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Legal Update
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US Securities and Exchange Commission Proposes Compensation Clawback Listing Standards Requirement

The US Securities and Exchange Commission (SEC) has proposed new Rule 10D-1, directing national securities exchanges and associations to establish listing standards that prohibit the listing of any security of a company that does not adopt and implement a written policy requiring the recovery, or "clawback," of certain incentive-based executive compensation. The recovery would be of the amount of incentive compensation that is later shown to have been paid in error, based on an accounting restatement that is necessary to correct a material error of a financial reporting requirement.

If a current or former executive officer received erroneously awarded incentive-based compensation within the three fiscal years preceding the date of determination that a restatement is required, the company would have to recover the excess incentive-based compensation on a "no-fault" basis. The proposal also specifies disclosure requirements relating to clawback policies and clawbacks.[1] Comments are due by September 14, 2015.

Background

Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) added Section 10D to the Securities and Exchange Act of 1934 (Exchange Act), which mandated that the SEC adopt a rule requiring clawback listing standards. The SEC's clawback proposal implements this statutory directive.

The Dodd-Frank Act clawback requirement set forth in Section 10D contains key differences from the clawback requirement that was implemented by Section 304 of the Sarbanes Oxley Act of 2002 (Sarbanes-Oxley Act). For example, the Dodd-Frank Act requirement applies to all current and former executive officers while the Sarbanes-Oxley Act provision applies only to the chief executive officer and the chief financial officer. In addition, the Dodd-Frank Act requirement applies to any accounting restatement that is due to material noncompliance, whether or not there is misconduct, while the Sarbanes-Oxley Act requirement applies only to accounting restatements resulting from misconduct.

Proposed Listing Standards

Incentive-Based Compensation. Proposed Rule 10D-1 defines incentive-based compensation as any compensation (including stock options and other equity awards) that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. For this purpose, the term "financial reporting measures" means measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, any measures derived wholly or in part from such financial information (such as non-GAAP financial measures), and stock price and total shareholder return.

The proposing release offers several examples of compensation that would, and would not, constitute incentive-based compensation. The following are non-exclusive examples of compensation that would constitute incentive-based compensation:

- 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 (SARs) 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.

The proposing release identifies the following non-exclusive examples of compensation that would not constitute incentive-based compensation:

- Salaries;
- Discretionary compensation, if it is not as part of a bonus pool that is based wholly or in part on a financial reporting measure performance goal;
- Bonuses based on subjective standards and/or completion of a specified period of employment;
- Non-equity incentive plan awards earned solely upon satisfying strategic or operational measures; and
- Equity awards where the grant is not contingent upon achieving any financial reporting measure performance goal and where vesting is contingent solely upon completion of a specified employment period and/or attaining non-financial reporting measures.

Amount Recoverable. The amount that listed companies would have to recover is the amount by which the incentive-based compensation that an executive officer received exceeds the amount such officer would have received had such incentive-based compensation been calculated following the accounting restatement.

To calculate the amount of the excess after an accounting restatement, the company would first need to recalculate both the applicable financial reporting measure and the amount of incentive-based compensation that was based on this measure. Next the company would have to determine whether the executive officer received a greater amount of incentive-based compensation based on the original calculation of the financial reporting measure (after taking into account any discretion applied by the compensation committee to reduce the amount received) than such officer would have received based on the recalculated financial reporting measure. If the compensation was only partially based on the financial reporting measure performance goal, the company would need to determine the portion of the original compensation that was based on or derived from the restated financial measure. The company would then have to recalculate the affected portion to determine the excess amount to be recovered.

Because incentive-based compensation that is based on stock price or total shareholder return is not subject to mathematical recalculation directly from the information in an accounting restatement, proposed Rule 10D-1 would permit companies to determine the recoverable amount based on a reasonable estimate of the effect of the accounting restatement on stock price or total shareholder return, as applicable, in such circumstances. When this occurs, the listed company must retain documentation of that

estimate determination and provide it to the exchange upon request.

If a cash award is paid from a bonus pool, the size of the aggregate pool would be reduced based on applying the restated financial reporting measure. No recovery would be required in cases where the aggregate reduced bonus pool would have been sufficient to cover individual bonuses. However, where a reduced bonus pool is less than the aggregate amount of all individual bonuses received from it, the excess amount that the company would have to recover would be the executive officer's *pro rata* portion of the deficiency.

Recovery Mechanics. With respect to recoverable equity incentive-based compensation, the recovery mechanics will depend on the form in which the executive officer holds such compensation at the time of recovery. For example, if an executive officer still holds shares, options or SARs at the time recovery is required, the recoverable amount would be the number of such equity awards that were received in excess of the number that should have been received after applying the restated financial reporting measure. If the executive officer has already exercised options or SARs, but still holds the underlying shares, the company would recover the number of shares underlying the excess options or SARs after applying the restated financial measure. If the shares have been sold, the company would recover the sale proceeds received by the executive officer for the excess number of shares. If an exercise price was paid to receive shares, the recoverable amount would be reduced to reflect the exercise price paid.

Recoverable amounts would be calculated on a pre-tax basis. If the same compensation is recouped pursuant to Section 304 of the Sarbanes-Oxley Act, such payment would reduce the amounts recoverable under the proposed listing standards.

Employees Covered. The proposed clawback would apply to any individual who served as an executive officer of the listed company at any time during the performance period for that incentive-based compensation, whether or not such individual is an executive officer at the time the company is seeking recovery. This clawback would apply even if the award was authorized before the individual became an executive officer or was a new hire inducement award. As proposed, the clawback is *not* limited to named executive officers (i.e., those executive officers whose compensation is described in the company's proxy statement). Furthermore, the clawback is *not* limited to executive officers who engaged in misconduct or were responsible for erroneous financial statements.

Proposed Rule 10D-1 defines executive officer as:

> the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer.

These specified officers would be subject to the clawback policy, even if the company does not otherwise treat any such individuals as an executive officer for any other purpose. Officers of the issuer's parents or subsidiaries may be deemed to be officers of the issuer if they perform such policy-making functions for the issuer. The SEC modeled this definition on the definition of "officer" for the purposes of Section 16 of the Exchange Act.

Restatements. Proposed Rule 10D-1 would require a clawback of incentive-based compensation when a listed company is required to prepare an accounting restatement as a result of its material noncompliance with any financial

reporting requirement under the securities laws. For the purposes of proposed Rule 10D-1, "an accounting restatement is 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." According to the proposing release, the rule does not describe any type or characteristic of an error that would be considered material "because materiality is a determination that must be analyzed in the context of particular facts and circumstances."

The proposing release identified the following as types of financial statement changes that would not be considered corrections of errors and, therefore, would not trigger a clawback under proposed Rule 10D-1:

- Retrospective application of a change in accounting principle;
- Retrospective revision to reportable segment information due to a change in the structure of an issuer'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.

Look-Back Period. As proposed, Rule 10D-1 requires listed companies to recover incentive-based compensation received during the three fiscal years preceding the date on which the company is required to prepare an accounting restatement to correct a material error. This date is measured from the earliest to occur of:

- The date the listed company's board of directors, board committee or authorized officer or officers concludes, or reasonably should have concluded, that the company's previously issued financial statements contain a material error, or
- The date a court, regulator or other legally authorized body directs the listed company to restate its previously issued financial statements to correct a material error.

The proposing release stated that "while not dispositive, we believe that an issuer would have to consider carefully any notice received from its independent auditor that previously issued financial statements contain a material error."

Incentive-based compensation would be deemed received in the fiscal period in which the financial reporting measure is attained, even if the payment or grant occurs in a subsequent fiscal period, and even if the officer's right to the incentive-based compensation is contingent: e.g., as satisfaction of a subsequent service-based vesting requirement. Incentive-based compensation would be subject to recovery under proposed Rule 10D-1 only if the executive officer receives such compensation while the issuer has a class of securities listed on an exchange or association.

Covered Companies. With very few exceptions, the proposed clawback listing standards would apply to all listed companies. This means that foreign private issuers, smaller reporting companies, emerging growth companies and companies that list only debt or preferred securities would be subject to the clawback listing standards to the extent that they have securities listed on a national securities exchange or association. Proposed Rule 10D-1 does not grant securities exchanges the discretion to exempt any categories of companies from the proposed listing standards.

The exceptions from applicability of the clawback listing standards are very narrow in scope. A clearing agency that serves as the issuer for securities futures products or standardized options would not be subject to the proposed rule. A registered investment management company would be exempt only if it has not

awarded incentive-based compensation to any of its executive officers in any of the last three fiscal years or, if the company has not been listed for three fiscal years, since its initial listing. Finally, the SEC has proposed exempting equity securities issued by a unit investment trust from the clawback listing standards.

Mandatory Clawback. Proposed Rule 10D-1 mandates recovery of compensation in the circumstances set forth in the rule rather than providing the board of directors with discretion to determine whether the clawback of compensation should be pursued. The SEC proposed only two narrow exceptions where recovery is considered impractical.

First, listed companies do not have to recover excess incentive-based compensation if the direct expense of recouping compensation would exceed the amount recoverable. However, to rely on this exception the company must first make a reasonable attempt to recover the requisite compensation and document the recovery efforts. Second, a foreign private issuer does not need to seek recovery of excess incentive-based compensation if it obtains an opinion of home-country counsel—that is "not unacceptable" to the applicable exchange or association—that recovery of such compensation would violate home-country law that was adopted prior to the date of publication of the proposed rule. For either of these exceptions, the determination would have to be made by the compensation committee or, in the absence of a compensation committee, by a majority of the independent directors. Also, as discussed below, the company would need to disclose why it did not pursue the recovery.

Boards of directors would not be permitted to pursue differential recovery among executive officers. In the case of pool plans, the SEC believes that recovery should be *pro rata*, even if the board exercised discretion with respect to individual grants.

While proposed Rule 10D-1 does not allow for discretion to decide whether compensation should be recovered in the circumstances covered by the rule, it does allow companies to exercise discretion in how to accomplish recovery, recognizing that the means of recovery may vary by the type of compensation arrangement, as well as by company. However, the proposing release states that the recovery of excess incentive-based compensation should proceed "reasonably promptly."

Indemnification Prohibited. Listed companies would be prohibited from indemnifying their executive officers for incentive compensation recoverable pursuant to clawback policies and from paying the premiums on any insurance policy protecting against such recoveries.

Non-Compliance. Under the proposed rules, a company would be subject to delisting if it does not:

- Adopt a compensation recovery policy that complies with applicable listing standards;
- Disclose the policy in accordance with SEC rules; or
- Comply with the policy's recovery provisions.

Proposed Disclosure Requirements

The proposed rules require listed companies to file their clawback policies as exhibits to their annual reports on Form 10-K. Foreign private issuers, including Canadian issuers using the multijurisdictional disclosure system known as MJDS, will be required to file their policies as exhibits to their annual report on Form 20-F or Form 40-F.

The SEC has proposed new subsection (w) to Item 402 of Regulation S-K, which would require disclosure in proxy and information statements if during its last completed fiscal year a listed company either (i) prepared an accounting restatement that required a clawback under the company's clawback policy or (ii) had

an outstanding balance of unrecovered excess incentive-based compensation relating to a prior restatement. In these circumstances a listed company would be required to disclose:

- For each restatement, the date on which the company was required to prepare an accounting restatement, the aggregate dollar amount of excess incentive-based compensation resulting from the restatement and the aggregate dollar amount of excess incentive-based compensation that remained outstanding at the end of its last completed fiscal year;
- If the financial reporting measure that was restated related to stock price or total shareholder return, the estimates used to determine the excess incentive-based compensation attributable to the restatement;
- The name of each person subject to a clawback from whom the company decided during the last completed fiscal year not to pursue recovery; the amount forgone for each such person; and a brief description of the reason the company decided in each case not to pursue recovery; and
- The name of, and amount due from, each person from whom, at the end of its last completed fiscal year, excess incentive-based compensation had been outstanding for 180 days or longer since the date the company determined the amount the person owed.

The new Item 402(w) disclosure requirement is not limited to named executive officers; this disclosure is separate from the compensation discussion and analysis (CD&A) requirement, but a listed company could choose to include it in its CD&A discussion of recovery policies and decisions. This disclosure would have to be block tagged using XBRL, the SEC's interactive data format. Information disclosed pursuant to Item 402(w) will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 unless specifically so incorporated.

When prior year compensation disclosed in a summary compensation table has been recovered, the amount shown in the applicable column of the summary compensation table must be reduced to include only the amount retained by the executive officer, with a footnote explaining the recovery. For example, if the company reported that in 2016 its chief executive officer earned $1 million in non-equity incentive plan compensation, and in 2017 a restatement of 2016 financial statements resulted in recovery of $300,000 of that compensation, the company's 2017 summary compensation table would revise the 2016 reported amount for non-equity incentive plan compensation to $700,000, provide footnote disclosure explaining that the company recovered $300,000 of previously reported compensation, and make a comparable change to 2016 total compensation for such officer.

Transition Period

Securities exchanges and associations must file their proposed listing standards within 90 days after the publication in the *Federal Register* of the final version of Rule 10D-1 that the SEC ultimately adopts. The new listing standards would have to become effective no later than one year following the date final Rule 10D-1 is published in the *Federal Register*.

Once clawback listing standards become effective, each company with securities listed on the applicable exchange or association would then have 60 days to adopt a clawback policy. The clawback requirement would have to apply to excess incentive-based compensation received on or after the effective date of Rule 10D-1 that results from attaining a financial reporting measure based on, or derived from, financial information for any fiscal period ending on or after the effective date of Rule 10D-1.

Listed companies would have to include the new clawback disclosures in proxy or information statements and Exchange Act annual reports

filed on or after the effective date of the listing standards.

Practical Considerations

Time Frame for Clawback Requirement. It will be at least several months before the SEC issues a final clawback rule. Afterwards, it will take time for the securities exchanges and associations to propose and finalize listing standards. Therefore, it is very possible that calendar year-end listed companies will not be required to adopt a Dodd-Frank Act clawback policy before they file their annual reports for 2015 and their proxy statements for 2016 annual meetings of stockholders. Until the securities exchanges and associations adopt final rules, there could be significant changes from the rules currently proposed.

Clawbacks in Advance of Requirement. Some investors view a clawback policy as an important corporate governance practice. As a result, many listed companies have already adopted corporate clawback policies. Despite the potential for changes to the clawback proposal, listed companies should analyze how proposed Rule 10D-1 will impact any existing clawback policies. Listed companies may also consider whether they want to adopt, prior to the finalization of the applicable listing standards, new clawback policies, or amendments to their existing clawback policies, that reflect some or all of the provisions proposed in Rule 10D-1.

The existence or lack of a clawback policy can impact a corporate governance rating. For example, Institutional Shareholder Services (ISS) rates corporate governance based on its Governance Quickscore product, which includes the question of whether the company discloses a clawback, as a factor in its methodology for assigning a governance rating. For the US market, ISS defines clawback "as the company's ability to recoup performance-based awards (including any cash-based incentive awards, at a minimum) in the event of fraud, restatement of results, errors/omissions or other activities related above."[2] In this context, ISS has stated that it is best practice for a company policy to go beyond the Sarbanes-Oxley Act clawback requirement.

A clawback policy may also impact the outcome of stockholder votes and 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.[3]

In addition, ISS has developed an equity plan scorecard approach for making its proxy voting recommendations on equity-based and other incentive plans on a case-by-case basis. One of the three "pillars" of this scorecard is grant practices and ISS has identified the existence of a clawback policy as one of the factors it uses to evaluate such plans. According to its FAQ on its equity plan scorecard, ISS will award full points for a clawback policy that authorizes recovery of gains from all or most equity awards in the event of certain financial restatements and awards no points for a clawback policy if it does not.[4] Proxy advisory firm Glass Lewis has stated that it will consider recommending that shareholders 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.[5]

Preparations for Clawback Policies. The proposed clawback requirement specifies that former executive officers must be covered by the clawback policy. Listed companies may want to use the time before clawback listing standards become effective to consider how they will implement clawbacks from former executive officers who are no longer employed by the company.

Proposed Rule 10D-1 does not include an impracticability exception, or any other exemption from a clawback, based on the fact that the recovery of compensation would violate

the terms of an existing agreement. Therefore, listed companies should review existing governance and executive compensation documents to determine if there are any existing provisions that would violate the clawback proposal, such as provisions prohibiting clawbacks, indemnifying executive officers from clawbacks or requiring company-paid insurance coverage with respect to recovered compensation. Listed companies may also want to consider adding provisions to new executive compensation documents acknowledging that executive officer compensation is subject to clawback policies that the company adopts.

Listed companies should consider whether they want to update their compensation committee charter to address clawback responsibilities, although they may want to wait for adoption of the final rule or listing standards before formally amending the charter.

Because clawback policies may affect the accounting treatment of the incentive-based compensation subject to the clawback policy, listed companies should involve their accountants in the decisions they make with respect to the design and drafting of their clawback policies.

Whether a company has an existing clawback policy, adopts one before the applicable listing standards become effective or plans to wait until the listing standards are effective before adopting a clawback policy, it is important for listed companies to monitor this rulemaking and bring it to the attention of their compensation committee and perhaps their full board of directors. Following the finalization of the SEC proposal and the adoption of listing standards by the applicable securities exchange or association, all listed companies will need a compliant clawback policy within 60 days. Therefore, now that the SEC has released its proposal, listed companies should use the time to consider what steps they will ultimately have to take to comply with the clawback requirement.

Compensation Decisions. When documenting the basis on which the compensation committee grants equity and non-equity awards, care should be taken to minimize any ambiguity as to whether the awards are subject to recovery as incentive-based compensation, in whole or in part, in the event of a later financial statement restatement. The basis for the grant of the compensation may cause certain cash payments or equity grants that would not otherwise appear to be incentive-based to be subject to the clawback policy. For example, in order to make compensation qualify as performance-based compensation exempt from the deduction limitation of Section 162(m) of the Internal Revenue Code, many listed companies use a two-step process for making equity grants to certain executive officers.

For the first step, the listed company sets a performance goal annually and makes the grant of restricted stock or restricted stock units subject to the satisfaction of such goal. If the goal is not met, no restricted stock units are granted to the executive officers. If it is met, then, as the second step, a stock pool is established pursuant to which the listed company can make discretionary equity grants (subject only to service-based vesting after the date of grant) to the executive officers. A listed company might not consider a restricted stock grant that is subject only to service-based vesting after the date of grant as incentive-based compensation. However, the restricted stock grant may be subject to the clawback policy because the two-step approach intended to satisfy the performance-based compensation exception conditions the grant of such restricted stock on the satisfaction of the goal established in the first step.

Similar care should be taken in drafting the CD&A section of the proxy statement. The company will want to avoid later claims by stockholders that the issuer should seek to recover a portion, or a larger portion, of the executive's compensation because the CD&A

disclosed that the compensation was incentive-based, or because the company tried to make its compensatory arrangements look more incentive-based than they really were.

Impact of Pre-Tax Recovery. The requirement that the recoverable amounts be calculated on a pre-tax basis could cause the executive officer to be required to pay back more on an after-tax basis than the officer originally received. At a minimum, the officer could have the liquidity issue of coming up with funds to repay the company. In addition, while the tax treatment of the repayment will depend on the executive's specific tax situation, the taxes paid on the original excess payment may not be fully recoverable from the applicable taxing authority.

Executive Officer Determinations. The proposed definition of executive officers for clawback is based on the definition used for the purposes the short swing rules under Section 16 of the Exchange Act. As a result, the same universe of officers would be subject both to Section 16 liability and clawbacks. Therefore, now may be a good time for companies to review which officers they treat as Section 16 officers to make sure they are comfortable with the set of officers they identify as being subject to both of these requirements.

Comments. Clawback policies, by their nature, represent a balancing of corporate governance concerns with the need to provide executive officers with meaningful incentive-based compensation designed to motivate them and align their interests with those of stockholders. The SEC's proposing release raises many complex issues that merit attention and further discussion, and the SEC has expressly requested comments on more than 100 specific questions. These questions include whether the proposed rule should apply to all listed issuers and whether compensation based on stock price or total shareholder return should be subject to recovery. Companies having views on any of these issues should consider being part of the dialogue by submitting comments to the SEC on this proposal.

For more information about the topics raised in this Legal Update, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, or any of the following lawyers:

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Endnotes

[1] Available at http://www.sec.gov/rules/proposed/2015/33-9861.pdf.

[2] ISS Governance Quickscore 3.0 Revised May 2015 available at http://www.issgovernance.com/file/products/quickscore_techdoc.pdf.

[3] See ISS's United States Summary Proxy Voting Guidelines for 2015 available at http://www.issgovernance.com/file/policy/1_2015-us-summary-voting-guidelines-updated.pdf.

[4] See ISS 2015 U.S. Equity Plan Scorecard Frequently Asked Questions, available at http://www.issgovernance.com/file/policy/2015faqusequityplanscorecard-042015.pdf.

[5] See the Glass Lewis Guidelines 2015 proxy season at http://www.glasslewis.com/assets/uploads/2013/12/2015_GUIDELINES_United_States.pdf.

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