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A PRACTICAL LOOK AT THE SEC'S PROPOSED CLAWBACK RULES

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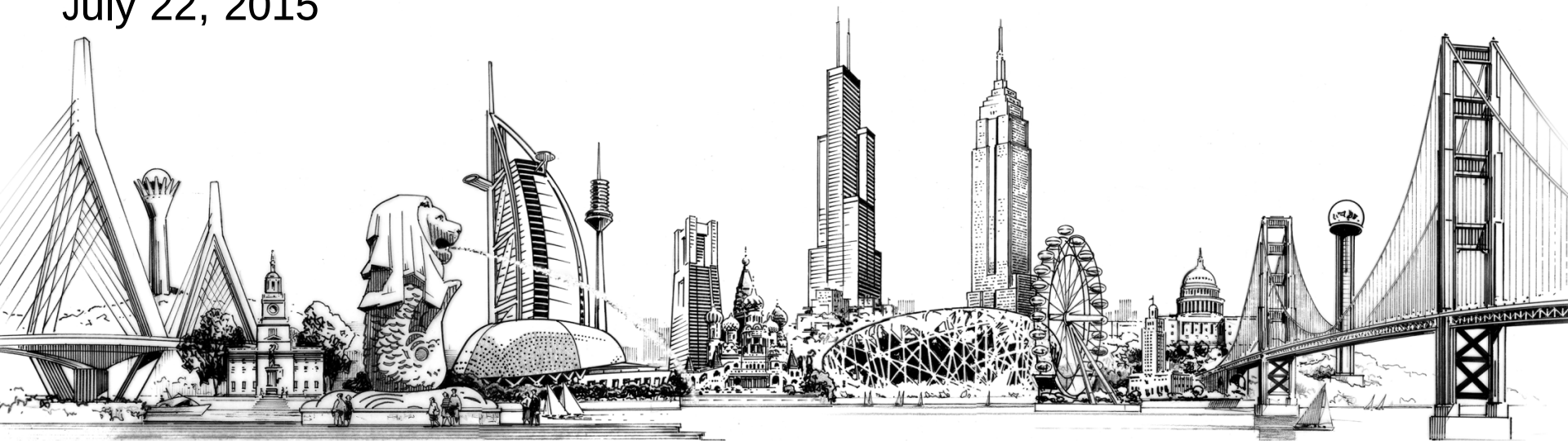

INTRODUCTION

Agenda

- Overview of Proposed Rule
- Timing and Transition
- Key Definitions
- Details of Proposed Rule
- Practical Implications

Overview of Proposed Rule 10D-1

- On July 1, 2015 the SEC issued proposed rules under the Dodd-Frank Act (which added Section 10D of the Securities Exchange Act)
  - **Required Policy** – Listed companies must adopt, disclose, and comply with a written policy to recoup "incentive-based compensation" in the event of an accounting restatement due to the "material noncompliance" of the company with any financial reporting requirement under the securities laws (no-fault rule)
  - **Incentive-based Compensation** – Any compensation "granted, earned or vested" based wholly or in part on any financial reporting measure
  - **Coverage** – Any *current or former* executive officer who "received" erroneously awarded incentive-based compensation (including stock-based compensation)
  - **Period** – The three completed fiscal years, during which any performance measure attained, immediately preceding the date on which the company determined *or should have determined* that a restatement would be required (actual payment date is irrelevant)
  - **Amount** – The excess over what would have been paid giving effect to the accounting restatement

Overview of Proposed Rule 10D-1

- Recovery is required (not discretionary)
- Listed companies that do not adopt, disclose, and comply with their recovery policies will be subject to delisting from their exchanges
- Applies to smaller reporting companies (SRCs), emerging growth companies (EGCs), and foreign private issuers (FPIs)
- Does not apply to companies with securities traded only on OTC market

Timing and Transition

- Comments on proposed rule due September 14, 2015
- Proposed timing and transition for final rule

Action	Timing
Exchanges file proposed listing rules	within 90 days after publication of final SEC rule
Exchanges' rules must be effective	within 1 year after publication of final SEC rule
Companies must adopt recovery policy	within 60 days after the effective date of their exchange's rules
Companies must recover all excess incentive-based compensation resulting from accounting restatement for any fiscal period ending on or after the effective date of the SEC rule	any accounting restatement after the company adopts its policy
Companies must comply with the new disclosures in proxy or information statements and Exchange Act annual reports	for all filings on or after the effective date of the exchange's rules

KEY DEFINITIONS

Definitions

- "**Compensation recovery policy**" – The policy required by the listing standards adopted pursuant to Exchange Act Rule 10D-1.
- "**Excess compensation**" – The amount of erroneously awarded incentive-based compensation subject to recovery, which equals the amount received by an executive officer that exceeds the amount that otherwise would have been received had the incentive-based compensation been determined based on the accounting restatement.
- "**Executive Officer**" – Includes the *current and former* president; principal financial officer; principal accounting officer or controller; any vice-president in charge of a principal business unit, division, or function; and any other officer who performs a significant policymaking function for the company, whether such person is or was employed by the company, the issuer's parent(s), or the issuer's subsidiaries. Same definition as for Section 16 officers.

Definitions

- "**Financial Reporting Measure**" – A measure determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measure derived wholly or in part from such measure, and stock price and total shareholder return. A financial reporting measure need not be presented within the financial statements or included in a filing with the SEC.
- "**Incentive-based compensation**" – Any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure.
- "**Received**" – Compensation is deemed "received" in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period.
- "**Required**" – An accounting restatement is deemed "required" as of the earlier of (1) the date the company concludes, or reasonably should have concluded, that its previously issued financial statements may contain an error; or (2) the date a court, regulator, or other legally authorized body directs the company to prepare a restatement to correct a material error.

THE PROPOSED RULE

No-Fault Recovery – Limited Exception

- Issuer would be required to recover erroneously awarded compensation under its recovery policy unless doing so is "impracticable"
  - Recovery required even if there is no misconduct or if the executive officer had no role in preparing a financial statement that is later restated
- 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, or
  - Recovery would violate a home-country law adopted before the publication of final Rule 10D-1 (provided such conclusion is based on an opinion of home-country counsel)
- Before reaching the conclusion that recovery is "impracticable," a company must first "make a reasonable attempt to recover" the compensation, document its attempt(s), and provide the documentation to its exchange

Disclosure of Recovery Policies and Actions Would Be Required

- New disclosure rules (under Regulation S-K Item 402) would require companies to disclose “recovery” policies and actions taken to recover erroneously awarded executive compensation
- Required disclosure would include, among other items:
  - Date of required accounting restatement
  - Aggregate excess compensation attributable to the restatement
  - Estimates used to determine excess compensation based on TSR/stock price
  - Information on executive officers from whom the company determined not to pursue recovery (e.g., name, reason for not pursuing, amount forgone)
  - Name of any executive officer from whom excess compensation outstanding for at least 180 days has not been recovered and amount yet to be recovered
- Disclosure would need to be electronically formatted using XBRL and must be “block-text tagged”

What Companies Are Covered by the Proposed Rule?

- Proposed rule would apply to most listed companies, including:
  - Emerging growth companies
  - Smaller reporting companies
  - Foreign private issuers
  - Controlled companies
  - Companies listing only debt and other non-equity securities
- Proposed rule would not apply to:
  - Listed registered investment companies that have not awarded incentive-based compensation to any executive officers within the last three fiscal years
  - Unit investment trusts
  - Companies listing securities futures products and standardized options cleared by a clearing agency

“Material Noncompliance” Really Means “Material Error”

- Intent behind Exchange Act Section 10D was for public companies to recover incentive compensation erroneously paid to executives as a result of “material noncompliance” with accounting rules
- According to the SEC, an error that is material to previously issued financial statements constitutes “material noncompliance”
  - “Materiality” must be analyzed in the context of particular facts and circumstances
  - 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 – “traditional” vs. “revision” (sometimes called “stealth”) restatements

What Financial Statement Changes Do Not Result in “Material Noncompliance”?

- The following retrospective 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

When Is a Restatement to Correct a Material Error Required?

- Under the proposed rule, a company's recovery policy must apply to any incentive-based compensation received during the three fiscal years immediately preceding "*the date that the issuer is required to prepare a restatement*" to correct a material error
- Date should be based on "issuer or third party determinations about the need for a restatement" and would occur on *the earlier of* the date that:
  - Management concludes, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error; or
  - A court or regulator directs the company to restate previously issued financial statements to correct a material error
- In determining the need for restatement, companies should apply judgment on an objective basis (reasonable company standard)
- A Form 8-K filing is not determinative of the trigger date

Executive Officer

- "Executive officer" used but not defined in Exchange Act Section 10D added by Dodd-Frank
- SEC elected to use Exchange Act Section 16 definition of "officer" to ensure inclusion of CFO and PAO or controller (these positions are not included in 3b-7 definition of "executive officer")
  - President
  - Principal financial officer
  - Principal accounting officer/controller
  - Vice president of a principal business unit, division, or function
  - Any other officer who performs a policymaking function
  - Any other person who performs similar policymaking functions for the issuer
- SEC believed these officers "set tone for and manage the issuer" and so should be subject to clawback (compare to no-fault provision)
  - Seeks comment on whether to specifically expand (e.g., to CIO, CLO) or narrow (to NEOs) definition
- ANY person who was an executive officer during the "performance period" is subject to clawback even if not an executive officer at the time it entered into a compensation agreement

What Is Included in "Incentive-Based Compensation"?

- Includes any compensation that is "granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure"
  - "Principles-based" definition is intended to be broadly applied
  - Non-equity incentive plan awards earned based wholly or in part on satisfying a financial reporting measure performance goal
  - Bonuses paid from a bonus pool based wholly or in part on satisfying a financial reporting measure performance goal
  - Proceeds received from sale of shares acquired through an incentive plan granted or vested based wholly or in part on satisfying a financial reporting measure performance goal
- Financial reporting measures are "[1] measures that are determined and presented in accordance with accounting principles used in preparing the issuer's financial statements, [2] any measures that are derived wholly or in part from such measures [e.g., non-GAAP], and [3] stock price and [4] total shareholder return" (TSR).
  - Need not be presented in financial statements or included in SEC filing
  - Includes non-GAAP financial measures

What Is Included in "Incentive-Based Compensation"?

- Examples of "financial reporting measures"
  - Revenues
  - Net income
  - Operating income
  - EBITDA
  - Earnings measures, such as earnings per share
  - Profitability of one or more segments (as disclosed in a financial statement footnote)
  - Financial ratios
  - Net assets/net asset value per share (for BDCs and the small number of RICs subject to the rule)
  - Liquidity measures, such as working capital or operating cash flow
  - Sales per square foot or same store sales where sales is subject to a restatement

What Is Included in "Incentive-Based Compensation"?

- Inclusion of stock price and TSR within the definition of "financial reporting measures" raises significant challenges (administrative and financial) in determining what constitutes recoverable incentive-based compensation
  - Issuers would be permitted to use estimates to determine excess compensation in connection with incentive-based compensation tied to stock price or TSR in order to address the "confounding factors" that make it "difficult to establish the relationship between an accounting error and the stock price"
  - Estimates must be reasonable and the company must maintain documentation of the determination of the estimate and provide it to its exchange
- The staff notes that commenters on Section 954 who raised these specific items suggested they be excluded because any connection between a restatement and stock price or TSR would be "speculative"

What Is Not Included in "Incentive-Based Compensation"?

- Incentive-based compensation *does not* include:
  - An incentive plan award that is granted, earned, or vested based solely upon the occurrence of certain non-financial events
    - Opening a specified number of stores
    - Obtaining regulatory approval of a product
  - Awards earned upon satisfaction of strategic measures, such as completing a merger, divestiture, or similar transaction
  - Awards that vest ***solely*** on the basis of completion of a specified employment period, such as service-vesting stock options, restricted stock, or RSUs
  - Salaries
  - Discretionary bonuses
  - Bonuses paid on subjective standards, such as leadership

When Is Incentive-Based Compensation Subject to Recovery?

- Incentive-based compensation is deemed to be "received," and therefore recoverable, in the fiscal period when the financial reporting measure specified in the incentive-based compensation award is *attained*
- Actual payment date does not matter

EXAMPLES

Type of Award	When Received
Equity award that vests upon satisfaction of a financial reporting measure and subsequent service	Deemed received in the fiscal period when the financial reporting measure is satisfied
Cash award earned upon satisfaction of a financial reporting measure	Deemed received in the fiscal period when the financial reporting measure is satisfied

- Because incentive-based compensation awards may have both service and performance conditions, an incentive award may be deemed to be "received" before all conditions are satisfied

What Amount of Incentive-Based Compensation Is Recoverable?

- Recoverable compensation = amount the executive received *less* the amount the executive would have received had the incentive-based compensation been based on the accounting restatement
- Recoverable compensation is calculated on a *pretax* basis
- Under the Internal Revenue Code, it is possible for an executive to recoup the taxes previously paid on recovered/clawed-back compensation, through somewhat complicated tax provisions

Company Indemnification Not Permitted

- SEC proposal would 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.
- SEC believes such indemnification arrangements “fundamentally undermine the purpose of Section 10D.”
- Executive officers could personally purchase third-party insurance (to the extent such insurance is available) to fund potential recovery obligations.
- Companies would not be permitted to pay, or reimburse the executive officer for, premiums.

PRACTICAL IMPLICATIONS

Initial Observations on the Proposed Rules

- Proposal would require companies to adopt recovery policies that go beyond the clawback policies that many companies have adopted in recent years.
- SEC is relatively constrained by Section 10D.
- SEC went further than required by defining “financial reporting measure” to include stock price and TSR, including the disclosure requirement, and requiring the use of XBRL formatting.
- Section 954 of the Dodd-Frank Act does not mandate delisting for a company’s failure to comply with its recovery policy.
- This is only a proposal, but if the final rules track the proposed rules, companies can expect challenges and costs.

What Should Companies Do Now?

- Socialize the proposal with your board and its committees, the company's executive officers and personnel responsible for employee plans and agreements
- Ensure that employment agreements, equity plans, deferred compensation plans, and bonus/incentive arrangements contain appropriate provisions to enable implementation of the Dodd-Frank recovery policies.
  - Create a contractual link between the incentive compensation and the recovery policy.
- Determine the executive officer group for purposes of the recovery policy and consider whether the executive officer scope is appropriately defined.
- Identify financial measures that may cause incentive compensation to become subject to recovery and consider how the recovery process would work for each. This is especially important for stock price and TSR measures.

What Should Companies Do Now?

- Consider whether incentive plans or equity compensation arrangements should be redesigned to address recovery considerations.
- The proposed rules create a tension between (1) aligning interests of executives and shareholders and (2) effectively incentivizing executives, which includes consideration of their perceptions of fairness.
- Consider a shift toward types of compensation that would not be covered by the rules, such as:
  - Equity compensation that vests based on service,
  - Incentive compensation using non-financial/non-stock price measures, and
  - Purely discretionary awards.
- Consider imposing deferrals or holding requirements on earned incentive awards to facilitate implementation of a recovery policy.
- Companies should keep in mind the need to explain the reasons for changes in the CD&A and the reactions of institutional investors.

What Should Companies Do Now?

- Review insurance arrangements to determine whether recovery liability is covered by the insurance.
- Review committee charters and other relevant board documents to ensure that the responsibility for determining the Dodd-Frank recovery process is appropriately addressed.
- Prepare to devote sufficient time and resources to develop a policy that is both compliant with the final rules and appropriate for the company's compensation policies and governance and compliance programs.

Examples of Recovery of Incentive Awards

- Let's look at the following hypothetical, which assumes the SEC Rule will take effect in July 2016, the stock exchange rule will take effect in the first half of 2017, and our company will have adopted its policy on June 30, 2017:
  - *Faceplant Inc. (FP), listed on the NYSE, is a big retailer. We'll look at grants of Incentive-based Compensation to (1) its CEO, Charlene, and (2) its Controller (principal accounting officer), Carl.*
  - *On June 30, 2015, when FP stock was trading at $15, the FP Compensation Committee granted 10,000 Incentive RSU's to Carl, which vest only if (1) FP's stock price is at least $18 on June 30, 2017 and (2) Carl remains in employment until June 30, 2018.*
  - *On January 15, 2016, the Compensation Committee approves a cash Annual Incentive Grant to Charlene, with maximum payout of $1 million, based on specified levels of revenues per store in the FY ending December 31, 2016.*
  - *In February 2017, FP reports record revenues for FY 2016 and soon thereafter Charlene collects her full $1 million cash Incentive payment.*
  - *On June 30, 2017, FP's stock is trading at $20, so Carl's Incentive RSU's satisfy the first vesting trigger.*

Examples of Recovery of Incentive Awards

- *In August 2017, the FP Audit Committee, after looking into questions regarding some complex synthetic financing transactions, determines that an inappropriate accounting method was used for those, making the 2016 reported financials materially inaccurate. There is no evidence of any wrongdoing, just an innocent mistake in a complex area of GAAP. Within four days after that determination, FP files an Item 4.02 Form 8-K reporting same.*
- *Immediately before the 8-K filing and announcement, FP stock traded at $20. A week after the filing, it had fallen to $16 (-20%). That week also saw a general stock market decline, with the S&P 500 declining 5% and the S&P Big Retail Index (fictional) declining 8%.*
- *In 2018, the restated financials for 2016 are finally filed, showing a 20% reduction in revenues. At that level, Charlene's Incentive Grant payout would have been the minimum of $250 thousand. She does not think she should return any of her $1 million because she had nothing to do with the accounting error. What if anything must FP do?*
- *Carl's Incentive RSU's won't finally vest until June 30, 2018, if he is still employed by FP then. Must FP do anything now, or ever, about that grant?*

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QUESTIONS?

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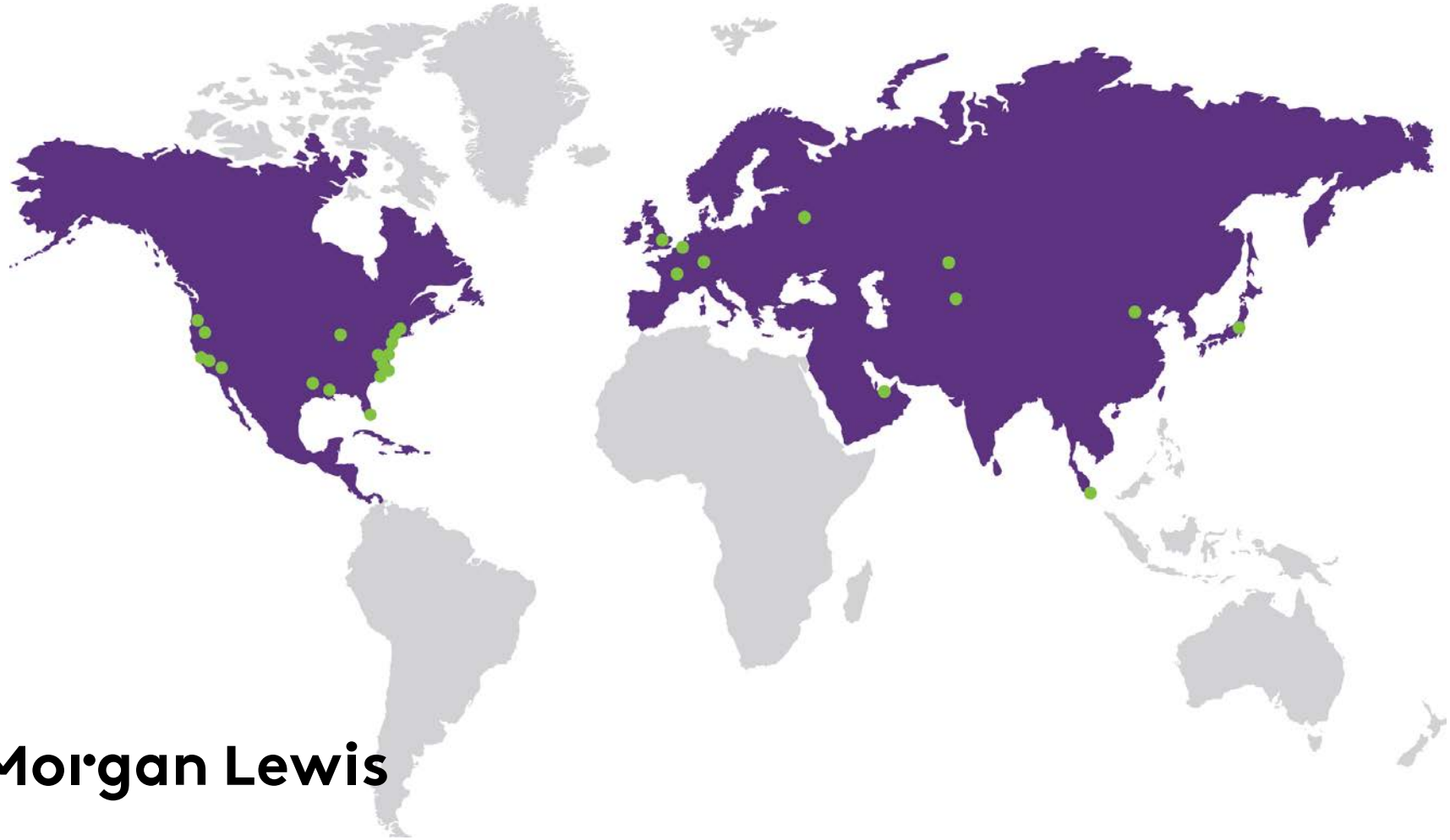

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THANK YOU