The SEC Proposes Rules to Require Clawback of Erroneously Awarded Incentive-Based Compensation

clawback (n.) /'klô,bak/: to get back by strenuous or forceful means

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The SEC has proposed rules directing national securities exchanges and associations to establish listing standards requiring companies to adopt policies that call for current or former executive officers to pay back incentive-based compensation received within three years prior to an accounting restatement in excess of what they would have received based on the restatement. This rule proposal is the last of the executive compensation rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Congress first began to address the clawback of incentive compensation received by senior executives prior to a restatement more than 13 years ago in the Sarbanes-Oxley Act of 2002. Section 304 provides that the CEO and CFO of a public company must reimburse the company for incentive-based or equity-based compensation if the company is required to prepare an accounting restatement due to material noncompliance by the issuer as a result of individual misconduct. The SOX clawback provision applies to compensation received during the 12-month period following the filing of the misstated financials. The Dodd-Frank Act and the SEC's proposed rules would broaden the scope of the SOX clawback provisions in several respects.

Which companies will be required to adopt clawback policies?

With limited exceptions, all companies with securities listed on a national securities exchange or the interdealer quotation system of a national securities association will need to implement a compliant clawback policy. Under proposed Rule 10D-1, each national securities exchange and national securities association will be required to adopt a listing requirement applicable to every listed company. The exchange or association would have to delist and prohibit the original listing of any security of a company that does not:

- adopt a clawback policy that satisfies the applicable listing standard;
- disclose information about the clawback policy in accordance with SEC rules; and
- comply with the clawback policy's recovery provisions.

The exchanges and associations will be free to adopt listing standards with requirements that are more extensive than those of proposed Rule 10D-1, and listed companies may adopt more extensive policies than those called for by the revised listing standards.

Who must be covered by the clawback policy?

As proposed, the clawback policy would cover any individual who served as an executive officer at any time during the applicable performance period affected by the accounting restatement. The proposed rules include a definition of an "executive officer" that is modeled on the definition of "officer" for purposes of Section 16 of the Securities Exchange Act of 1934. As such, the definition includes a company's president, principal financial officer, principal accounting officer, 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.

What compensation must be clawed back?

At a minimum, the policy must state that, in the event of a financial restatement due to material noncompliance with the financial reporting requirements of the securities laws, any person who served as an executive officer during the preceding

three-year period and received incentive-based compensation for that period must pay back any amount in excess of what the executive would have received if the amount were determined under the restated financial statements. The determination of excess compensation is calculated without regard to the tax impact.

"Incentive-based compensation" is defined to mean any compensation that is granted, earned or vested based wholly or in part on the attainment of a financial reporting measure. Financial reporting measures are those based on the accounting principles used in preparing the company's financial statements (such as revenue), or any measures derived wholly or in part from such financial information (such as same store sales and various non-GAAP financial measures) and need not be presented within the financial statements or an SEC filing. Even salary increases based on the attainment of a financial reporting measure would be subject to recovery under the required clawback policy. For incentive-based compensation based on stock price or total shareholder return, companies would be permitted to use a reasonable estimate of the effect of the restatement on the relevant measure when determining the amount that should be recovered. Salary increases, bonuses and other compensation awarded upon satisfaction of subjective standards or contingent solely upon the occurrence of certain non-financial events (such as granting a certain number of licenses or obtaining regulatory approval of a new product) would not be subject to the clawback requirements.

Companies would have discretion under the proposed rule not to recover the excess incentive-based compensation received by executive officers if the direct expense of enforcing recovery would exceed the amount to be recovered and the company's compensation committee makes a determination that recovery would be impracticable. Before concluding that recovery would be impracticable, however, a company must make a reasonable attempt to recover the incentive-based compensation and must document its attempts to recover. The company also would be required to disclose in its annual meeting proxy statement why it determined not to pursue recovery and submit its recovery documentation to the applicable securities exchange or association. Companies would also be able to forego recovery where it would violate home country law and they obtain a legal opinion to that effect.

Will the clawback policy apply even if the restatement was due to an innocent mistake?

Yes. Unlike the SOX clawback provision, the proposed rule (consistent with the Dodd-Frank Act provision) mandates that the clawback policy must apply on a "no-fault" basis to recover "any compensation in excess of what would have been paid to the executive officer had correct accounting procedures been followed." The proposed rule further states that any accounting error that is material to previously issued financial statements constitutes "material noncompliance" by the company with a financial reporting requirement. Accordingly, in the event a company is required to prepare a restatement merely to correct an error that is material to previously issued financial statements, the obligation to prepare the restatement would trigger application of the clawback policy.

What period would be covered by the clawback?

The proposed rule would require clawback of incentive-based compensation received for the three completed fiscal years immediately preceding the date that the company is required to prepare an accounting restatement for any periods that end on or after the effective date of the proposed rule, regardless of when the compensation is actually paid. This restatement date is defined as the earlier to occur of: (1) the date the company concludes, or reasonably should have concluded, that its previously issued financial statements contain a material error; or (2) the date a regulatory body directs the company to restate its previously issued financial statements to correct a material error.

For example, using the proposed recovery period trigger and a 2015 effective date, if a calendar year company concludes in November 2018 that a restatement is required and files the restated financial statements in January 2019, its clawback policy would require the company to recover all erroneously awarded incentive-based compensation that is granted, earned or vested by the executive officers and former executive officers in 2015, 2016 and 2017.

What must be disclosed?

As proposed, the rules require each listed company to adopt a compensation recovery policy and to file that policy as an exhibit to the company's annual report on Form 10-K. If a clawback is triggered, a company would be required to make certain disclosures under new Item 402(w) of Regulation S-K in those filings where executive compensation disclosure is required pursuant to Item 402, including annual reports on Form 10-K, the annual meeting proxy statement and any other proxy or consent solicitation materials that require executive compensation information. The proposed rule amendments

would also require a company to adjust the compensation amounts included in its Summary Compensation Table for the fiscal years in which the amounts recovered were initially reported, with those amounts identified by footnote.

Under the proposed rules, required proxy statement disclosure when a compensation clawback has been triggered would include:

- the date the company was required to prepare the accounting restatement;
- the aggregate dollar amount of "excess" incentive-based compensation and any amount that remained outstanding at the end of the last completed fiscal year;
- any estimates used in determining the amount of excess incentive-based compensation;
- the name of each person subject to recovery of excess incentive-based compensation as of the end of the fiscal year from whom the company decided not to pursue recovery, the amount in question, and a brief description of the reason the company decided not to pursue recovery; and
- the name of each person from whom, as of the end of the fiscal year, excess incentive-based compensation had been outstanding for 180 days or longer.

Proposed Instruction 4 to new Item 402(w) would provide that, if the aggregate dollar amount of excess incentive-based compensation has not yet been determined, a company could disclose this fact and explain the reasons. The SEC also proposed that the disclosure required by Item 402(w) be provided in interactive data format using XBRL block-text tagging. The interactive data would have to be provided as an exhibit to the definitive proxy or information statement and as an exhibit to the annual report on Form 10-K.

Can a company indemnify its executive officers against amounts clawed back?

The proposed rule and accompanying SEC commentary expressly prohibit listed companies from indemnifying executives against the loss of erroneously awarded compensation due to a clawback or paying or reimbursing executives for insurance premiums to cover losses incurred under a compensation recovery policy. In its proposing release, the SEC mused that the insurance market could develop a policy that would allow an executive, as an individual, to purchase insurance against the loss of incentive-based compensation when the material accounting error is not attributable to the executive. In that event, an executive would be able to hedge the risk of a clawback liability, but the company would not be permitted to incur the cost of such a policy or reimburse the employee.

What is the timing for implementation of these rules?

The SEC provided that covered exchanges and associations be required to file their proposed listing rules no later than 90 days following publication of the final adopted version of Rule 10D-1 in the Federal Register, and that such listing rules be effective no later than one year following that publication date. A listed company then would be required to adopt its clawback policy no later than 60 days following the effective date of the revised listing standards.

There is no definitive timetable for the SEC’s adoption of final rules. The comment period for the proposed rules expires September 14, 2015, making adoption before year end unlikely.

What should we be doing now?

It may be several months before the SEC adopts final clawback rules, and several more months before the securities exchanges and associations are able to propose and finalize their revised listing standards, taking into account their respective public notice periods. Only then would the 60 day period for a listed company to adopt a clawback policy begin to run. Therefore, it seems likely that listed companies will not need to comply with a listing standard requiring adoption of a specified clawback policy until sometime in 2016.

Although there could be significant changes to the proposed requirements prior to adoption of final rules by the SEC and the exchanges, the substance of the clawback requirements are statutorily mandated, and therefore not likely to change materially. Therefore, listed companies considering voluntary adoption of a clawback policy may wish to adopt a policy that follows the standards in the proposed rules. Companies with a clawback policy in place should review their policy to

determine whether amendments will be needed if Rule 10D-1 is adopted substantially as proposed and whether to modify their policy now or wait until final rules are adopted.

Implementation of a clawback policy may impact the recommendations of proxy advisory firms. In its discussion of primary evaluation factors for executive pay for the say-on-pay vote, ISS has stated that a rigorous clawback provision is a factor that potentially mitigates the impact of risky incentives. Proxy advisory firm Glass Lewis has stated that it will consider recommending a vote against all members of the compensation committee when a new employment contract is given that does not contain a clawback and the company had a material restatement. With final rules now on the horizon, listed companies that do not have a clawback policy in place should begin considering the adoption of a clawback policy either in the near term or be ready to comply with the rules when finalized.

Listed companies may also wish to consider how the proposed definition of incentive-based compensation will apply to their compensation program if a clawback is required and whether any changes should be made to their program to reduce the risk that compensation would need to be clawed back from executives, balancing this risk with the increasing need in today's environment for compensation to be incentive-based. Companies should also consider the tax (including under Code Section 409A) and liquidity implications for executives of clawing back compensation paid as many as three years previously and how a clawback could best be implemented to minimize the negative impact on executives. Companies will also want to consider the tax and accounting implications for themselves as well as whether and how any of their compensation contracts or plans will need to be modified as a result of the implementation of a clawback policy.

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