Australian Government

The clawback of executive remuneration where financial statements are materially misstated

DISCUSSION PAPER
December 2010

The clawback of executive remuneration where financial statements are materially misstated

Discussion Paper
Australian Government
December 2010

ISBN 978-0-642-74626-9

CONSULTATION PROCESS

Request for feedback and comments

The Government is seeking your feedback and comments on the issues outlined in this paper, particularly on the options that are outlined.

The information will inform the Government's proposed approach on these issues and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: COB 30 March 2011

Email:	clawback@treasury.gov.au
Mail:	Clawback of executive remuneration Corporations and Financial Services Division The Treasury Langton Crescent PARKES ACT 2600
Inquiries:	Inquiries can be directed to Ms Ronita Ram or Mr Richard Chung
Phone:	02 6263 3168/02 6263 2200

Foreword

The remuneration of company directors and executives is an issue which has caused considerable debate among shareholders, business groups and the wider community. The recent global financial crisis highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking.

The global financial crisis also highlighted the need to maintain a robust regulatory framework that promotes transparency and accountability on remuneration practices, and better aligns the interests of shareholders and the community with the performance and reward structures of Australia's corporate directors and executives.

Internationally, remuneration practices have been considered by various forums, such as the Group of Twenty (G20) and the Financial Stability Board (FSB). Both the G20 and the FSB have made recommendations, which are being implemented in Australia, to improve remuneration practices in the financial sector as part of their responses to the crisis.

In March 2009, Chris Bowen, the then Assistant Treasurer, asked the Productivity Commission (PC) to undertake an extensive review of Australia's director and executive remuneration framework. The PC's terms of reference were framed broadly to enable it to undertake an extensive review spanning all aspects of Australia's remuneration framework applying to companies that are disclosing entities.

The PC's final report concluded that Australia's corporate governance and remuneration frameworks are among the world's best. However, the report makes a number of recommendations to further strengthen Australia's remuneration framework. These recommendations are designed to improve board capacities, reduce conflicts of interest, encourage stakeholder engagement, improve relevant disclosure and ensure well conceived remuneration policies.

The Government fully understands the community's concerns about excessive and inappropriate remuneration practices. The Government is committed to ensuring that Australia's remuneration framework promotes responsible remuneration practices that are in line with community expectations as well as international best practice.

While Australia's current remuneration framework is fundamentally sound, some aspects require further strengthening and modernising to ensure that it meets the regulatory challenges of the 21st Century. As such, the Government intends to implement many of the PC's recommendations, and further strengthen six of the PC's proposals by expanding their scope, coverage and enforceability.

In addition, the Government is releasing this discussion paper on a further proposal, not identified by the PC, to clawback remuneration where a company's financial statements are materially misstated.

The Government is committed to improving Australia's remuneration framework and I welcome submissions on the proposals outlined in this paper.

The Hon David Bradbury MP
Parliamentary Secretary to the Treasurer

TABLE OF CONTENTS

PART 1: BACKGROUND INFORMATION

THE PRODUCTIVITY COMMISSION'S REPORT ON EXECUTIVE REMUNERATION AND THE GOVERNMENT'S RESPONSE

1.1 In March 2009, the Hon Chris Bowen, the then Assistant Treasurer, requested the Productivity Commission (PC) to undertake a review of Australia's executive remuneration framework. The PC released a draft report in September 2009 and undertook extensive consultation before releasing its final report in December 2009. The PC's final report proposes a number of recommendations to further strengthen Australia's remuneration framework.

1.2 The Government responded to the PC's report on 16 April 2010 and indicated its intention to implement most of the PC's recommendations. The Government also announced that it would undertake further consultation on an additional proposal to clawback bonuses paid to directors and executives in the event of a material misstatement in the company's financial statements. This discussion paper is the first step in the public consultation process to canvass the introduction of a clawback provision.

OTHER RECENT GOVERNMENT INITIATIVES

Reforms to termination benefits

1.3 The Government has already implemented certain initiatives to strengthen aspects of Australia's executive remuneration framework, such as the recent reforms to provide shareholders with greater power to reject excessive termination benefits — or 'golden handshake' payments — given to company directors and executives.

1.4 Such payments are awarded to outgoing company directors and executives at a time when they are no longer able to influence the company's future performance. They provide little benefit to the company and are often regarded by shareholders and the wider community as unjustified, particularly in circumstances of poor company performance.

1.5 The key elements of the Government's reform included:

- significantly lowering the threshold for shareholder approval of termination benefits — from seven years' total remuneration to one year's base salary;
- expanding the scope of individuals covered to senior executives (previously, only directors were captured by the regulatory regime);
- broadening the meaning of a 'benefit'; and
- implementing a number of other improvements to the framework, such as strengthening the integrity of the shareholder vote, facilitating recovery of unauthorised termination benefits and substantially increasing the relevant penalty provisions.

1.6 These reforms increased the accountability of company management in setting executive remuneration by empowering shareholders to reject excessive termination benefits to company directors and executives. The reforms received Royal Assent on 23 November 2009.

Australia's implementation of international financial sector remuneration standards

1.7 Australia has also played a key role in developing new global standards on pay in the financial sector. These standards have been implemented by the Australian Prudential Regulation Authority (APRA), ensuring remuneration arrangements do not lead to excessive risk taking within Australia's financial institutions.

1.8 The standards took effect from 1 April 2010.

1.9 APRA's remuneration standards apply to all Authorised Deposit-taking Institutions (ADIs), general insurers and life insurers. The key components of the APRA standards are:

- all regulated institutions will be required to establish a board remuneration committee and have in place a remuneration policy;
- the performance-based components of remuneration must be designed to align remuneration with prudent risk taking; and
- any performance-based components must be able to be adjusted to zero.

1.10 The remuneration requirements outlined in APRA's prudential standards and guidelines emphasise that risk must be managed in a way that supports long-term financial soundness. A key feature of APRA's approach is that performance-based bonuses should not vest until sufficient time has passed to measure the outcomes of business activities and decisions.

1.11 Although APRA's standards do not specifically relate to the clawback of remuneration that has already been paid out or the clawback of remuneration due to the occurrence of financial misstatements, the standards require that any unvested performance-based component of remuneration be at risk, and must be able to be reduced or eliminated if long-term performance objectives are not realised.

PART 2: OVERVIEW OF THE EXISTING AND PROPOSED FRAMEWORKS

THE CURRENT FRAMEWORK

2.1 Many aspects of measuring performance-based remuneration are reliant on information contained in company financial statements. If it is subsequently revealed that the financial statements were materially misstated, an executive should not be able to retain any excess remuneration contingent on that incorrect information. Material misstatements in the financial statements can occur either through deliberate misconduct or unintentional error, and may be large enough to influence the decision making of investors and other stakeholders. For example, the company's share price may be artificially inflated due to the misstated financial information, resulting in larger bonuses for directors or executives.

2.2 Under the current framework, shareholders are only able to recover overpaid remuneration amounts by commencing legal proceedings. There is currently no legislative requirement that provides for 'clawing-back' bonuses or other remuneration in the event of material misstatement in the financial statements. In recent times, some companies in other jurisdictions have introduced a clawback provision in their own constitutions; however, there is no obligation for all companies to do so.

2.3 The problem in relation to the current framework is that the onus is placed on shareholders to pursue legal action for the recovery of overstated bonuses. Such legal action is often a costly and arduous process for both shareholders and companies. Hence, the current corporate governance framework in relation to this issue may not produce optimal outcomes.

2.4 Based on information provided by the Australian Securities and Investments Commission (ASIC), material misstatements in the financial statements are not an uncommon occurrence among listed companies in Australia.

THE CLAWBACK PROPOSAL

2.5 A clawback would involve the creation of an obligation for directors and executives to repay to the company any remuneration that is based on financial information that turns out to be materially misstated.

2.6 This may be a recoupment of remuneration already paid to the executive, or a cancellation of an outstanding but unvested and unpaid future award. The corporate regulator would also have the power to commence legal action in order to recover these funds.

2.7 This paper seeks comments on whether a clawback requirement should be introduced in Australia, and if so, how it should be implemented. If a clawback requirement is considered appropriate, there are a number of implementation options which will need to be considered. These implementation issues are discussed in further detail in Part 3.

2.8 The Government will carefully consider the comments received in response to this discussion paper before deciding whether to proceed with a clawback requirement.

DISCUSSION OF THE CLAWBACK PROPOSAL

2.9 The clawback proposal aims to remove the onus to recover overpaid remuneration from shareholders. If implemented, it will strengthen the ability of shareholders to recover overpaid remuneration from directors and executives as a result of materially misstated financial accounts. The proposal is intended to simplify the process for shareholders to pursue the overpayment of remuneration and to hold directors and executives more directly accountable for repaying remuneration to which they are not entitled.

2.10 The proposal will also provide a further incentive for executives to fulfil their duties as outlined in the *Corporations Act 2001* (Corporations Act). Specifically, the proposal will prevent executive directors, who are responsible for ensuring that a company's financial statements are true and fair, from being rewarded for breaching this duty. It is also hoped that placing a greater value on the accuracy of financial statements will reduce the need for shareholder class actions arising from the public release of misleading financial statements.

2.11 As outlined in the next section, there has been substantial growth since 2006 in the number of clawback provisions used by companies in other jurisdictions. This growth has partly reflected the turbulent periods experienced by financial markets and the resultant increased scrutiny of pay practices of directors and executives of large companies.

2.12 This scrutiny has included a focus on the role of executive remuneration in fostering company risk. There is an argument that the introduction of a clawback policy may mitigate the effect of arrangements that could otherwise promote risky behaviour by company executives. For example, a clawback could discourage executives from taking questionable actions that may lift stock prices in the short term but would ultimately result in financial restatements[1].

2.13 This is in line with the argument that a requirement to clawback remuneration based on erroneous financial reporting is an important step in reining in excessive executive pay and can help shift management's focus from short-term profits to long-term growth and stability. This argument is based on the premise that executives would be less willing to undertake short-term minded risk for quick financial reward when a clawback arrangement is in place.

2.14 A clawback may be argued to be a preventive rather than a purely remedial or punitive measure. This is because the introduction of a clawback policy removes the incentive for executives to consider deliberately misstating company earnings in order to inflate their bonus figures. An introduction of a well-crafted clawback policy would ensure that executives engaging in misconduct would not be able to receive unearned company funds.

1 Investor's Working Group, *U.S. Financial Regulatory Reform: An Investor's Perspective*, p 23, Investor's Working Group, 2009, viewed 4 May 2010, http://www.cfainstitute.org/ethics/Documents/us_investors_working_group_report.pdf.

2.15 There is a moral force to the argument that shareholders should be able to clawback bonuses that have been paid on fictitious accounting profits. Most shareholders would find it unfair if corporations were to allow executives to retain remuneration that was issued erroneously. In this context, it is arguable that all companies should have appropriate governance structures to ensure that remuneration of executives has been objectively verified as based on correct underlying figures.

EXAMPLES OF THE IMPLEMENTATION OF CLAWBACK PROPOSALS IN OTHER JURISDICTIONS

2.16 The ability to clawback overpaid bonuses has been identified as an important regulatory development in some overseas jurisdictions. There have been several examples of governments, regulatory bodies and companies in other jurisdictions invoking or implementing a clawback provision where erroneous financial information is released.

United States

2.17 The most significant international development is the passing of financial reform legislation in the United States. The Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (commonly known as the Dodd-Frank Act), which was signed into law on 21 July 2010, primarily aims to reform the United States financial system to reduce the impact of future financial crises. It also contains significant proposals to change executive compensation and corporate governance rules for all public companies.

2.18 One of the reforms to the US executive compensation framework proposed in the Dodd-Frank Act is the provision to clawback overpaid remuneration when financial information is materially misstated. Section 954 of the Dodd-Frank Act, 'Recovery of Erroneously Awarded Compensation', requires national securities exchanges and associations to adjust their listing standards to prohibit listing for any company that does not fully disclose and implement a policy to recover performance-based remuneration paid to current or former executive officers based on erroneous financial data. If a company is required to issue an accounting restatement due to material noncompliance, it must recover any erroneously paid remuneration over the three-year period preceding the date of the accounting restatement. Further details can be found in Section 3: Issues for Consultation.

2.19 The Dodd-Frank Act's provision goes further than existing US law on clawback of remuneration. Section 304 of the Sarbanes-Oxley Act of 2002 has a similar requirement for companies to rescind bonuses or other incentive-based or equity-based compensation from executives in the event of an accounting restatement. However, the provision contained in the Sarbanes-Oxley Act applies only to Chief Executive Officers and Chief Financial Officers and requires an act of 'misconduct'. The proposal contained in the Dodd-Frank Act applies to all executive officers and does not require 'misconduct'. Additionally, the Dodd-Frank Act proposes that all incentive-based compensation during the preceding three-year period from the date of the accounting restatement be clawed back, while Sarbanes-Oxley only requires this for the preceding 12 months.

---

2 One hundred and eleventh congress of the United States of America, *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Pub.L.111-203, H.R. 4173), section 954, p 529, U.S. Government Printing Office, Washington, D.C., 2010, viewed 29 September 2010, http://www.gpo.gov/fdsys/search/pagedetails.action?granuleId=&packageId=BILLS-111hr4173ENR.

United Kingdom

2.20 The UK House of Commons has also considered the possibility of introducing a clawback-style requirement. A House of Commons Treasury Committee publication entitled *Banking Crisis: reforming corporate governance and pay in the City*[3] was released in May 2009 and contained a section that addressed the issue of clawbacks, bonus deferral and share-based remuneration in the banking sector. Included in this section was the exploration of a 'practice of recovering bonuses where, for example, the profits on which the bonus payment was made turn out to be illusory or do not materialise'.[4] The publication concludes that the use of mechanisms to defer or clawback bonus payments from executives should be encouraged to align the interests of executives more closely with those of shareholders.

European Union

2.21 The European Corporate Governance Forum released a statement in March 2009 concerning director remuneration in the midst of the global financial crisis. It believes that the substance of director remuneration should not be regulated at an EU level. Rather, it believes that it is for companies and their shareholders to determine what pay structure and levels are appropriate for their directors in light of their particular circumstances, and that general best practices should be followed so that appropriate consideration is given to the effects of performance-based pay and company risks. One such best practice is in relation to the clawback. The document states that 'to the extent possible under applicable employment laws and companies' legislation, the company should reserve the right, at the discretion of non-executive directors, to reclaim performance linked remuneration elements which were paid to or vested on executive directors on the basis of results that afterwards were found to have been significantly misstated because of wrongdoing or malpractice'.[5]

---

3 United Kingdom House of Commons Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City*, Ninth Report of Session 2008-09, House of Commons Treasury Committee, London, 2009, viewed 22 April 2010, http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf.

4 Ibid, p 23.

5 European Corporate Governance Forum, *Statement of the European Corporate Governance Forum on Director Remuneration*, point 7, dash number 6, European Union, Brussels, 2009, viewed 22 April 2010, http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/459&format=HTML&aged=0&language=EN&guiLanguage=fr.

Company constitutions

2.22 To reinforce their commitment to sound governance and in the face of shareholder activism and heightened regulatory scrutiny, the boards of many companies have voluntarily been imposing clawback policies. In the US, many of these policies have generally been more onerous than those mandated by section 304 of Sarbanes-Oxley. According to the *2009 Fortune 100 Clawback Policy Report* conducted by Equilar, 17.6 per cent of the US Fortune 100 companies had clawback policies in 2006; this had increased to 72.9 per cent by 2009.[6] Among the Fortune 100 companies that disclosed the implementation date, 94.9 per cent adopted their policy in 2006 or later. The majority of these policies allow companies to take back compensation in the event of a financial restatement or misconduct. The same report also noted that some clawback policies had applied to equity in addition to cash compensation, with financial and insurance companies the most likely to contain clawbacks.

2.23 The following are some notable examples of companies introducing clawback provisions into their own constitutions:

- In overhauling its pay practices for top management, Royal Dutch Shell has moved to introduce a right to clawback incentives paid within the previous 12 months in the case of any material misstatements.[7]
- British Telecom added clawback provisions to their remuneration schemes, allowing companies to reclaim bonuses paid out on profits resulting from 'decisions that proved damaging in the longer term'.[8]
- Pharmaceutical company GlaxoSmithKline imposed a clawback mechanism on its Chief Executive Officer (CEO) and Chief Financial Officer (CFO) that allows payouts to be reclaimed should 'problems arise after awards have been made'.[9]
- Electronic components distributor Premier Farnell has overhauled its remuneration scheme by introducing a clawback of any bonuses if they were paid on reliance of results which turn out to have been inaccurate.[10]

---

6 Equilar Inc., *2009 Fortune 100 Clawback Policy Report*, Equilar Inc., Redwood Shores, California, 2009, viewed 22 April 2010, http://www.equilar.com/Executive_Compensation_Reports.php.

7 T Bergin, 'Shell to curb pay, bonuses after investor revolt', Reuters, 16 February 2010, viewed 1 March 2010, http://www.reuters.com/article/idUSTRE61F1IB20100216.

8 A Wilson, 'Executive bonus clawbacks catch on beyond banks', The Telegraph, 31 May 2009, viewed 1 March 2010, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5417547/Executive-bonus-clawbacks-catch-on-beyond-banks.html.

9 G Ruddick, 'GSK to overhaul pay amid anger at executive bonuses', The Telegraph, 9 March 2009, viewed 1 March 2010, http://www.telegraph.co.uk/finance/newsbysector/pharmaceuticalsandchemicals/4939449/GSK-to-overhaul-pay-amid-anger-at-executive-bonuses.html.

10 J Sibun, 'Premier Farnell to claw back bonuses', The Telegraph, 30 May 2009, viewed 1 March 2010, http://www.telegraph.co.uk/finance/newsbysector/mediatechnologyandtelecoms/5413252/Premier-Farnell-to-claw-back-bonuses.html.

2.24 A number of major investment banks also have clawback provisions, although they relate more to the circumstances where short-term profits are not sustained than the matter of material financial misstatements. According to its compensation report, for example, UBS AG clawback a portion of a cash award when executives fail to achieve specific profit targets.[11]

11 A Leondis and M Collins, 'Spending Bonus Cash Becomes Risky as Clawback Rules Increase', Business Week, 8 January 2010, viewed 1 March 2010, http://www.businessweek.com/news/2010-01-08/spending-bonus-cash-becomes-risky-as-clawback-rules-increase.html.

PART 3: ISSUES FOR CONSULTATION

3.1 Part two explored the possible need for a clawback mechanism, the rationale for any such reform, and international examples of where clawback mechanisms have been implemented.

Key question

Do you believe that a reform to clawback director and executive remuneration when financial statements are materially misstated is needed to further enhance Australia's executive remuneration framework? Would the benefits of such a reform outweigh the compliance costs?

3.2 There are a number of questions in relation to the implementation of such a provision. Among these are:

- how the clawback should be introduced;
- whether it should be enshrined in legislation;
- which members of the executive board it should apply to;
- what kind of event would trigger a clawback; and
- the appropriate amount of the clawback.

3.3 This section provides a range of options in relation to each issue.

HOW WOULD THE PROVISION BE IMPLEMENTED?

3.4 Broadly, there are three ways in which a clawback provision could be introduced. These methods involve either 'black letter law', best practice guidance, or a mixture of both. The method chosen will also affect which regulators and parties are involved in enforcing the clawback.

3.5 A related question is whether the clawback provision should be applied to publicly listed companies only or whether it should also apply to all disclosing entities, large proprietary companies and registered schemes that are required to prepare financial reports under section 292 of the Corporations Act. The argument for applying the clawback to publicly listed companies only is that they are the only companies that are realistically large enough to practically warrant a clawback of bonuses in the event of material misstatements. In the scenario that the provision should be extended beyond listed companies to all reporting entities, the provision would need to be enacted through the Corporations Act. This is because a clawback that is enforced through the Australian Securities Exchange (ASX) Listing Rules would apply to listed entities only.

Legislation

3.6 The first option is to enshrine a provision to clawback bonuses in the event of a financial misstatement in the Corporations Act.

3.7 If the provision were to be drafted through legislation, there should be sufficient detail to minimise confusion as to how the clawback would be practically applied. The Government would publicly consult on such details in finalising the draft legislation.

3.8 A clear and detailed legislative requirement should minimise the possibility of executives challenging the clawback in court. One of the major benefits of the clawback would be to remove the current costly and arduous litigation processes that shareholders currently face in recovering overpaid remuneration.

3.9 If the clawback requirement were inserted into the Corporations Act, the Australian Securities and Investments Commission (ASIC) would need to be given powers to clawback bonuses where a company failed to do so in a timely manner.

ASX Listing Rules

3.10 An alternative to introduction through legislation would be for the ASX to insert a clause into its Listing Rules requiring companies to clawback bonuses in the event of a material misstatement. This option would impose a clawback rule on all ASX-listed companies in Australia as the Listing Rules are enforceable under the contract between the ASX and listed entities. The Listing Rules are also enforceable against listed entities under the Corporations Act. Hence, if legislation were to be referenced in a clawback dispute under this option, the law would be enforced through the powers handed to the ASX and the application of their Listing Rules.[12]

3.11 It is important to note that, if implementation through the ASX Listing Rules or Corporate Governance Principles is considered to be the most appropriate method, then the Government would recommend to the ASX or ASX Corporate Governance Council (CGC), respectively, to insert a clawback provision. The final decision to implement the clawback provision would ultimately be a matter for the ASX or ASX CGC.

ASX Corporate Governance Council Principles

3.12 A second alternative to the introduction of the clawback through legislation would be for the requirement to be enforced through the Corporate Governance Principles and Recommendations of the ASX CGC. The role of the CGC is to develop and maintain corporate governance guidelines for listed entities in Australia.

3.13 Under this option, the ASX CGC could introduce an 'if not, why not' recommendation, specifying that listed companies should clawback bonuses from their executives where based on financial information that turns out to be materially misstated. Listed companies that fail to do so would need to provide an explanation.

12 Australian Securities Exchange, *ASX Listing Rules*, Australian Securities Exchange, Sydney, 2010, viewed 28 April 2010, http://www.asx.com.au/supervision/rules_guidance/listing_rules1.htm.

3.14 The option to regulate the clawback provision via the Corporate Governance Principles is intended to give companies greater liberty in designing and implementing their own provisions to recover erroneously awarded remuneration. This would also complement the increased self-regulation seen in the number of companies voluntarily inserting clawback provisions into their constitutions.

3.15 A downside to implementation through the CGC is that directors and executives would not be legally obligated to return overpaid bonuses, nor would the company be threatened with removal from the exchange due to non compliance with the Listing Rules.

Option A.1

Legislation via the Corporations Act

Option A.2

ASX Listing Rules

Option A.3

ASX Corporate Governance Council Principles

WHO WOULD THE PROVISION APPLY TO?

3.16 The primary question in relation to the breadth of the clawback proposal is whether all Key Management Personnel should be subject to the clawback in the event of a material misstatement, or whether the clawback should only apply to the CEO and the CFO, as they are directly responsible for the accuracy of the financial statements. A further question is posed as to whether the clawback should also be applied to former executives who have left the company but may have served during the relevant period in which the misstatement occurred.

3.17 As mentioned in part two, the Dodd-Frank Act proposes the extension of the clawback provision already in place via the Sarbanes-Oxley Act to apply to all current and former executives for the preceding three-year period. However, it is arguable that executives other than the CEO and CFO should not be subject to a clawback as they are not directly responsible for ensuring that the financial statements are accurate and not materially misstated.

3.18 There are potential drawbacks associated with each of the available options. If the clawback applied only to the CEO and CFO, it may provide a disincentive for qualified persons to take on these specific roles. On the other hand, applying the provision to all Key Management Personnel would be more costly and onerous to apply. In regard to whether the clawback should be applied to executives who have subsequently left the company, a current executive could feel pressure to resign if the policy were not applicable to former personnel.

Option B.1

Current CEO and CFO only

Option B.2

All current Key Management Personnel

Option B.3

B.1 or B.2, but all current *and* former personnel

HOW WOULD THE CLAWBACK EVENT BE TRIGGERED?

3.19 A key issue to be considered is how the provision to clawback bonuses from executives will be triggered. In considering the triggering of the clawback event, it is also necessary to consider practical questions in regard to what attributes and circumstances will or will not make a director or executive liable to the clawback.

A 'material misstatement' event

3.20 A key question is what would constitute a 'material misstatement'. The term 'material' is defined in the accounting standards set out by the Australian Accounting Standards Board (AASB)[13] as follows:

Material	Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.	AASB 101.7, AASB 108.5, AASB 1031.A

3.21 In this context, a material misstatement in the financial statements is an error in the financial statements that would be large enough to influence the economic decisions made by users on the basis of that information.

3.22 Generally, a material misstatement is publicised when a company makes a subsequent announcement to the market that it is re-releasing its financial statements due to the discovery of a materially misstated error. If members of the executive board had received performance-based remuneration in which all or a portion of the remuneration was quantitatively determined through the use of numbers from the financial statements, then the company will be obliged to clawback all or part of that remuneration.

13 Australian Accounting Standards Board, *Glossary of Defined Terms from Australian Accounting Standards*, p 38, Australian Accounting Standards Board, Melbourne, 2008, viewed 29 April 2010, http://www.aasb.gov.au/admin/file/content102/c3/AASB_Glossary_2009_Q4.pdf.

3.23 However, the actual date considered the definitive 'material misstatement' event could occur on one of several occasions. It could be the date on which the material misstatement in the company's financial reports is publicly announced to the market, or it could be the date on which the financial statements of the company are re-issued to eliminate the misstatement and fulfil reporting requirements. A third option would be to determine the material misstatement event that triggers the clawback provision to be whichever of the above occurs first.

Option C.1

Public announcement of the material misstatement of the erroneous financial statements.

Option C.2

Release of the recast financial statements by the company.

Option C.3

Whichever first occurs.

A trigger other than a 'material misstatement'?

3.24 Despite the emphasis on the element of a material misstatement in the financial statements as the trigger for the clawback of remuneration, it may be worth considering alternative triggers for the clawback provision. This is primarily due to the controversy surrounding the use of 'material misstatements' and the subjectivity surrounding its definition. Alternatives for the trigger could include a greater emphasis on acts or prohibited activities or deliberate misconduct by the executive, or a failure to meet specific profit targets or other performance measures. Suggestions are sought on potential alternative triggers.

How would the clawback amount be determined?

3.25 Another key question is how to determine the precise quantum of bonuses to be clawed back. This is a potentially difficult issue to address, due to the complicated and intertwined nature of remuneration packages. A practical application of a clawback provision may be particularly difficult when bonuses are determined through a method that takes a company's share price movements into account, as there may be difficulties in establishing causal links between the misstated information and share price movements. However, there are options to overcome these difficulties, as outlined below. Many of these options are consistent with methods adopted in overseas jurisdictions.

3.26 What follows is a summary of different possibilities or methods for quantifying the clawback of bonuses, as well as an attempt to address other pertinent issues that accompany the implementation. An implementation of the clawback provision could adopt one or a combination of the following methods.

An amount in excess of what would have been paid under the restated results

3.27 The section of the Dodd-Frank Act that legislates for the recovery of erroneously awarded compensation states that the company that is required to prepare an accounting restatement must recover from the executive the amount in excess of what would have been paid to the executive under the accounting restatement.

3.28 Under this approach, the amount to be clawed back would be the difference between what has been awarded under the materially misstated financial statements and what should have been awarded under the re-stated financial statements.

3.29 Reconciling the quantity of the remuneration should not be overly complicated if the remuneration amount was determined through the use of accounting-based metrics. If the accounting restatement has caused a change in a metric that helps determine an executive's bonus (such as earnings per share, return on equity, earnings before interest, taxes, depreciation and amortisation, and net profit after tax) then the bonus to be paid back to the company would be determined through a computation of the bonus formula that incorporates the accounting metrics.

3.30 What is less clear is how overpaid remuneration that is caused by a material misstatement will be quantified when performance-based remuneration is based on changes in the company's share price. What is also less clear is how the issue of stock options as compensation, as is regulated in the Dodd-Frank Act, will be reconciled if that issue occurred on the basis of materially misstated financial information. These issues pose implementation difficulties, and as such, some further alternate options are identified below.

A 'bright line' test

3.31 An alternative to the reconciliatory method is the adoption of a 'bright line' measure or a number of 'bright line' measures that could potentially be implemented in tandem. A 'bright line' measure may be easier to apply where the exact nexus between the misstatement and the effect on a company's share price cannot be definitively quantified.

3.32 The following lists several possible 'bright line' measures to clawback bonuses:

- (Option D.2.1:) Adopt a threshold to link the clawback amount to be disgorged by executives to the percentage of material misstatement in proportion to the whole financials. For example, the percentage of bonuses to be clawed back could be ten times the percentage of the misstatement. This means that if the material misstatement is eight per cent, the amount to be disgorged from the executive should be 80 per cent of their performance-based remuneration. In the scenario that the material misstatement exceeds more than ten per cent, a flat 100 per cent of the bonus would be disgorged.
    - A secondary option to this would be to set a specified threshold and then require the need for shareholder approval if the director or executive wants to retain a greater quantity of the rescinded portion of their remuneration. This is similar to the Government's recent reforms to termination benefits where amounts greater than the threshold can be provided to directors and executives, provided shareholder approval is obtained.

- (Option D.2.2:) Although there are causation issues surrounding the determination of the impact of a material misstatement on a company's share price, there are several possible methods for which share-based bonuses could be rescinded:
  - Look at a set indicator other than share price (for example, net profit after tax) in quantifying the clawback amount.
  - Clawback profits from the sale of shares that was awarded as bonuses during the period of material misstatement.
  - Freeze share options that were allocated to executives as performance-based remuneration during the period of material misstatement.

A clawback from total remuneration

3.33 An alternative option would be to adopt a threshold that is similar to the 'bright line' measure where the clawback is linked to the percentage of the material misstatement (Option D.2.1). The difference here would be that the clawback amount to be disgorged from executives would be taken from *total* remuneration, rather than performance-based remuneration only.

3.34 As the amount of the executive's total remuneration is likely to be much larger, a more appropriate measure may be to multiply the percentage of pay to be clawed back by a smaller amount, such as five. This means that if the material misstatement is eight percent of the total financials, the amount to be clawed back from total remuneration would be 40 per cent. If this option were to be explored further, consultation will be extensive to ensure that the right percentage figure is applied to the provision.

3.35 This method may be preferable in order to address any squeezing of the 'balloon effect' — the transfer of remuneration funds to fixed pay categories. In other words, this method would discourage the shifting of remuneration and aim to still maximise alignment between company and shareholders' interests through the use of pay.

Option D.1

The amount in excess of what would have been paid under the restated financial results.

Option D.2

A 'bright line' test:

Option D.2.1: Adopt a threshold that links the amount to be clawed back to the percentage of material misstatement

Option D.2.2: Adopt a specific method to clawback share-based remuneration, including the use of a set indicator, clawing back profits realised from the sale of shares, and freezing share options allocated during the period of the material misstatement.

Option E.1

The quantity of remuneration to be clawed back should be determined from the executive's pool of *total* remuneration, rather than performance-based remuneration only.

Option E.2

The quantity of remuneration to be clawed back should be determined from the executive's pool of performance-based remuneration only.

An underpayment in the executive's bonus caused by a material misstatement

3.36 While the primary focus of this paper is overpayments to executives, it is also necessary to consider a scenario whereby a material misstatement in the financial statements has resulted in the underpayment of the performance-based remuneration of a director or executive. This may be due to an understatement in an accounting metric that is used to calculate the executive's bonus, as opposed to an overstatement. If this case arises, there are two broad options that should be considered to resolve this discrepancy.

3.37 The first option is to reconcile the discrepancy in the remuneration amount by allowing the company to pay to the executive the extra remuneration amounts that the executive is entitled to. As management is exposed to the risk of a clawback of their pay when there is a downward revision to the financial statements, there is an argument that they should be entitled to benefit from an upward revision to the financial statements.

3.38 The second option is to prohibit the executive from receiving the extra remuneration amounts to which they would have been entitled. The argument for supporting this option is that management should not be rewarded for a material misstatement in the financial statements, which may have caused shareholders to trade on incorrect information.

Option F.1

Allow the company to pay to the executive the extra bonus amounts that the executive is entitled to.

Option F.2

Prohibit the executive from receiving the extra remuneration amounts.

When would the clawback amount need to be repaid?

3.39 In the event that an executive is required to repay bonuses to the company, it is necessary to consider the timing in relation to when the disgorged bonuses must be returned to the company. Remuneration could be clawed back from executives immediately following the clawback event once the amount has been quantified definitively. Alternatively, bonuses could be clawed back following a specified time period such as after the corrected financial statements have been cleared and released to the market, or after the executive reaches the end of their term. The timing of the repayment should be made clear so as to protect an executive from the belated assertion of a clawback claim long after the issue is discovered.

Option G.1

An executive must repay the remuneration immediately after the company is aware that the clawback event has been triggered.

Option G.2

An executive must repay the remuneration following a specified time period.

A deliberate intention to mislead or act of misconduct

3.40 An important question to consider is whether an intention by an executive to mislead users through the release of false financial information should be taken into account in the clawback provision.

3.41 This question is pertinent because the material misstatement in the financial accounts may be due to, at one extreme, a deliberate attempt by a director or executive to manipulate the results presented in the financial statements in order to bolster their own pay package, which may be vested in the financial outcomes of the company.

3.42 An example is a case taken by the US Securities and Exchange Commission (SEC) against Maynard L Jenkins, former CEO of the CSK Auto Corporation in 2009.[14] In this case, the SEC charged CSK executives of orchestrating an accounting scheme to inflate the company's financial results and overstate its net income. Pursuant to the existing section 304

---

14 Securities and Exchange Commission, Press Release: 'SEC Seeks Return of $4 million in Bonuses and Stock Sale Profits From Former CEO of CSK Auto Corp.', Securities and Exchange Commission, Washington, D.C., 2009, viewed 1 March 2010, http://www.sec.gov/news/press/2009/2009-167.htm.

of the Sarbanes-Oxley Act, the SEC sought to disgorge all of Jenkins' bonuses, other incentive-based remuneration and profits realised from the sale of CSK stock during the period of fraudulent behaviour. This is an example of where a clawback would be pursued due to an act of deliberate misconduct on the part of a company's executive.

3.43 On the other hand, however, it may be possible that a material misstatement in the financial statements may be caused by an innocent error, or unexpected circumstances free of any act of misconduct. As this error would have been unintentional, one view is that this should not justify a clawback of bonuses from any directors or executives as they were entirely free from fault from the misstatement.

3.44 However, there is an argument for disregarding the need for an intention element, as whether there was an intention to defraud shareholders or not, the executive has received an unearned windfall that should be repaid.

3.45 Moreover, existing laws already deal with circumstances of deliberate misstatements of accounts and set out penalties for failing to comply with accounting standards or distributing misleading information.

3.46 An intention element also creates evidentiary issues, being far more difficult to prove and potentially resulting in unnecessary litigation. If a clawback policy does require misconduct to trigger disgorgement, the policy should carefully set out the indicators of the requisite intention.

Option H.1

Intention element necessary for the clawback provision to be invoked.

Option H.2

Intention element of 'misconduct' not necessary.

RE-ISSUE OF FINANCIAL STATEMENTS DUE TO SUBSEQUENT EVENTS

3.47 Another important issue to consider is a situation whereby the financial statements of a company may be required to be re-issued due to the occurrence of subsequent events that may affect the company's financial accounts for the previous financial year. These may be events occurring after the date of the financial report but affecting the period relevant to that financial report. The auditing standards framework has a standard covering this topic — ASA 560 Subsequent Events.[15] An example of a subsequent event could be the collapse of company X for which company Y is a major creditor after company Y's financial report date — this would significantly affect company Y's bad debts provisions.

3.48 As seen from this example, it is possible that information in the financial statements may be restated due to an unforeseen subsequent event or a change in circumstances. Similar to the previous subsection in which the issue of misconduct was raised, it is possible that executives may have had no fault in the occurrence of a subsequent event that would have a

15 Auditing and Assurance Standards Board, Auditing Standard ASA 560 *Subsequent Events*, Auditing and Assurance Standards Board, Melbourne, 2008, viewed 5 May 2010, http://www.auasb.gov.au/admin/file/content102/c3/ASA_560_27-10-09.pdf.

material impact on a company's financial accounts. It may hence be arguable that, in these circumstances in which subsequent events occur, directors and executives should be exempt from a clawback of their bonuses. On the other hand, however, it may be possible that some subsequent events may be connected with preceding company actions or be a consequence of decisions made at the senior level, such as a poor assessment of credit risk.

3.49 Again, if executives' interests are to be aligned with those of shareholders, it may be that the culpability of executives is irrelevant when considering whether an unwarranted bonus should be repaid.

Option I.1

A subsequent externally-based event should exempt executives from the clawback provision.

Option I.2

A subsequent externally-based event should not exempt executives from the clawback provision.

How far back should the clawback provision apply?

3.50 It is necessary to consider the duration of the period that the clawback provision should be applied to. This timeframe could be the 12 months preceding the 'material misstatement' event (which was considered in detail under Option C).

3.51 Option J.2 proposes to apply the clawback to the three-year period preceding the date of the material misstatement. This option is consistent with the proposal in the Dodd-Frank Act. This option would also be consistent with the timeframe set out in the Government's reforms to termination benefits for directors and executives.

3.52 A matter of concern is whether a cap should be imposed on how far back a clawback can be applied. Although unlikely, it is possible that a clawback could be applied when a material misstatement occurs for a set of financial statements that dates back 20 years. However, it may be desirable to disregard the discovery of material misstatements in financial statements that exceed a certain period of time (possibly three or five years). The argument for supporting this approach is that there would be difficulties in recovery and enforceability given the long period of time that has lapsed since the original event.

Option J.1

The 12-month period preceding the 'material misstatement' event.

Option J.2

The three-year period preceding the 'material misstatement' event.

Option J.3

Do not impose a time limit on how far back a clawback of executive remuneration can be applied.

WHO IS RESPONSIBLE FOR APPLYING THE CLAWBACK OF BONUSES?

3.53 As previously mentioned, a key advantage of the clawback proposal is that it removes the onus on shareholders to litigate where errors in the financial statements have caused a discrepancy in pay. One option is to place the onus on the company (which may be represented by its remuneration committee, or an officer responsible for risk management) to recover any bonuses which were based on financial information that subsequently turned out to be materially misstated. It is envisaged that ASIC would pursue the recovery of overpaid bonuses only when the company fails to fulfil its responsibilities.

3.54 An alternative option is to place the onus directly on the directors and executives themselves, rather than the company, whilst providing robust penalties for a failure to do so.

3.55 It may also be necessary to consider whether there should be a mechanism for parties other than ASIC to request that a company's financial statements should be reviewed to ensure adequate compliance with reporting requirements. Third parties may separately wish to make the case that remuneration should be clawed back due to materially misstated financial statements. Potential third parties are wide ranging and could include company shareholders, whistleblowers and creditors. The most appropriate course of action for concerned third parties would be to raise the issue with ASIC, who would investigate further depending on whether they deem the matter to be of substantial concern.

Option K.1

Place the onus on the company to reconcile the bonuses of executives if there are discrepancies as a result of the financial misstatement, with ASIC intervening only if the company fails to fulfil its responsibility.

Option K.2

Place the onus on directors and executives themselves to repay remuneration, with strict penalties for non-compliance and enabling ASIC to take action if the individual fails to do so.

POSSIBLE EXCEPTIONS TO THE CLAWBACK

3.56 It is worth considering how such a material misstatement can affect the metrics of the financial statements that determine the remuneration amounts received by company executives. Such metrics include earnings per share, return on equity, net profit after tax and earnings before interest, taxes, depreciation and amortisation. While highly unlikely, it is possible a material misstatement in the financial statements may not actually affect the metric that affects the executive's remuneration. This would thereby make the remuneration amounts of the executives correct, assuming the amount has been calculated correctly. In this scenario, it seems unlikely that a clawback should be necessary, since the remuneration amounts are technically correct. Suggestions for other reasonable exceptions to the clawback provision will be sought in the public consultation process.

Table 1 — Summary of options

Key question	
Do you believe that a reform to clawback director and executive remuneration when financial statements are materially misstated is needed to further enhance Australia's executive remuneration framework? Would the benefits of such a reform outweigh the compliance costs?	
Means of Implementation	
Issue	**Option A.1**
The clawback could be enshrined into law, it could be mandated through stock exchange listing rules or guidance could be provided through the best practice guidelines.	Enshrine a provision to clawback bonuses into the Corporations Act.
	Option A.2
	Have the ASX insert a clause requiring companies to clawback bonuses into their Listing Rules.
	Option A.3
	Introduce the provision through the Corporate Governance Principles and Recommendations that are released by the ASX Corporate Governance Council.
Extent of application towards senior officials	
Issue	**Option B.1**
The clawback provision could apply to the CEO and CFO as they are the executives directly responsible for the financial statements, or a broader application could see all key management personnel subject to the clawback. The clawback provision could apply to current executives only, or be extended to current and former executives.	The current CEO and CFO only.
	Option B.2
	All current Key Management Personnel.
	Option B.3
	B.1 or B.2, but all current *and* former personnel.
A 'material misstatement' event	
Issue	**Option C.1**
The clawback could be triggered upon a public announcement of the material misstatement or the release of revised financial statements.	Public announcement of the material misstatement of the financial statements.
	Option C.2
	Release of the recast financial statements by the company.
	Option C.3
	Whichever first occurs between C.1 and C.2.
Calculation of clawback amount	
Issue	**Option D.1**
A key element of the clawback provision is the consideration of how the quantum of bonuses to be clawed back from directors and executives should be determined.	The difference between what was awarded under the materially misstated financial statements and what should have been awarded under the re-stated financial statements.
	Option D.2 — A 'bright line' test
	Option D.2.1
	Adopt a threshold that links the amount to be clawed back to the percentage of material misstatement.
	Option D.2.2
	A specific method to clawback share-based remuneration, including the use of a set indicator, clawing back profits realised from the sale of shares, and freezing share options allocated during the period of the material misstatement.
A clawback from total remuneration	
Issue	**Option E.1**
Should the clawback of remuneration be taken from the executive's pool of total remuneration, or should the clawback be confined to the executive's pool of performance-based remuneration only?	The quantity of remuneration to be clawed back should be determined from the executive's pool of total remuneration, rather than performance based remuneration only.
	Option E.2
	The quantity of remuneration to be clawed back should be determined from the executive's pool of performance based remuneration only.

Table 1 — Summary of options (continued)

An underpayment in the executive's bonus	
Issue	**Option F.1**
It is possible that a material misstatement in the financial statements has in fact caused the performance-based remuneration of a director or executive to be underpaid.	Allow the company to pay to the executive the extra remuneration amounts that the executive is entitled to.
	Option F.2
	Prohibit the director or executive to receive the extra remuneration amounts.
Repayment of bonus	
Issue	**Option G.1**
It is necessary to consider when the overstated bonuses should be returned to the company.	An executive must repay the remuneration immediately after the company is aware that the clawback event has been triggered.
	Option G.2
	An executive must repay the remuneration following a specified time period.
Deliberate intention to mislead	
Issue	**Option H.1**
Should an intention by an executive to mislead the public through the release of false financial information be required to trigger the clawback, or should it be a strict liability provision?	Intention element necessary for the clawback provision to be invoked.
	Option H.2
	Intention element of 'misconduct' not necessary.
Subsequent events	
Issue	**Option I.1**
A situation whereby the financial statements of a company may be required to re-issued due to the occurrence of subsequent events that may materially affect the company's financial accounts for the previous financial year.	A subsequent externally-based event should exempt executives from the clawback provision.
	Option I.2
	A subsequent externally-based event should not exempt executives from the clawback provision.
Timeframe	
Issue	**Option J.1**
What time frame should be applied to the clawback provision for it to be invoked?	The 12-month period preceding the 'material misstatement' event.
	Option J.2
	The three-year period preceding the 'material misstatement' event.
	Option J.3
	Do not impose a time limit on how far back a clawback of executive remuneration can be applied.
Responsibility for application	
Issue	**Option K.1**
Who should be responsible for directly applying the clawback of remuneration?	Place the onus on the company to reconcile the bonuses of executives with ASIC intervening only if the company fails to fulfil its responsibility.
	Option K.2
	Place the onus on directors and executives themselves to repay remuneration, with strict penalties for non-compliance, and enabling ASIC to take action if the individual fails to do so.