



Audit Point of view

Executive Compensation Clawback Rules in Canada

Controversial rule could affect executives working for US-listed Canadian companies

As the U.S. Securities and Exchange Commission (SEC) continues the process of implementing the hundreds of regulations mandated by the Dodd-Frank Act, Canadian boards and audit committees would be wise to pay close attention to how these new rules could potentially impact their business dealings. One set of potentially concerning rules is related to executive compensation clawbacks.

While not yet final in the U.S., these rules may prove of particular interest to audit committees as their implementation would be closely linked to financial statement restatement proceedings. This, of course, would also be of interest to directors serving on a compensation committee.

The proposed rules

The proposed rules seek to address “incentive-based compensation”—that is, “compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure.” In this context, “financial reporting measure” refers to a “measure determined and presented based on accounting principles of the company, any measure derived therefrom and share price and total shareholder return.”



Under the proposed rules:

- All companies (including foreign private issuers and Multijurisdictional Disclosure System [MJDS] issuers) listed on a U.S. exchange will be required to adopt compensation recovery policies and publicly file them with the SEC;
- Recovery is required from current and former executive officers who received “incentive-based compensation” during three fiscal years prior to the date of a restatement to correct a material error;
- Companies are required to recover an amount of compensation that exceeds the amount that would have been received based on the restated financial information; and
- Indemnification of executive officers is not permitted.

What does this change mean?

If a U.S.-listed company, for example, has paid an executive a bonus of \$5,000 tied to the company’s income for a specific year, but that income gets restated later to a lower amount, the company is obligated to retrieve that compensation in the amount that was overpaid.

The proposed rules are controversial for several reasons. For one, recovery would be required on a “no fault” basis, without regard to whether any misconduct occurred or whether an executive took official responsibility for the erroneous financial statements. Additionally, the rules’ three-year look-back means executives no longer in the company’s employ may need to be pursued for repayment, which could be a difficult proposition to execute.

The rules, when they do come into effect, are expected to apply to all companies listed on a U.S. stock exchange, whether domestic or foreign—so there will likely be no exemption for Canadian companies. Also critical is that companies and boards are not permitted to indemnify executive officers against losses from a clawback. It may be that insurance products are being developed to protect incentives, but any such products could not be purchased or subsidized by the company’s insurance policies.

What should audit committees be doing?

It's important to remember that the final rules are not out yet in the U.S. That said, while there may be some tweaks, they are likely to come into effect—substantially as currently proposed—within the next 12 months. At a minimum, companies doing business in the U.S. should look at their compensation policies and consider adjusting how they are set up. For example, companies may want to move away from “incentive-based compensation” entirely and instead craft compensation measures that are not tied to financial reporting outcomes.

Get ahead of what could be a time-consuming process

The possible arrival of executive compensation clawback rules in Canada should absolutely be on the audit committee agenda for discussion with the board's compensation committee, the board itself and management. Changing an executive compensation plan is a time-consuming, multiphase process. It would be a smart move to get ready now by understanding what may be coming—and what may have to be done to manage it effectively.

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