

## CLIENT ALERT

### Navigating Compensation Governance

## What You Should Know About ISS's and DOJ's Clawback Policies

As companies adopt Dodd-Frank compliant mandatory clawback policies, some companies are also considering whether to adopt discretionary clawback policies compliant with Institutional Shareholder Services' (ISS) and/or Department of Justice's (DOJ) clawback requirements.

### Key Considerations for Boards and Management

- A company should assess whether to adopt an ISS compliant clawback policy by considering the following factors.
  - Companies rarely need to maintain an ISS compliant clawback policy to secure an ISS positive vote recommendation on a company's equity plan/share request proposal.
  - However, the adoption of an ISS compliant clawback policy could result in ISS supporting an incrementally larger share request (whether such incrementally larger share request would be material depends on a company's particular facts and circumstances).
  - ISS does **not** consider a company's clawback policy when determining its say-on-pay vote recommendation.
- Companies should assess the merits of whether to adopt a DOJ compliant clawback policy based on advice from legal counsel; however, companies should note the following:
  - The adoption of a DOJ compliant clawback policy is relevant in the context of DOJ's resolution of a criminal case against a corporate defendant.
  - Under a recently instituted pilot program, DOJ prosecutors may reduce criminal financial penalties to the extent a corporate defendant recoups compensation paid to an allegedly wrongdoing employee.
  - To be eligible for fine reduction, a subject company needs to have maintained a clawback policy covering virtually all employees and supervisory personnel and implemented certain compensation program policies.

## ISS Proxy Voting Policy on Compensation Clawbacks

A company's adoption of an ISS compliant clawback policy may confer certain limited benefits to the company in the context of an equity plan proposal (or share request). However, as discussed below, certain applications of the policy may prove problematic.

- **ISS Evaluation of Company Clawback Policy.** ISS evaluates clawback policies in the narrow context of equity plan proposals. Under its Equity Plan Scorecard (EPSC) methodology, ISS considers and scores 14 separate factors (one of which includes a company's clawback policy) to determine whether to recommend shareholders vote FOR or AGAINST a company's equity plan proposal. For a company's clawback policy to receive a positive score, the policy must authorize recovery upon a financial restatement of "all or most equity-based compensation for all NEOs (including both time- and performance-vesting equity awards)." A Dodd-Frank compliant mandatory clawback policy would not meet this requirement because recovery is limited to performance-based equity awards.
- **Limited Benefit to Maintaining ISS Compliant Clawback Policy.** The adoption of an ISS compliant clawback policy confers limited benefit to a company (under ISS policy):

- The EPSC factor related to clawback policies is moderately weighted relative to the other 13 factors. We estimate that the maximum point score for this factor comprises less than 4% of the maximum point score allowed under EPSC (e.g., 100 points). ISS will recommend shareholders vote FOR an S&P 500 company's equity plan proposal if the company scores at least 59 points under the EPSC.<sup>1</sup>

Therefore, companies rarely need to rely on scoring points for maintaining an ISS compliant clawback policy to garner sufficient points to receive a positive ISS vote recommendation. However, the adoption of an ISS compliant clawback policy could result in ISS supporting an incrementally larger share request. Whether such incremental increase would be material depends upon a company's particular facts and circumstances.

- ISS vote recommendation on a company's say-on-pay proposal is not affected by whether the company maintains an ISS compliant clawback policy (or any type of clawback policy).

- **Application of ISS Compliant Clawback Policy may be Problematic.** Beyond the limited benefit conferred to companies adopting an ISS compliant clawback policy, companies should note that the application of the policy is inherently problematic. As noted, ISS policy requires clawback policies to allow for the recoupment of time-based equity awards in the event of a restatement. However, unlike equity awards linked to financial performance metrics, a financial restatement does not result in the payment of "excess" incentive compensation in the case of time-based equity awards. Nonetheless, ISS policy implicitly requires companies to recoup some undefined quantum of time-based equity awards.

Therefore, unlike a Dodd-Frank compliant clawback policy, which is intended to prevent unjust enrichment through the recoupment of "excess" incentive compensation, an ISS compliant clawback policy includes a punitive element through the potential recoupment of equity awards not linked to financial reporting measures. Whether the punitive recoupment of compensation solely due to a

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<sup>1</sup> ISS will recommend shareholders vote FOR a Russell 3000 company's equity plan proposal if the company scores at least 57 points under the EPSC.

financial restatement is appropriate absent misconduct is a fair question for Boards and Compensation Committees to consider prior to implementing an ISS compliant clawback policy.

**Meridian comment.** Certainly, a business case can be made for the implementation of clawback/forfeiture policies beyond a Dodd-Frank compliant mandatory clawback policy. Many companies maintain discretionary clawback policies to prevent unjust enrichment in the case of a financial restatement and/or error in the calculation of incentive payouts and which cover an executive group broader than the requirements of Dodd-Frank. In addition, some company policies provide for the punitive recovery of compensation in the event of employee misconduct. *However*, unlike an ISS compliant clawback policy, these policies directly link the potential recovery of compensation to the objectives underlying the policies.

## Department of Justice Policy on Recoupment of Compensation

Earlier this year, the DOJ criminal division announced a 3-year pilot program (“Program”) under which the DOJ would offset criminal financial penalties by the amount of compensation recouped from employees who engaged in alleged wrongdoing. The nature and application of the Program is outlined below.

- **Is Not Law but an Internal DOJ Policy.** The Program is not a regulation or federal law. Companies are not required to adopt clawback policies of any kind in response to the Program. In addition, a new White House administration could terminate or modify the Program. Lastly, DOJ could modify or terminate the Program at the end of its 3-year term (i.e., March 3, 2026).
- **Applies Solely to DOJ Resolution of Criminal Investigation.** The Program kicks in when the DOJ enters into a criminal resolution with a corporate defendant. In drafting a criminal resolution, DOJ prosecutors may consider possible fine reductions when a subject company seeks to recover compensation from allegedly culpable employees. The Program does not extend to DOJ civil enforcement actions, which may result in restitution, forfeiture, disgorgement, agreed-upon payments and/or related penalties.
- **Compliance Potentially Reduces Criminal Fines.** A subject company may be eligible for reduction in a criminal fine if the company has:
  - fully cooperated with DOJ criminal investigation,
  - timely and appropriately remediated the corporate misconduct,
  - implemented a program to recoup compensation from
    - employees who engaged in wrongdoing in connection with the conduct under investigation, or
    - employees who both (a) had supervisory authority over the employee(s) or business area engaged in the misconduct and (b) knew of, or were willfully blind to, the misconduct, and
  - in good faith initiated the process to recoup compensation before the time of criminal resolution.

A subject company must also agree to implement compliance-related criteria in its compensation and bonus system<sup>2</sup> and to report annually to the Criminal Division about that implementation during the term of the criminal resolution.

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<sup>2</sup> Under the Pilot Program, a subject company may be required to implement, among other things: (i) a prohibition on bonuses for employees who do not satisfy compliance performance requirements; (ii) disciplinary measures for employees who violate applicable law and others who

- **Determination of Fine Reduction.** Under the Program, DOJ prosecutors will reduce a subject company's financial penalty by the amount of compensation the company is **attempting** to clawback from the employee who allegedly committed wrongdoing. However, if at the end of the resolution term, the subject company recovers from the employee a lesser amount, the financial penalty would be increased by the difference between the amount of compensation sought and the amount of compensation recovered. If a company's good faith attempt to recoup compensation is unsuccessful, DOJ prosecutors may in their discretion reduce the company's financial penalty by up to 25% of the amount of compensation the company attempted to clawback.

**Meridian comment.** To comply with DOJ requirements, a company must adopt a clawback policy that covers virtually all employees and all supervisory personnel. In contrast, the vast majority of discretionary clawback policies maintained by large public companies cover a far smaller employee group, typically limited to officers or senior management. So far, only a minority of large public companies have chosen to adopt a DOJ compliant clawback policy. Whether the prevalence of such policies increases over time is not clear.

We recommend companies consult with their legal counsel to determine the merits of implementing DOJ compliant clawback policy.

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(a) had supervisory authority over the employee(s) or business area engaged in the misconduct and (b) knew of, or were willfully blind to, the misconduct; and (iii) incentives for employees who demonstrate full commitment to compliance processes.