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SEC Proposes Compensation Clawback Rules

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Highlights

- As mandated by the Dodd-Frank Act, the Securities and Exchange Commission has proposed rules requiring national securities exchanges to require listed companies to develop, implement and disclose policies to recover excess incentive-based compensation paid to executive officers.
- The proposed rules, with limited exceptions, apply to all listed companies and require recovery of excess compensation paid to a company's current and former Section 16 officers on a no-fault basis.
- No exceptions are provided for smaller reporting companies, emerging growth companies, or foreign private issuers.
- Recovery would be triggered when a company is required to restate previously filed financial statements to correct a material accounting error, and would apply to any incentive-based compensation received during the three completed fiscal years immediately preceding the date the issuer is "required" to prepare the restatement.
- The recovered amount would equal the difference between the incentive-based compensation received and the amount of incentive-based compensation that would have been received if calculated on the basis of the restated financial statements.
- The types of compensation subject to recovery include any incentive-based compensation that is granted, earned or vested based wholly or in part on the attainment of any financial reporting measure. Financial reporting measures are measures that are determined and presented in accordance with the accounting principles used to prepare the company's financial statements, any measures derived wholly or in part from such measures, and stock price and total shareholder return.
- Companies are prohibited from indemnifying executives against the loss of compensation recovered by the company or reimbursing them for premiums for a third-party insurance policy against such loss.
- Companies must disclose in Exchange Act annual reports and in proxy statements ongoing and forgone recoveries, including names of executive officers and specific amounts recovered or recoverable.

Overview

On July 1, 2015, the Securities and Exchange Commission voted 3-2 to propose new rules requiring national securities exchanges to establish listing standards requiring listed companies to develop, implement and disclose clawback policies. The clawback policies contemplated under the proposed rules would require a listed company to recover from its executive officers certain incentive-based compensation when the listed company is required to prepare a restatement of its previously issued financial statements to correct a material error. Under the proposed rules, listed companies would be subject to delisting if they fail to comply.

The proposed rules would implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added Section 10D to the Securities Exchange Act of 1934. The clawback rules are one of four governance and executive compensation-related provisions applicable to public companies under the Dodd-Frank Act (clawbacks, pay-versus-performance, hedging policy and pay ratio) and are the last of the four to be proposed. The proposed rules would supplement the statutes and regulations that the SEC currently administers with respect to the recovery of executive compensation, including the misconduct-based clawback provisions under Section 304 of the Sarbanes-Oxley Act of 2002.

The SEC faces a difficult task in implementing the statutory mandate. However in many respects the proposal would go beyond the requirements of the statute and in some cases would create significant practical compliance challenges, including with regard to (i) clawbacks of incentive-based compensation determined based on stock price or total shareholder return (TSR); (ii) application to executives located in jurisdictions that are not the company's home country; (iii) restrictions on companies' discretion to forgo, reduce, settle or make alternative recovery arrangements; and (iv) the prohibition on companies indemnifying executive officers for amounts subject to clawback.

Clawback Policy Requirement

Proposed Rule 10D-1 under the Exchange Act would require the national securities exchanges to propose listing standards, subject to the SEC's approval, requiring listed companies to adopt and comply with a clawback policy that meets specified criteria. The clawback policy would require listed companies to recover incentive-based compensation from current and former executive officers who received such compensation during the three fiscal years preceding the date on which the company is required to prepare a restatement of its previously issued financial statements to correct a material error. Recovery would be required on a "no-fault" basis without regard to whether any misconduct occurred or whether an executive officer had any responsibility for the error.

The recovery amount would equal the amount of incentive-based compensation received by an executive officer in excess of the amount the executive officer would have received had the incentive-based compensation been determined based on the restated financial statements.

Proposed Rule 10D-1 would prohibit a listed issuer from indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation or reimbursing an executive for any premiums paid toward a third-party insurance policy to cover potential recovery obligations.

Companies Subject to the Proposed Requirements

The proposed rules would apply to all issuers with securities listed on any national securities exchange, except for certain registered investment companies to the extent they do not provide incentive-based compensation to their employees. The proposed rules provide no blanket exclusions or exceptions for foreign private issuers, smaller reporting companies, emerging growth companies, or controlled companies.

Except for certain securities futures products and standardized options, the proposed rules provide no exception for issuers on the basis of the type of securities listed. Issuers of listed debt or preferred securities that do not have listed common equity would be subject to the proposed rules.

Covered Executive Officers

The proposed rules apply to any current or former executive officer of the listed company. The proposed definition of "executive officer" is modeled after the definition of "officer" in Exchange Act Rule 16a-1(f). The definition encompasses the listed company's president; principal financial officer; principal accounting officer (or if there is no such accounting officer, the controller); and any vice-president in charge of a principal business unit, division or function; and any other person who performs policy-making functions for the company. This is a broader definition than the definition of "executive officer" under Exchange Act Rule 3b-7 or the definition of "named executive officer" for compensation disclosures under Item 402(a)(3) of Regulation S-K.

Restatements Triggering Potential Clawback

The clawback process would be triggered when a company is required to prepare an accounting restatement to correct a material error. For purposes of the proposed rules, a company is deemed to be "required to prepare an accounting restatement" upon the earlier to occur of:

- the date the company's board of directors or committee thereof, or an authorized officer of the company (if board action is not required), concludes or reasonably should have concluded that the company's previously filed financial statements contain a material error; or
- the date a court, regulator or other legally authorized body directs the company to restate its previously issued financial statements to correct a material error.

The proposed rules define an accounting restatement as "the result of the process of revising previously issued financial statements to reflect the correction of one or more errors that are

material to those financial statements." In its discussion of the proposed rules, the SEC stated that it did not propose to describe any type or characteristic of an error that would be considered material for purposes of the rule, instead noting that materiality is a determination that must be analyzed in the context of particular facts and circumstances. As further noted by the SEC, companies would need to consider whether a series of immaterial error corrections, whether or not they resulted in filing amendments to previously filed financial statements, could be considered a material error when viewed in the aggregate, thus requiring a restatement of previously filed financial statements.

The proposed rules follow the accounting standards for determining what restatements result from the correction of accounting errors. Under US Generally Accepted Accounting Principles, the following events do not constitute an error and would not trigger the clawback process:

- retrospective application of a change in accounting principle;
- retrospective revision to reportable segment information due to a change in the structure of a company's internal organization;
- retrospective reclassification due to a discontinued operation;
- retrospective application of a change in reporting entity, such as from a reorganization of entities under common control;
- retrospective adjustment to provisional amounts in connection with a prior business combination; and
- retrospective revision for stock splits.

Incentive-Based Compensation Subject to Recovery

Under the proposed rules, incentive-based compensation subject to recovery would include compensation that is granted, earned or vested based wholly or in part on the attainment of any financial reporting measure. "Financial reporting measure" is broadly defined to include:

- measures determined and presented in accordance with the accounting principles used to prepare the listed company's financial statements;
- any measures derived wholly or in part from that financial information; and
- stock price and TSR.

Financial reporting measures would include, among others, revenues; net income; operating income; profitability of one or more reportable segments; financial ratios; net assets or net asset value per share (for registered investment companies and business development companies subject to the rule); EBITDA; funds from operations and adjusted funds from operations; liquidity measures; return measures; earnings measures; sales per square foot or same store sales, where sales is subject to an accounting restatement; revenue per user, or average revenue per user, where revenue is subject to an accounting restatement; cost per employee, where cost is subject to an accounting restatement; any of such financial reporting measures relative to a peer group, where the company's financial reporting measure is subject to an accounting restatement; and tax basis income.

Compensation that would be subject to the recovery policy includes, but would not be limited to, non-equity incentive plan awards that are earned based wholly or in part on satisfying a financial reporting measure performance goal; bonuses paid from a "bonus pool," the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal; restricted stock, restricted stock units, performance share units, stock options and stock appreciation rights that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal; and proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal.

Incentive-based compensation would not include salaries; bonuses paid solely at the discretion of the compensation committee or board that are not paid from a "bonus pool," the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal; bonuses paid solely upon satisfying one or more subjective standards and/or completion of a specified employment period; non-equity incentive plan awards earned solely upon satisfying one or more strategic measures or operational measures; or equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more non-financial reporting measures.

Incentive-based compensation would be deemed "received" in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, which may not coincide with the period when the executive officer actually receives payment.

Calculating the Recovery Amount

Under the proposed rules, the amount to be recovered would equal the amount of incentive-based compensation received by an executive officer in excess of the amount the executive officer would have received had the incentive-based compensation been determined based on the restated financial statements. While this approach theoretically appears straight-forward, the recovery amount with respect to certain types of incentive-based compensation may be complicated to determine. For incentive-based compensation calculated on the basis of stock price or TSR, listed companies would be permitted to use a reasonable estimate of the effect of the restatement on the applicable measure to determine the amount to be recovered.

The proposing release includes guidance on how the recovery amount would be calculated in a number of specific fact patterns. For example, the release describes the following calculation methodologies:

- For awards based on both (i) the achievement of a financial reporting measure and (ii) the discretion of the compensation committee, companies would first recalculate the portion based on the financial reporting measure, then would reconsider the discretionary portion to determine whether the accounting restatement would have caused an increase or

decrease in the discretionary award under the terms of the plan. Companies would recover the difference between the original amount and the lesser amount determined under the restated financial statements.

- For bonus pools, companies would first recalculate the aggregate pool amount that would have been awarded under the restated financial results. Companies would recover from all pool participants on a pro rata basis, even if the amounts of individual awards were made in the compensation committee's discretion.
- For incentive-based awards granted in the form of shares, options, or SARs, the proposed rule provides specific guidance. Where at the time of recovery the executive officer:
  - holds shares, unexercised options or SARs, the recoverable amount would be the excess number of shares, options or SARs received.
  - has exercised options or SARs but the underlying shares have not been sold, the recoverable amount would be the number of shares underlying the excess options or SARs received.
  - has sold shares received upon exercise, the recoverable amount would be the sale proceeds received with respect to the excess number of shares received.

Very Limited Board Discretion Not to Pursue Recovery

Under proposed Rule 10D-1, a listed company must recover what the rule deems to be erroneously paid incentive-based compensation in accordance with its clawback policy, except in specified limited circumstances in which it is impractical to do so. The proposed rule gives a listed company's board discretion not to pursue recovery when the direct enforcement costs (the expenses that would need to be paid to a third party to assist in enforcing the policy) would exceed the amount to be recovered. Before concluding that collection is impracticable, however, a listed company must make a "reasonable attempt" to recover the incentive-based compensation, document its attempts and provide the documentation to the applicable securities exchange. In addition, listed companies would be permitted to forgo recovery under the proposed rule if doing so would violate home country law in effect prior to the date that proposed Rule 10D-1 is published in the Federal Register. To rely on the exception, a company would be required to obtain an opinion of home country counsel, not unacceptable to the applicable national securities exchange, that recovery would result in such a violation.

In addition, a listed company would not have discretion with regard to the amount to be recovered, regardless of whether discretion was used in determining the original award amount. Similarly, a listed company would not be permitted to settle for less than the full recovery amount unless full recovery is impracticable from a cost standpoint (in which case the same conditions would apply as for a determination to forgo recovery). On the other hand, acknowledging that the appropriate means of recovery may vary by issuer and by type of compensation arrangement, the SEC noted its belief that listed companies should be able to exercise discretion in how to accomplish recovery. The SEC cautioned, however, that regardless of the means of recovery used, recovery should be accomplished promptly.

New Disclosures

Each listed company would be required to file its clawback policy as an exhibit to its Exchange Act annual report, and also would be required to make certain disclosures in its annual report and in any proxy or information statement in which executive compensation disclosure is required. The proposed rules would add new paragraph (w) to Item 402 of Regulation S-K, and would require disclosures if at any time during its last completed fiscal year either:

- the company prepared a restatement that required recovery of excess incentive-based compensation pursuant to the clawback policy; or
- the company had an outstanding balance of unrecovered excess incentive-based compensation resulting from the application of the clawback policy to a prior restatement.

The disclosures must include the following information:

- for each restatement, the date the company was required to prepare the accounting restatement, the aggregate dollar amount of excess incentive-based compensation attributable to the restatement, and the aggregate dollar amount of unrecovered excess incentive-based compensation outstanding as of the end of the company's last fiscal year;
- the estimates used to determine the excess incentive-based compensation attributable to the accounting restatement, if the financial reporting measure related to a stock price or TSR metric;
- the name of each person subject to recovery from whom the company decided not to pursue recovery during the last completed fiscal year, the amounts due from such person, and the company's reason for not pursuing recovery; and
- the name of each person and the amount of excess incentive-based compensation due from such person, if at the end of the company's last completed fiscal year, amounts due have been outstanding more than 180 days since the date the company determined the amount the person owed.

If amounts are recovered pursuant to a company's clawback policy, the company would be required to update its Summary Compensation Table disclosures in subsequent filings to reflect the amount originally awarded less amounts subsequently recovered.

Foreign private issuers, including Canadian issuers using MJDS, would be required to make these disclosures (other than the Summary Compensation Table disclosures) in their annual reports on Form 20-F, Form 10-K, and Form 40-F, as applicable. Because Section 14(a) of the Exchange Act does not apply to foreign private issuers, such issuers would not be required to disclose information in any proxy or consent solicitation materials.

The proposed clawback rules would also require companies to block tag the proposed disclosures in eXtensible Business Reporting Language (XBRL).

Comment Period and Timing Considerations

The comment period on the rule proposal will close September 14, 2015.

The proposed rules would require the national securities exchanges to file proposed listing standards no later than 90 days following the publication of the adopted version of Rule 10D-1 in the Federal Register, with a requirement that the listing standards become effective no later than one year following the publication date.

Listed companies would be required to adopt a clawback policy no later than 60 days following the date on which the exchange's listing standards becomes effective. Listed companies would also be required to recover all excess incentive-based compensation related to financial reporting measures based on financial information for any fiscal period ending on or after the effective date of Rule 10D-1, but only with respect to compensation that is granted, earned or vested on or after the effective date of Rule 10D-1. Listed companies would be required to comply with the new disclosure requirements in Exchange Act annual reports and proxy or information statements filed on or after the effective date of the listing standard.

While companies should monitor the progress of the proposal and keep their boards of directors apprised of developments in the rulemaking, we caution against rushing to amend existing clawback policies to conform to the proposal. Similarly, for companies without an existing clawback policy, while there may be any number of reasons to adopt a clawback policy before the SEC rules are finalized and the exchange listing standards effective, we do not advise rushing to adopt a policy now solely for the purpose of trying to conform to the SEC proposal. There are a number of steps still to be taken before final listing standards are in place, and it is unlikely that the final listing standards will correspond to the proposal in every respect.

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