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SEC PROPOSES RULES REQUIRING COMPANIES TO ADOPT, DISCLOSE, AND COMPLY WITH CLAWBACK POLICIES ON ERRONEOUSLY AWARDED EXECUTIVE COMPENSATION

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BACKGROUND

On July 1, 2015, the US Securities and Exchange Commission (SEC) issued a long-awaited release (Proposing Release) proposing rules that would direct the national securities exchanges to establish listing standards requiring listed companies, including emerging growth and smaller reporting companies, to adopt a policy that requires their executive officers to pay back to the company any incentive-based compensation awarded to them based on incorrect financial information that was later corrected in an accounting restatement.

The SEC was required to issue these rules pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and section 10D of the Securities Exchange Act, as amended (Exchange Act), enacted under the Dodd-Frank Act. Listed companies that do not adopt, disclose, and comply with their recovery policies will be subject to delisting from their exchange.

Highlights of the Proposing Release are summarized below.

Requirement to Adopt, Disclose, and Comply with a "Recovery Policy" Applicable to All "Executive Officers"

Proposed Rule 10D-1 would require that listed companies adopt, disclose, and comply with a written policy providing that, in the event a company is required to prepare an accounting restatement due to the "material noncompliance" of the company with any financial reporting requirement under the securities laws, the issuer "will recover" the amount of erroneously awarded incentive-based compensation, which would be the amount received by the executive officer that exceeds the amount that otherwise would have been received had the incentive-based compensation been determined based on the accounting restatement. We refer to the amount that may be subject to recovery as "excess compensation."

In essence, and as explained in more detail below, the recovery policy would apply to excess compensation received by an individual (including a former employee) who served as an "executive officer" any time within a performance period for which excess compensation was paid if the performance period occurred during the three completed fiscal years immediately preceding the date that the company is "required" to prepare a restatement of its previously issued financial statements to correct a material error. Because the focus of the recovery policy is on the performance period for which the excess compensation was paid, the actual payment date of the compensation is not relevant. Under the proposal, compensation is deemed "received" in the fiscal period during which the financial reporting measure upon which it is based is attained, regardless of when the executive officer is actually paid. An accounting restatement is deemed "required" as of the earlier of the date upon which the company concludes or reasonably should have concluded that it is required or the date upon which a governing authority orders the company to prepare a restatement.

Under the proposed rules, the term "executive officer" is based on the definition of "officer" in Exchange Act Rule 16a-1(f), which defines the class of persons required to file ownership and transaction reports under section 16(a) of the Exchange Act. Thus, a company's principal financial officer and principal accounting officer or controller are specifically defined to be executive officers for purposes of the proposed rules.[1] Recovery would be required regardless of whether there was any misconduct and even

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1. The definition of "executive officer" in Exchange Act Rule 3b-7 does not specifically include an issuer's principal financial officer, principal accounting officer, or controller, although companies, as a general practice, identify their chief financial officers as executive officers due to their policy-making function. The Proposing Release states that incentive-based compensation includes an award authorized before the individual became an executive officer, and inducement awards granted in new hire situations, as long as the individual served as an executive officer of the issuer at any time during the award's performance period. Recovery, however, would not apply to an individual who is an executive officer at the time recovery is required if that individual was not an executive officer at any time during the performance period related to such compensation.

if an executive officer had no role in preparing the company's financial statements that were later required to be restated.

Recovery Must Be Pursued Unless Recovery Is "Impracticable"

Under the proposal, an issuer would be required to recover erroneously awarded compensation under its recovery policy unless doing so is "impracticable." Circumstances under which recovery would be deemed "impracticable" are very limited. Recovery would be "impracticable" only if the direct expense paid to a third party to assist in enforcing recovery would exceed the amount to be recovered[2] or, in the case of foreign private issuers, only if recovery would violate home country law, provided the home country law was adopted by the home country before the publication of final Rule 10D-1. Moreover, a conclusion that recovery would violate home country law must be based on an opinion of home country counsel obtained by the issuer supporting that conclusion.

Before reaching the conclusion that recovery is "impracticable," an issuer would be required to first "make a reasonable attempt to recover" the compensation, document its attempt(s), and provide the documentation to its exchange. The determination generally must be made by the company's independent compensation committee. The SEC noted that this determination, "as with all determinations under proposed Rule 10D-1, would be subject to review by the listing exchange."[3]

In explaining its determination to permit issuers to forego recovery only in narrow circumstances, the SEC characterizes Exchange Act section 10D as mandating "no-fault recovery" and therefore intending that "issuer[s] should pursue recovery in most instances." The SEC also stated that issuers "should recover excess incentive-based compensation reasonably promptly, as undue delay would constitute non-compliance with an issuer's policy as required."[4]

Disclosure Requirement

The SEC proposes to amend certain of its disclosure rules to require listed companies to file their "recovery" policies as an exhibit to their annual reports on Form 10-K—or, with respect to foreign private issuers, Form 20-F—and to disclose any actions taken to recover erroneously awarded executive compensation.[5]

Although not specifically required by section 10D, the SEC proposes to add paragraph (w) to Regulation S-K Item 402, which would require companies to disclose their actions to recover erroneously awarded compensation under their recovery policies following a restatement. The required disclosure would include, among other items:

- The date on which the issuer was required to prepare an accounting restatement (as determined by the test used to compute the three-year look-back period discussed below)
- The aggregate dollar amount of excess incentive-based compensation attributable to the restatement
- Any estimates (discussed below) used to determine the excess compensation, if the financial reporting measure on which the compensation was based related to a stock price or total shareholder return measure
- Specified information relating to any relevant executive officer from whom the issuer determined not to pursue recovery, including the name of the individual, the amount foregone, and the reason the issuer decided not to pursue recovery

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2. In this regard, the Proposing Release states that "the only criteria that should be considered are whether the direct costs of enforcing recovery would exceed the recoverable amounts . . . " Proposing Release, section II.C.3.b.

3. Proposing Release, section II.C.3.b.

4. Proposing Release, section II.C.3.c.

5. Canadian filers using the multijurisdictional disclosure system would include the policy and disclosures in Form 40-F; management investment companies subject to the proposed rules would include the policy and disclosures in Form N-CSR.

- If applicable, the name of any executive officer from which excess compensation outstanding for at least 180 days has not been recovered and the amount yet to be recovered

Significantly, the disclosure required by proposed Item 402(w) would need to be electronically formatted using XBRL and must be "block-text tagged."

Policy and Disclosure Requirement Would Apply to Most Companies

The proposal applies to all listed companies,[6] with very few exceptions. Emerging growth companies, smaller reporting companies,[7] foreign private issuers,[8] and controlled companies[9] would not be exempt from the proposed requirements.[10] Furthermore, the proposed requirements would apply to companies listing only debt and other nonequity securities, except for securities futures products and standardized options cleared by a clearing agency.[11]

The SEC does, however, propose a conditional exemption for listed registered investment companies that have not awarded incentive-based compensation to any of their executive officers within the last three fiscal years[12] and an unconditional exemption for unit investment trusts.[13]

"Material Noncompliance" Means "Material Error"

In discussing the proposed rules, the SEC quotes the US Senate Report[14] indicating that the intent behind Exchange Act section 10D was to result in "public companies [adopting policies] to recover money that they erroneously paid in incentive compensation to executives as a result of material noncompliance with accounting rules. This is money that the executive would not have received if the accounting was done properly."[15] The SEC believes that "an error that is material to previously issued financial statements constitutes 'material noncompliance' by the issuer with a financial reporting requirement under the securities laws, as contemplated by Section 10D."[16]

With respect to "material noncompliance," the Proposing Release states that "'materiality' is a determination that must be analyzed in the context of particular facts and circumstances."[17] The SEC further states that "issuers should '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.'"[18] However, the SEC notes that the following retrospective

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6. Incentive-based compensation would be subject to the issuer's recovery policy only to the extent that it is received while the issuer has a class of securities listed on an exchange.

7. As to emerging growth and smaller reporting companies, the SEC notes that domestic issuers who are nonaccelerated filers accounted for approximately 55% of total US issuer restatements.

8. As noted above, the SEC proposes an accommodation to foreign private issuers in that they may forego recovery as impracticable if the recovery would violate home country laws, provided certain conditions are met.

9. New York Stock Exchange and Nasdaq Stock Market rules generally define a "controlled company" as a company for which a majority of the voting power for the election of directors is held by an individual, another company, or a group.

10. The SEC notes that the proposed requirements "could, in certain respects, impose a disproportionate burden on these categories of issuers" but states that "there is also reason to believe that these issuers, as well as investors and the markets in general, may derive benefits from being subject to" the requirements. Proposing Release, section II.A.1.

11. This exception is based on the SEC's view that the clearing agency's incentive-based compensation programs and financial statements are not relevant to investors in such securities.

12. This exception is based on the fact that "registered management investment companies typically rely on employees of the investment adviser to manage fund assets and carry out other related business activities. Such employees are typically compensated by the investment adviser of the registered management investment company as opposed to the fund." Proposing Release, section II.A.3.

13. The Proposing Release notes that unit investment trusts do not have corporate officers and are not otherwise actively managed.

[14] Report on the Senate Committee on Banking, Housing, and Urban Affairs, S. 3217, Report No. 111-776 (April 30, 2010).

15. Proposing Release, section II.B.1.

16. *Id.*

17. *Id.*

18. *Id.*

changes to an issuer's financial statements do not represent error corrections and therefore would not trigger application of a listed company's recovery policy:

- Application of a change in accounting principle
- Revision to reportable segment information due to a change in the structure of an issuer's internal organization
- Reclassification due to a discontinued operation
- Application of a change in reporting entity, such as from a reorganization of entities under common control
- Adjustment to provisional amounts in connection with a prior business combination
- Revision for stock splits

Determination of When the Issuer Is Required to Prepare a Restatement of Its Previously Issued Financial Statements to Correct a Material Error

Proposed Rule 10D-1 states that an issuer's recovery policy "shall apply to any incentive-based compensation received[[19]] during the three completed fiscal years immediately preceding the date that the issuer is required to prepare a restatement of its previously issued financial statements to correct a material error."[20] The SEC proposes that the "date on which an issuer is required to prepare an accounting restatement" should be based on "issuer or third party determinations about the need for a restatement" and therefore would occur on the earlier of the date that (i) management[21] concludes, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error; or (ii) a court or regulator directs the issuer to restate previously issued financial statements to correct a material error.

The SEC noted that the first proposed date is expected to coincide with the occurrence of the event triggering a filing under Item 4.02(a) of Form 8-K; however, for purposes of applying the recovery policy, neither proposed date is predicated on the actual filing of the Form 8-K.

The SEC recognizes that companies "must apply judgment before concluding that previously issued financial statements contain a material error" and stated that such judgment "should be applied on an objective basis, which is when a reasonable issuer, based on the facts available, would have concluded that the previously issued financial statements contain a material error."[22]

Types of Incentive-Based Compensation Subject to a Recovery Policy

The proposal defines "incentive-based compensation" as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure."[23] Financial reporting measures are "measures that are determined and presented in accordance with accounting principles used in preparing the issuer's financial statements, any measures that are derived wholly or in part from such measures, and stock price and total shareholder return."[24] The SEC notes that a financial reporting measure need not be presented in the financial statements or otherwise included in a filing with

19. The concept of when incentive-based compensation is deemed "received" is discussed in the next section.

20. Proposed Rule 10D-1(b)(1)(ii).

21. The proposed rule specifies that this determination is made by "the issuer's board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take such action if board action is not required." Proposed Rule 10D-1(c)(2).

22. Proposing Release, section II.B.2.

23. Proposed Rule 10D-1(c)(4).

24. *Id*.

the SEC, and also notes that the definition is broader than (and thus encompasses) non-GAAP financial measures.[25]

The inclusion of stock price and total shareholder return within the definition of "financial reporting measures" is significant. The SEC reasoned that stock price and total shareholder return "are affected by accounting-related information and . . . are subject to our disclosure requirements."[26] The SEC also noted that total shareholder return is a "frequently used performance metric" and its exclusion "might not promote the goals we believe Congress intended."[27] Nevertheless, as explained below, the inclusion of stock price and total shareholder return raises special challenges in determining what constitutes recoverable incentive-based compensation.

The Proposing Release states that, although the definition of "incentive-based compensation" is intended to be "applied broadly and flexibly," the definition does not encompass all forms of incentive compensation:

> An incentive plan award that is granted, earned or vested based solely upon the occurrence of certain non-financial events, such as opening a specified number of stores, obtaining regulatory approval of a product, or consummating a merger, divestiture or similar transaction . . . would not be "incentive-based compensation" because these measures . . . are not financial reporting measures.[28]

Similarly, awards that vest solely on the basis of completion of a period of employment, such as service-vesting stock options and restricted stock units (RSUs), are not covered by the proposal because vesting is not dependent, in whole or in part, upon the attainment of a financial reporting measure.[29]

Determining When Incentive-Based Compensation Is Subject to the Recovery Policy

Under the proposal, incentive-based compensation is deemed to be received, and therefore recoverable for purposes of a recovery policy, during the period when the financial reporting measure specified in the incentive-based compensation award is attained—even if the payment or grant date occurs after the end of that period. Noting that incentive-based compensation awards may have multiple performance conditions, the SEC states that all conditions need not be satisfied for an incentive award to be deemed to be received.

The Proposing Release includes an example in which the number of RSUs ultimately payable in stock is determined after a three-year performance period based on financial reporting measure performance, but service-vesting of the award will not occur until two more years elapse. Under this scenario, the executive officer would be deemed to have "received" the compensation when the relevant financial reporting measure goal is met, and if the company's board determines that a restatement is required, and the deemed receipt occurs within the three-year look back period, the number of RSUs ultimately payable in stock would be reduced, even if the executive had not yet satisfied the service-vesting period.

In explaining its rationale for this position, the SEC noted that if the incentive compensation was not deemed to be received until after the service-vesting period, such an outcome would not "appropriately implement the policy underlying Section 10D, because it would mean that the mere passage of time pursuant to a service-based vesting condition or a subsequent performance condition unrelated to a financial reporting measure would preclude the issuer from recovering incentive-based compensation."[30]

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25. Proposing Release, section II.C.2 includes a nonexclusive list of financial reporting measures and types of compensation that would be subject to the recovery policy.

26. Proposing Release, section II.C.2.a.

27. *Id*.

28. *Id*.

29. Proposing Release, section II.C.2 includes examples of compensation that would not be "incentive-based compensation."

30. Proposing Release, section II.C.2.c.

Thus, the focus is on the attainment of the financial reporting measure, regardless of whether any subsequent time-based vesting or other vesting requirement has been met.

Recoverable Compensation

The amount of incentive-based compensation that is recoverable is equal to the difference between what the executive officer received and the lesser amount that the executive would have received had the incentive-based compensation been determined based on the accounting restatement, computed without regard to any taxes paid (i.e., on a pretax basis). In connection with incentive-based compensation tied to stock price or total shareholder return, the SEC acknowledged "potential administrative burdens that could be imposed on issuers in determining the amount of compensation to be recovered," including, "in some cases . . . complex analyses that require significant technical expertise and specialized knowledge, and may involve substantial exercise of judgment in order to determine the stock price impact of a material restatement."[31] In recognition of these challenges, the proposal would permit issuers, in connection with incentive-based compensation tied to stock price or total shareholder return, to use estimates in connection with determining excess compensation; the issuer would be required to disclose the estimates used in determining the excess incentive-based compensation attributable to such accounting restatement. The estimate must be reasonable, and the issuer must maintain documentation of the determination of the estimate and provide it to its exchange.

Despite this accommodation, the challenges in determining the amount of excess compensation in the context of performance measures based on stock price or total shareholder return are formidable. The SEC noted that, because of "confounding factors, it sometimes may be difficult to establish the relationship between an accounting error and the stock price."[32] The use of the word "sometimes" arguably constitutes an understatement. In the section of the Proposing Release dealing with economic analysis of the proposed rules, the SEC notes that some companies "may decide to use a methodology that is testable, supported by published literature, or follows procedures that derive from objective standards because such a methodology may reduce the likelihood that the reasonableness of the amount of excess incentive-based compensation required to be recovered would be challenged by interested parties."[33] As a result, companies may well feel compelled to utilize such a "testable methodology," which—as the SEC acknowledges—may entail the retention of an expert for which "the monetary costs that would be incurred . . . could be substantial."[34]

Indemnification Not Permitted

In the Proposing Release, the SEC states its view that indemnification arrangements that permit executive officers to retain erroneously awarded incentive-based compensation "fundamentally undermine the purpose of Section 10D." Therefore, the SEC proposes to prohibit a listed company from indemnifying or purchasing insurance for any executive officer or former executive officer against the loss of any erroneously awarded compensation. The SEC noted that an executive officer could personally purchase third-party insurance (to the extent such insurance may be available) to fund potential recovery obligations, but also stated that the company would not be permitted to pay or reimburse the executive officer for premiums.

Timing and Transition

31. Proposing Release, section II.C.2.a.

32. *Id*.

33. Proposing Release, section III.B.2.

34. The SEC also stated that "[o]ther issuers may decide to use a methodology that results in less complex implementations . . . because, for example, by using simpler implementations, issuers may already be in a position to determine with reasonable confidence . . . that, after taking into account a reasonable range of variation in the 'but for' price [i.e., the stock price that would have been if financial statements originally had been presented as later restated], no amount of incentive-based compensation tied to stock price and/or [total shareholder return] was erroneously awarded to executive officers in the first place and consequently no recovery is required." Proposing Release, section III.B.2. While such circumstances may exist in some instances, it is likely that they will be decidedly less common than situations where determination of the "but for" price would require complex and expensive analysis.

The SEC proposes that the exchanges file their proposed listing rules no later than 90 days following the date final Rule 10D-1 is published in the *Federal Register*, and that their rules be effective no later than one year following that publication date. Companies would then be required to adopt recovery policies within 60 days after the effective date of the rules issued by their respective exchange and to recover all excess incentive-based compensation received by current and former executive officers on or after the effective date of final Rule 10D-1 that results from attaining a financial reporting measure based on financial information for any fiscal period ending on or after the effective date of Rule 10D-1. Companies would be required to comply with the new disclosures in proxy or information statements and Exchange Act annual reports filed on or after the effective date of the exchange's rules.

SOME INITIAL THOUGHTS

The Proposing Release calls for recovery policies that would go far beyond the clawback policies that many companies generally adopted after the enactment of the Sarbanes-Oxley Act of 2002[35] and the addition of section 10D to the Exchange Act pursuant to the Dodd-Frank Act. The proposed rules would require companies to make decisions entailing difficult judgments, as the Proposing Release acknowledges. The proposal also would provide for an expansion of the use of XBRL formatting in the context of executive compensation disclosures. We question whether the actual usage of XBRL data justifies the time and expense required to implement the XBRL tagging requirement, and suggest that empirical data indicating how many investors and other end users actually use this information should be discussed in the cost-benefit analysis of any SEC proposal or final rule requiring XBRL tagging.

Companies with clawback policies will be required to amend them in significant ways if the final rules are adopted substantially as proposed. They, as well as companies that have not yet adopted any clawback policy, should begin to discuss internally the SEC's proposed rules and follow comments submitted to the SEC on its proposal in order to prepare for the final rules. Because companies can be delisted if they do not comply with final rules requiring them to adopt, comply with, and make disclosures with respect to a recovery policy, issuers will have to exercise a good deal of care and devote sufficient time and resources to develop a policy that is both compliant with the final rules and appropriate with respect to their particular compensation policies and governance and compliance programs.

Although the Proposing Release is only a proposal, the issues raised by the proposal are significant enough that companies may want to reconsider aspects of their incentive plans given the challenges and costs they may face if the final rules are adopted as proposed. For example, companies may consider moving to more fixed compensation, time-based vesting of equity awards, premium priced option awards instead of options that vest based on financial or stock performance, incentive compensation based on non-financial metrics, or discretionary awards. Companies may also consider imposing deferrals or holding requirements on earned incentive awards to facilitate implementation of a recovery policy under the proposed rules. Any such considerations should be thoughtfully balanced against the company's goals for its executive compensation program, tax ramifications, shareholder input and best practices. Companies also should address recovery policies in employment agreements, equity plans and other incentive plans to make clear the company has a contractual right to enforce the recovery policy they will be required to adopt after the SEC finalizes its rules.

Finally, the proposal and the SEC's discussion related to the use of estimates in determining the amount of excess compensation in respect of incentive compensation related to total shareholder return metrics underscores concerns already expressed by commentators with regard to the use of total shareholder return as the measure of "financial performance" in the context of the SEC's "pay for performance" rule

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35. Section 304 of the Sarbanes-Oxley Act of 2002 generally provides that if an issuer is required to prepare an accounting restatement due to material non-compliance as a result of misconduct with any financial reporting requirement under the securities laws, its chief executive officer and chief financial officer will reimburse the issuer for any bonus or other incentive-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the SEC (whichever occurs first) of the financial document embodying such requirement and any profits realized from the sale of securities of the issuer during that 12-month period. The Proposing Release states that if an executive officer reimburses the issuer pursuant to section 304, such amounts should be credited to the extent that an issuer's Rule 10D-1 recovery policy requires repayment of the same compensation by that executive officer.

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proposals. The SEC's acknowledgement of "confounding factors" that "sometimes" make it "difficult to establish the relationship between an accounting error and the stock price" indicates that market factors independent of issuer financial performance may well raise questions regarding the comparability of total shareholder return among issuers. Coupled with the concern of several commentators that total shareholder return is a decidedly imperfect measure of executive performance when compared to measures such as net income or revenues that are more directly related to executive performance, these considerations suggest the advisability of careful consideration by the SEC with regard to use of total shareholder return in this context.

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