Rethinking Clawback Policies for the 2025 Compensation Season

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Last month, Institutional Shareholder Services ("ISS") issued an update to its FAQs on executive compensation policies clarifying that, for purposes of ISS's say-on-pay vote recommendation, clawback policies must explicitly cover all time-vesting equity awards to receive credit for a "robust" clawback policy. A clawback policy that meets only the minimum Dodd-Frank requirements will not be considered robust for ISS purposes since the listing exchanges' rules issued under the SEC's Rule 10D-1 do not cover exclusively time-vesting equity awards. This was consistent with ISS's view expressed in the context of its Equity Plan Scorecard policy.

However, this new off-cycle FAQ highlights a critical issue for public companies, boards and compensation committees as they prepare for the 2025 compensation season: **Is it time to adopt or amend a discretionary clawback policy?**

Mandatory vs. Discretionary Clawback Policies

As required by the national exchanges' and the SEC's rules promulgated under the Dodd-Frank Act, each issuer of publicly traded securities must have a clawback policy to recover erroneously awarded incentive compensation from current and former executive officers in the event of an accounting restatement. Issuers were required to adopt a clawback policy that complied with the listing standards no later than December 1, 2023. Recovery under the Dodd-Frank clawback policy applies only in the event of an accounting restatement and mandates the recovery of only the amount of excess incentive compensation that was based on the misstatements in the financial reporting.

In contrast, discretionary clawback policies provide broader authority, allowing boards the discretion to recoup compensation in additional scenarios such as fraud, reputational harm or violations of company policy. Many public companies—both before and since the Dodd-Frank rules were finalized—have adopted broader, discretionary clawback policies that provide for recovery of a broader range of compensation in other

circumstances. Other companies are considering whether to do so or amend what they currently have in place.

How Do Discretionary Policies Differ from Dodd-Frank Clawback Policies?

A discretionary clawback policy enables a company's board of directors or compensation committee to recoup variable compensation from executives or other employees in circumstances beyond mandatory recovery under the Dodd-Frank rules. These discretionary policies differ in several ways from the Dodd-Frank clawback policies. For example, they may feature:

- different triggers beyond a financial restatement, including fraud, misconduct that causes reputational or financial harm, violation of company policy or code of conduct, violation of law, violation of restrictive covenants, materially inaccurate financial statements (even in the absence of a financial restatement) or some combination of the above;
- a longer or shorter lookback period than the three-year period from the date the compensation was earned under the Dodd-Frank rules;
- a different class of covered individuals than the executive officers covered by the Dodd-Frank rules, which could be narrower (i.e., only the named executive officers) or broader (e.g., all members of senior management above a certain level, all participants in the incentive programs subject to the clawback or all employees); and
- a broader range of compensation subject to recovery than the amount subject to recovery under the Dodd-Frank clawback polices, including time-based equity awards, discretionary bonuses or all variable compensation.

Also, unlike the mandatory Dodd-Frank clawback policies, these discretionary policies typically provide committee discretion in determining whether to pursue recovery under the policy from any specific executive and in determining the amounts subject to recovery. A discretionary clawback may be part of the Dodd-Frank clawback policy, a separate standalone policy, or the terms may be included directly in an equity or cash incentive plan.

How Common Are Discretionary Clawback Policies?

Recent surveys highlight a growing trend among companies adopting policies that exceed Dodd-Frank requirements. In an internal study among 45 large-cap companies with market capitalization of greater than $10 billion, FW Cook found that **80%** maintained an expanded clawback policy that went beyond the SEC requirements. Of the companies in the survey, 66% had policies that covered a broader population than SEC requirements (either by title, coverage of all corporate officers or of the entire executive/leadership group) and 67% covered broader types of compensation (such as all cash and equity incentives). The most common clawback triggers were fraud or misconduct (64%), reputational, financial and other harm to the company (31%), violation of company policy/code of conduct (25%), violation of restrictive covenants (17%), financial restatement with misconduct (17%), financial restatement without misconduct (14%), materially inaccurate financial statement (11%), failure of risk management (6%), failure to supervise (6%) and termination for cause (3%).

Similarly, a recent study by Dragon GC published in the Harvard Law School Forum on Corporate Governance analyzed 401 S&P 500 companies that filed independent clawback policy disclosures within the 12-month period ended May 7, 2024. Over **70%** of the companies in their study have implemented clawback policies that go beyond the Dodd-Frank requirements. The report identified the five most common discretionary clawback triggers beyond financial restatements among the companies in the study: breaches of company policies or legal requirements (51.4%), breaches of fiduciary duty or fraud (48.6%), misconduct with reputational or financial harm (32.9%), crimes committed by the executives (23.9%) and harmful or inappropriate conduct (20%).[1]

Benefits of a Discretionary Clawback

Clawback policies are generally considered by shareholders to be a necessary corporate governance and risk management feature to deter and provide accountability for executive actions that are harmful to the company. Shareholder advisory firms, such as ISS, Glass Lewis and BlackRock, increasingly expect to see companies have clawback policies broader than what is required under the Dodd-Frank rules.

Shareholder Advisory Firm and Investor Views

As noted in the introduction to this Debevoise InDepth, ISS recently clarified in its FAQs on executive compensation policies that, for purposes of ISS's say-on-pay vote recommendation, clawback policies must explicitly cover all time-vesting equity awards

[1] The study also reported that 28.9% of the companies in the study had an "administrative enforcement" trigger.

in order to receive credit for a "robust" clawback policy. This is consistent with the view ISS had already taken for purposes of analyzing equity-based incentive program proposals under its Equity Plan Scorecard ("EPSC") policy. Under ISS's FAQs on Equity Compensation Plans, in order to receive EPSC points for the clawback policy factor, an issuer's clawback policy should authorize recovery upon a financial restatement and cover all or most equity-based compensation for all NEOs, including both time- and performance-vesting equity awards.

Glass Lewis's view on clawback policies under its 2025 U.S. Benchmark Policy Guidelines is that effective clawback policies should provide companies with the authority to recoup incentive compensation (whether time-based or performance-based) in the event of a restatement of financial results or similar revision of performance indicators upon which the awards were based. In addition, recovery should be available when there is evidence of problematic decisions or actions, such as material misconduct or a material reputational failure, material risk management failure or material operational failure, the consequences of which have not already been reflected in incentive payments and where recovery is warranted. Glass Lewis expects that this authority to recoup should be provided regardless of whether the employment of the executive officer was terminated with or without cause.

BlackRock's view, expressed in its 2024 Proxy Voting Guidelines for U.S. Securities, is that it favors prompt recovery from any senior executive whose compensation was based on faulty financial reporting or deceptive business practices. This includes Dodd-Frank-compliant policies and broader policies requiring recovery from (or the foregoing of) the grant of any awards by any senior executive whose behavior caused material financial harm to shareholders, material reputational risk to the company or resulted in a criminal investigation, even if such actions did not ultimately result in a material restatement of past results. BlackRock generally supports shareholder proposals on these matters unless the company already has a robust clawback policy in its view.

Companies should consider shareholder advisory firm and shareholder guidelines as part of policy design to avoid negative vote recommendations. Companies should clearly communicate the rationale for clawback policies in proxy statements to address shareholder concerns and secure support during say-on-pay votes.

DOJ's Compensation Incentives and Clawback Pilot Program

In addition, where companies are subject to a Department of Justice ("DOJ") enforcement action, the company may pay reduced fines by maintaining such a discretionary clawback. Beginning in March 2023 and continuing for three years, the DOJ has implemented a Compensation Incentives and Clawbacks Pilot program under which companies may seek additional fine reductions where they successfully claw back

(or even attempt to claw back) compensation from individual wrongdoers, including from culpable employees and others who had supervisory authority over the employees or business area engaged in the misconduct and/or knew of, or were willfully blind to, the misconduct.

Are There Any Issues with Enforcing Discretionary Clawback Policies?

State wage and hour laws can make it difficult to recover compensation paid to employees. It is generally easier to claw back incentive compensation than salary and wages, but still current and former executives may claim that recovery is not permitted under applicable law. Companies are better positioned to enforce clawback policies if there is a contractual basis for enforcement. Companies may require signed individual acknowledgments for clawback policies where possible and/or incorporate provisions requiring adherence to the clawback policy in employment agreements, equity plan and award agreements and separation agreements. This is the case with both Dodd-Frank policies and discretionary policies.

To aid with enforcement, companies can also consider including additional enforcement mechanisms in their clawback policy and acknowledgment agreements if the current or former executive fails to pay amounts when due—e.g., venue clauses, arbitration provisions and/or a requirement that the executive reimburse the company for expenses and legal fees.

The upcoming 2025 compensation season presents an opportunity for companies to reassess their clawback policies in light of evolving corporate governance expectations and regulatory developments. While mandatory Dodd-Frank clawbacks are necessary, discretionary policies offer companies greater flexibility to address misconduct, protect their reputations and align with shareholder priorities.

Next Steps:

1. Where companies have existing discretionary policies, companies should review these policies to confirm whether any standalone clawback policy or related terms set forth in an incentive plan are sufficiently rigorous under proxy advisor or shareholder guidelines. Consider whether any changes are appropriate for the organization.

2. For companies without existing discretionary policies, consider whether the board should have the authority to recoup compensation in other circumstances to comply with proxy advisor guidelines or to otherwise strengthen the company's corporate governance program. While industry and peer benchmarking can be

instructive, companies should design discretionary policies that reflect their own unique risks and organizational and compensation structures.

3. Engage with legal counsel to ensure that all clawback policies are enforceable under state laws and are integrated into agreements where appropriate.

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