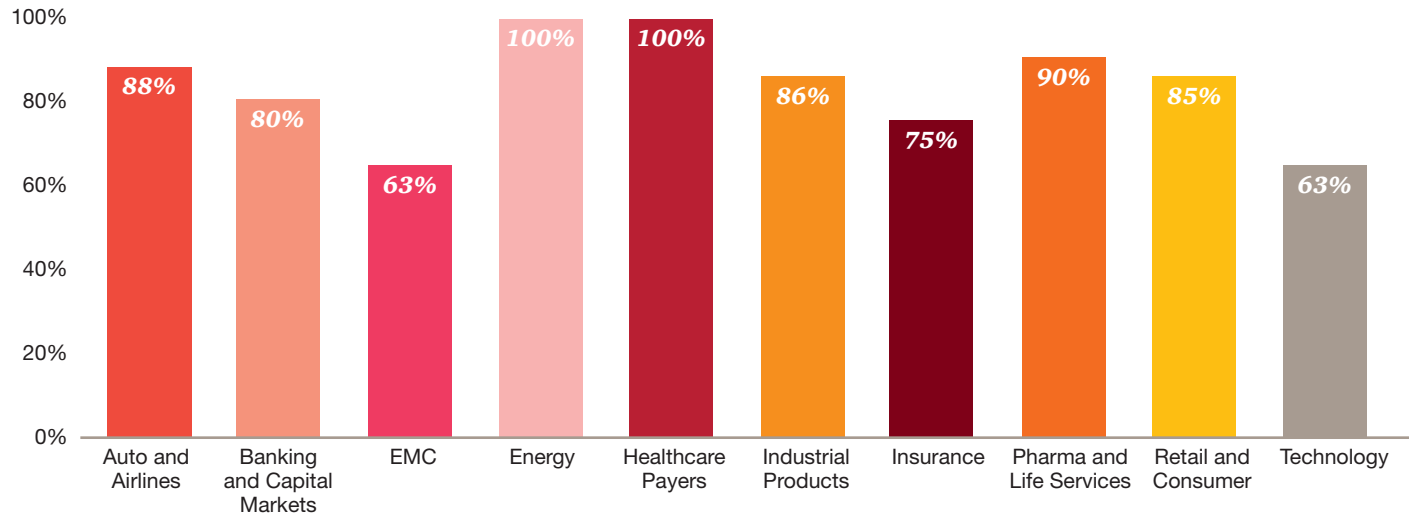
Below are the sector comparisons for common clawback triggers other than restatements. While about half of the companies selected included a fraud component in their clawback policies, there was a wide range among individual sectors, from 25% in the Insurance and Auto and Airlines sectors to 71% in the Energy sector.

Fraud



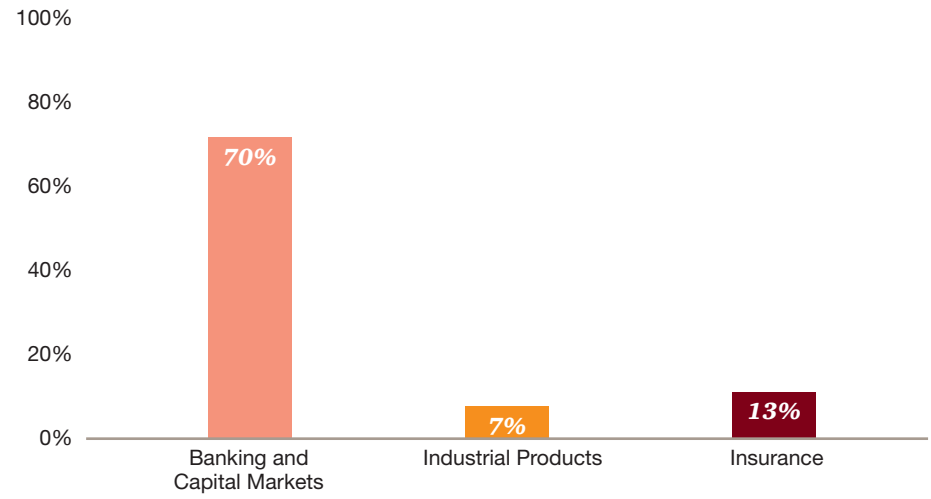
All of the companies in the Healthcare Payer and Energy sectors indicated misconduct of any type as a clawback trigger; however, it was only mentioned by 63% of EMC and Technology sector companies.

Misconduct



New types of recoupment policies have been developed by companies in recent years; the most common addresses inappropriate risk-taking by executives. Financial services firms led the way in developing these clawbacks, which generally permit recovery of compensation when an employee is found to have violated formal company risk policies or quantitative risk thresholds. Below are the industries with risk taking clawback triggers. None of the other industries mention this type of trigger.

Risk taking



Some recent examples of clawback policies from financial services firms with triggers based on excessive risk-taking:

"The negative adjustment resulting from risk related actions allows [the Bank] to recoup unvested equity awards from recipients whose inappropriate risk-taking activities have resulted in or are expected to result in a material adverse impact to [the Bank] in the future. By doing so, [the Bank] is able to add further risk-balancing to our incentive arrangements by accounting for both forward- and backward-looking risk adjustments."

"The Committee adopted a global incentive compensation discretion policy that sets forth standards for the exercise of managerial discretion in annual performance compensation decisions and specifically provides that all managers must consider whether an employee effectively managed and supervised the risk control practices of his or her employee reports during the performance year."

Other types of recoupment provisions recently adopted include:

"The Committee endorsed a set of principal elements for a recoupment policy applicable to senior executives in the event of misconduct resulting in a material violation of a company policy relating to manufacturing, sales or marketing of products that causes significant harm to the company."

"For these… awards, and other equity awards granted to our named executives beginning in 2013, added an adjustment provision that gives the HRC full discretion to cancel all or a portion of these awards if…the award was based on materially inaccurate performance metrics, whether or not the executive was responsible for the inaccuracy…"

Discretionary Features

Companies often consider whether and to what extent to allow for discretion when structuring a clawback provision. As discussed earlier, certain types of discretion may lead to undesired accounting results (i.e., mark-to-market treatment). So any discretionary features should be carefully considered, and as always, it is important to include not only the HR/benefits and legal teams when developing new clawback provisions, but the finance/accounting function as well.

When considering discretion in a clawback, we assessed the provision in two parts.

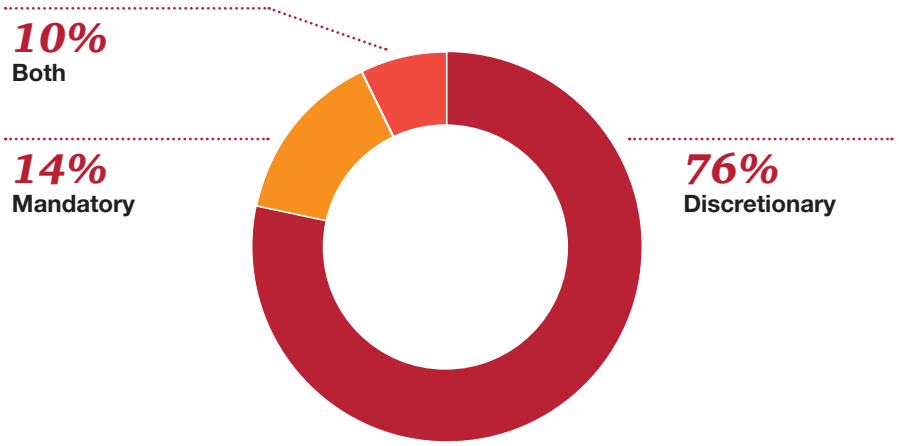
1. The clawback triggering event (that is — what will give rise to a potential recoupment?)
2. The potential consequence (that is — what, if anything, will be recouped if a triggering event occurs?)

We found that the events that trigger a clawback are generally not discretionary. We did not identify any provisions that provide for blanket discretion by the Board or Compensation Committee to determine whether a clawback event has occurred.

Conversely, we found many examples of discretion in determining the potential consequence, or extent of recovery of compensation once the triggering event has occurred. While some recoupment policies upon triggering of a clawback do not allow for discretion or judgment (i.e., they are mandatory), many others reserved the right to apply the recoupment policies on a case-by-case basis (i.e., they are discretionary). And some companies use both, depending on the clawback trigger.

Of the 100 companies studied, 76% provide discretion to determine whether or not to enforce their clawback policies on a case-by-case basis, 14% mandate the recovery of awards upon discovery of any clawback triggering behaviors or actions, and 10% provide discretion to determine whether or not to enforce their clawback policies for certain clawback triggers or awards and mandate the recovery of awards for others.

Discretion for clawback



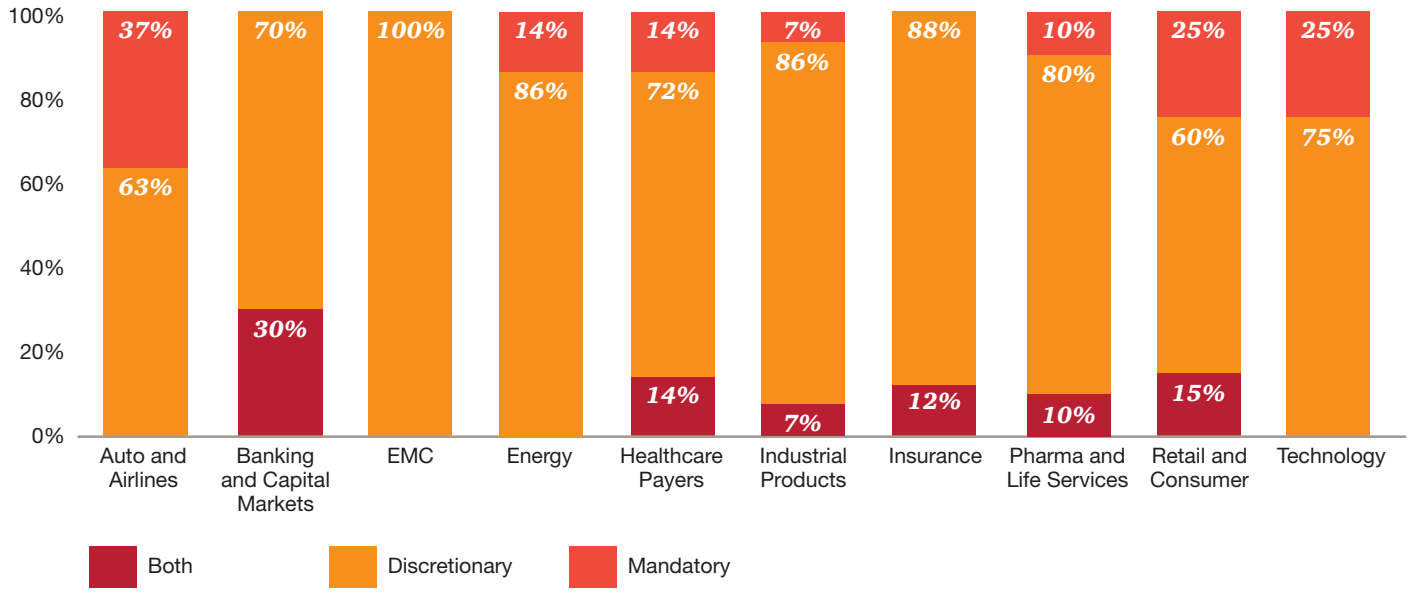
Below is an example of clawback that appears to be mandatory:

"[We] implemented the Executive Compensation Incentive Recoupment (Clawback) Policy during fiscal year 2009. Under the policy, the Committee requires all executive officers elected by the Board to reimburse any incentive awards if…"

An example where enforcement is discretionary:

"Under this policy, the Compensation Committee may seek to recover payments of incentive compensation if the performance results leading to the payment are later subject to a downward adjustment or restatement of financial or nonfinancial performance. The Committee may use its judgment in determining the amount to be recovered where the incentive compensation was awarded on a discretionary basis, as with awards under the Incentive Plan for fiscal year 2010."

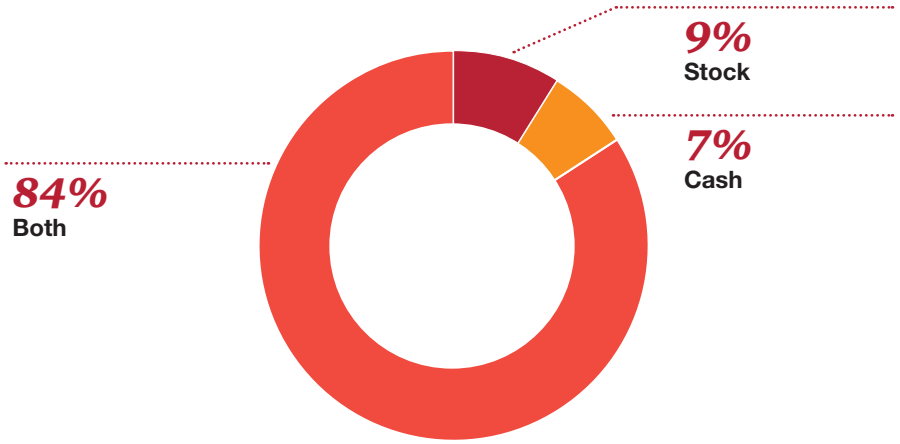
Discretion for clawback by sector



Award types subject to clawbacks

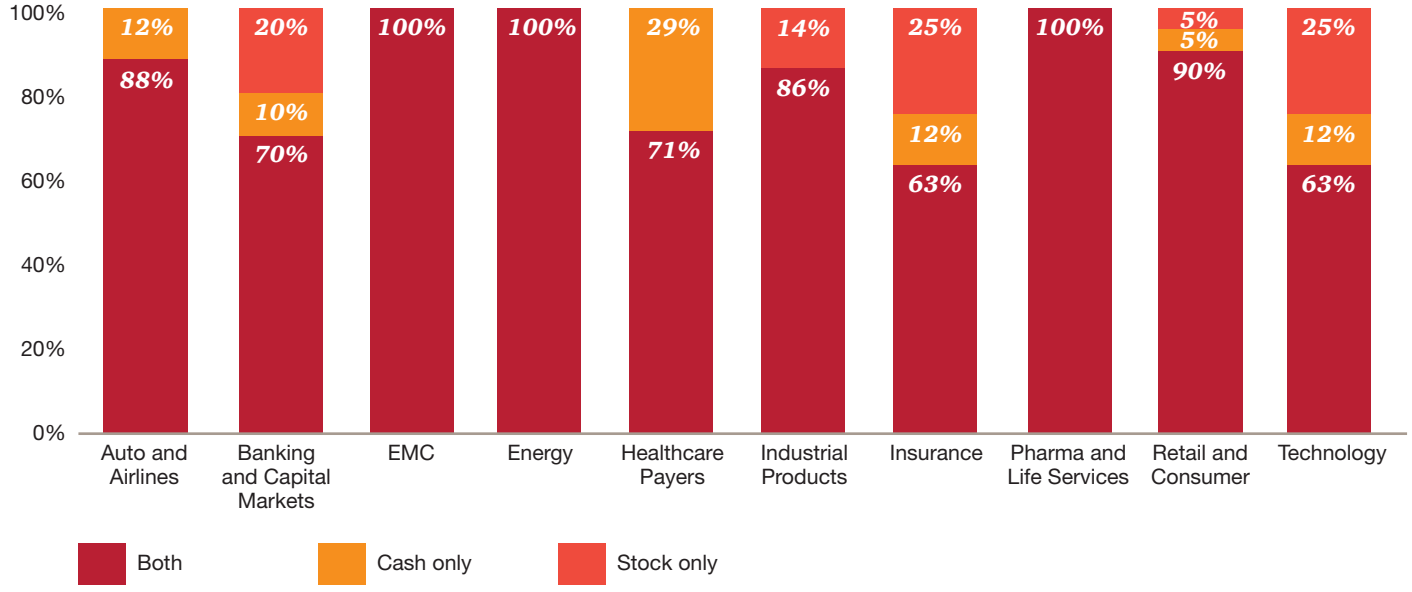
Awards subject to recoupment can be equity incentives (stock), cash bonuses, or a combination of both. The vast majority of companies studied (84%) may recover both cash and stock awards if clawback policies are triggered, while 9% only recover equity awards and the remaining 7% only recover cash incentives. Below is the breakdown of awards subject to clawback.

Types of awards subject to clawback



Sector results were similar to overall results, with 100% of the companies in three of the sectors reporting that both types of awards are subject to clawback. We found that 25% of companies in the Technology and Insurance sectors have clawback policies applicable only to stock compensation.

Types of awards subject to clawback by sector



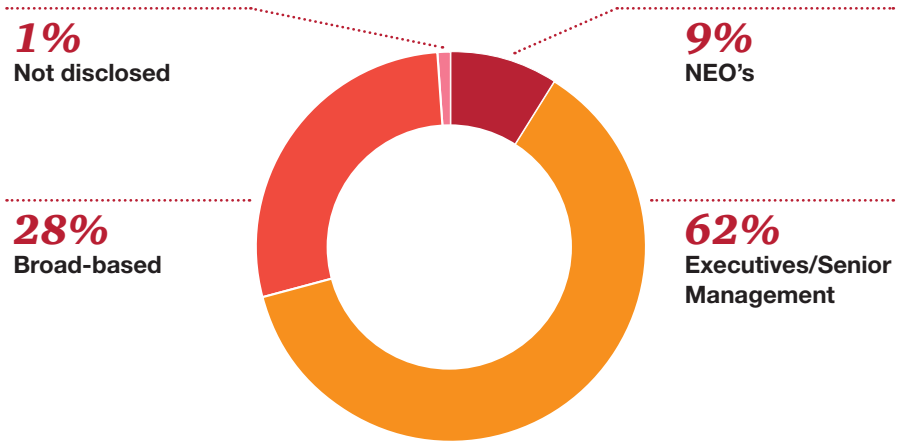
Employees subject to clawbacks

Clawback policies may only apply to certain levels of employees within the organization. In the companies studied, we identified three groups of employees:

1. Named Executive Officers ("NEO's"), which may include all named executive officers or just the CEO and CFO,
2. Executives/Senior Management only (inclusive of NEO's), and
3. Broad-based, which includes all employees or all participants.

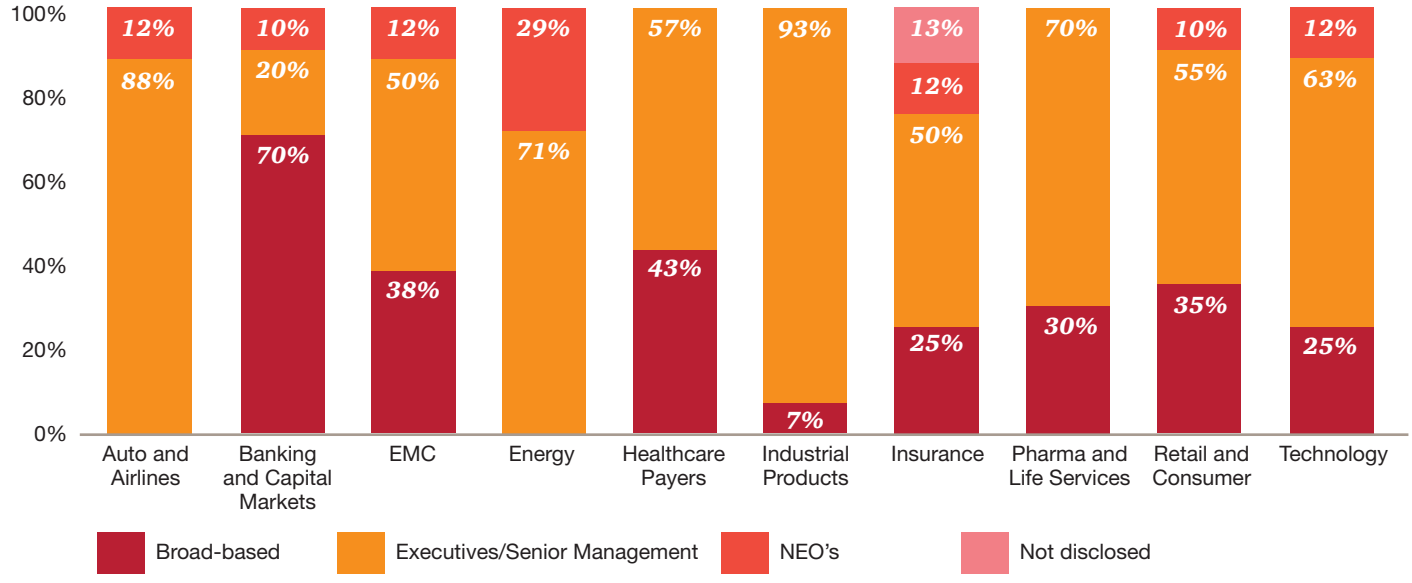
The majority of companies studied (62%) extend their clawback policy to just the Executives/Senior Management team, while 28% extend their clawback policies to their broad-based employee population, and 9% extend their clawback policies only to the NEO's. Below is the breakdown of the employees subject to clawback policies.

Employees subject to clawback



Sector results were similar to overall results, with the majority of companies in most of the sectors reporting that only Executives/Senior Management level employees are subject to a clawback. We found that 70% of the companies in the Banking & Capital Markets sector reported that they extend their clawback policy to the broad-based employee population.

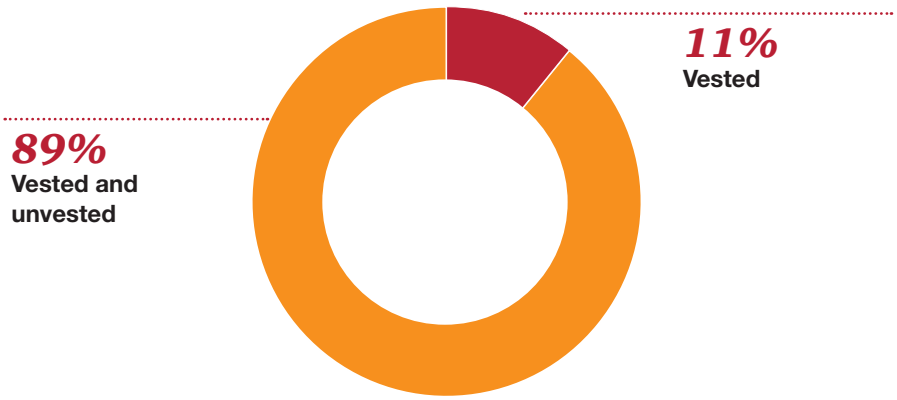
Employees subject to clawback by sector



Vesting Status

Recoupment policies can apply to all awards, regardless of vesting status. While some companies may only recover awards that have not yet vested, other companies may recover awards regardless of their vesting status. Of the companies studied, 89% of the companies may recoup awards regardless of whether the awards have vested, while 11% report recovery of only fully vested awards. Sector results generally followed overall results.

Clawback of vested/unvested awards



Look-back Period

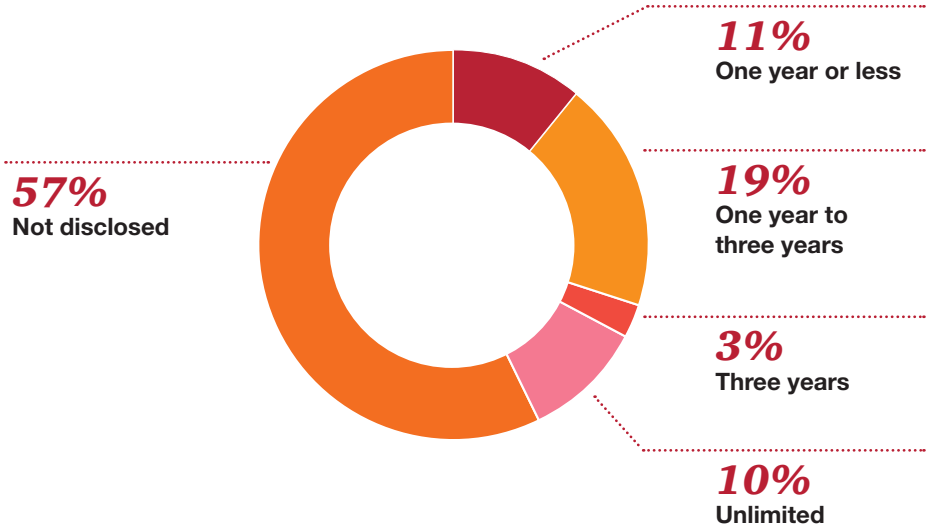
Recoupment policies may apply to awards granted during a particular period of time prior to the clawback triggering event (look-back period). Of the 100 companies, only 42% disclosed or referenced any look-back periods. Of the companies describing a look-back period, the most common look-back periods were in the range of one to three years. Also of interest, 10% of the companies specifically indicated that there was no limitation on the length of the look-back period.

Below are examples of look-back provisions:

"If an executive engages in any of the above "violation events", any option gains realized over the two years before the event and the value of any restricted stock vesting over the year before the event are required to be paid back"

"The [clawback] policy was updated to provide an expanded definition of misconduct to include serious violations of the Code of Business Conduct & Ethics and violations of law within the scope of employment at the Company. In addition, the three-year discovery limit for misconduct was eliminated."

Clawback look-back period



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Our expertise in tax, accounting, actuarial valuation, finance, operations and compliance; our leadership in human capital management, measurement and program development; and our disciplined approach to execution and change set us apart. With more than 8,000 Human Resource Services (HRS) practitioners in 100 countries — including over 1,500 HRS practitioners in the U.S. — PwC helps to align human capital strategies with business strategies and drive shareholder value for our clients.

PwC is at the forefront of understanding the strategic importance of human resources as a sustainable competitive advantage and has developed sophisticated assessment methodologies to assess the entire human resources function movement, from paper management (driven by compliance, regulations, and a control philosophy) to the enterprise mission of recruiting, retaining, retraining, measuring, motivating, and rewarding human resource capital. To assist organizations in aligning human resources to better meet customer requirements, PwC experts review all human resources activities to ascertain opportunities for automation, streamlining and reduction of non-value adding processes.

For more information, feel free to contact the authors:

Ken Stoler
Partner
(213) 270-8933
ken.stoler@us.pwc.com

Nicole Berman
Director
(973) 236-4202
nicole.s.berman@us.pwc.com

Ken Gritzan
Manager
(646) 471-4596
ken.gritzan@us.pwc.com

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