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# Memorandum

## SEC Proposes Executive Compensation Clawback Rule

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On July 1, 2015, the Securities and Exchange Commission ("SEC") proposed a rule requiring that national securities exchanges and national securities associations prohibit the listing of any security of an issuer that is not in compliance with Dodd-Frank's requirements for disclosure of the issuer's "policy on incentive-based compensation and recovery of incentive-based compensation that is received in excess of what would have been received under an accounting restatement" (commonly referred to as a "clawback policy").[1] The proposed rule would direct the exchanges to establish listing standards requiring issuers to:

- Adopt and comply with policies that provide for clawback of incentive-based pay that is based on financial information reported under the securities laws. The policies would need to apply to the listed issuers' executive officers; and
- Disclose those recovery policies as an exhibit to their annual reports.

Issuers may be subject to delisting if they do not comply with these standards.

Proposed Rule 10D-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") would codify "the listing requirements that exchanges would be directed to establish pursuant to Section 10D of the Exchange Act," which was added by Section 954 of the Dodd-Frank Act.

### Issuers and Securities Subject to the Proposed Rule

Under the proposed rule, the requirements would broadly apply to "all listed issuers," including smaller reporting companies, emerging growth companies, foreign private issuers, controlled companies and issuers

[1] *Listing Standards for Recovery of Erroneously Awarded Compensation*, Release Nos. 33-9861; 34-75342; File No. S7-12-15 (July 1, 2015), at 1 (hereinafter "Release"). The proposal passed by a 3-2 vote, with Commissioners Michael S. Piwowar and Daniel M. Gallagher voting against the proposal.

of debt and non-equity securities. [2] Thus, there are more categories of issuers who would be subject to this rule than to other Dodd Frank-based disclosure obligations, such as say-on-pay or pay ratio disclosure. The requirements would also apply to all securities issued, with limited exceptions for:

- security futures products;
- standardized options; and
- securities of certain registered investment companies.[3]

## Clawback Trigger

Under the proposed rule, if issuers are required to prepare an accounting restatement to correct "an error that is material to previously issued financial statements, the obligation to prepare the restatement would trigger application of the recovery policy."[4] The SEC does not state what type of error would be considered "material" for purposes of proposed Rule 10D-1 but does provide 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."[5] Further, the SEC lists some "types of changes to an issuer's financial statements [that] do not represent error corrections" and therefore would *not* trigger the issuer's clawback policy, including:

- "Retrospective application of a change in accounting principle;
- Retrospective revision to reportable segment information due to a change in the structure of issuers' internal organization;

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[2] Release at 10.

[3] The proposed rule would not apply to a registered management investment company if such company has not awarded incentive-based compensation to any executive officer of the company in the last three fiscal years (or, for companies that have been listed for less than three years, since the initial listing). However, management investment companies who *have* paid incentive-based compensation in the three-year period would be subject to the proposed rule. In addition to management investment companies that have not paid incentive-based compensation to their executives within the last three fiscal years, the SEC proposes to exempt from the requirements of Rule 10D-1 the listing of any security issued by a unit investment trust.

[4] GAAP defines an error in previously issued financial statements as "[a]n error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error." Under IFRS, prior period errors are "omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that: (a) was available when financial statements for those periods were authorised for issue; and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud." Release at 24 n.66, quoting FASB ASC Topic 250, Accounting Changes and Error Corrections; IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors, paragraph 5.

[5] Release at 25.

- 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."

## Clawback Period

Under the proposed rule, exchanges and associations must adopt listing standards requiring issuers to adopt and comply with policies mandating the recovery of excess incentive-based compensation "during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement." Noting that Section 10D does not indicate when an issuer is "required to prepare an accounting restatement," the SEC proposes that this requirement should run from the earlier of:

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

According to the SEC, the first proposed date should generally coincide with the occurrence of an event that would be described in Item 4.02(a) of Exchange Act Form 8-K, "although neither proposed date is predicated on a Form 8-K having been filed." The first date would simply be the date the issuer has concluded that previously issued financial statements contain a material error, even if the exact amount of the error has not yet been determined.

## Executives Subject to Recovery Policy

Under Section 10D(b)(2) of the Exchange Act, excess incentive-based compensation granted to "any current or former executive officer of the issuer" is subject to clawback. Proposed Rule 10D-1 would apply to all executive officers of the issuer. The proposed rule's definition of "executive officer" would be modelled after the definition of "officer" in Rule 16a-1(f) and would include the an issuer's:

- president;
- principal financial officer;
- principal accounting officer (or in the absence of such an officer, the controller);
- any vice president in charge of a principal business unit, division or function;
- any other officer who performs a policy-making function;

- any other person who performs similar policy-making functions for the issuer; and
- any executive officer of the issuer's parents or subsidiaries if such officer performs policy-making functions for the issuer.

In addition, as with the "officer" determination under Section 16, "if pursuant to Item 401(b) of Regulation S-K the issuer identifies a person as an 'executive officer,' it would be presumed that the board of directors has made that judgment and the persons so identified are executive officers for purposes of proposed Rule 10D-1."

Under the proposed rule, recovery of excess incentive-based compensation would be required from any individual who served as an executive officer "at any time during the performance period for that incentive-based compensation." Accordingly, "incentive-based compensation derived from an award authorized before the individual [became] an executive officer and inducement awards granted in new hire situations" would be subject to clawback so long as the individual served as an executive officer at the company at any time during the award's performance period.

## Incentive-Based Compensation Subject to Clawback

The SEC proposes to define "incentive-based compensation" as "any compensation that is **granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure."**[6] In turn, "financial reporting measures" would be defined as "measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return." Accordingly, "incentive-based compensation" would include the following types of awards that are earned based wholly or in part by satisfying a financial target:

- options;
- cash awards;
- bonuses paid from a bonus pool;
- restricted stock, restricted stock units, performance share units, stock options and stock appreciation rights; and
- proceeds received upon the sale of shares acquired through an incentive plan.
- Under the proposed rule, incentive-based compensation is deemed received in the fiscal period during which the financial reporting measure specified in the award is met, even if the payment or grant occurs after the end of that period.

[6] Release at 41 (emphasis added).

## Compensation Specifically Excluded from Incentive-Based Compensation

Incentive-based compensation would *not* include awards "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, consummating a merger or divestiture, [or] completing a restructuring plan or financing transaction." The SEC does not consider the following types of compensation to be "incentive-based compensation":

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

## Time Period Covered by Recovery Policy

Under the proposed rule, the three-year look-back period would be calculated as "the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement," rather than a preceding three-year calendar year period. If an issuer changes its fiscal year end during the three-year look-back period, the issuer would be required to "recover any excess incentive-based compensation received during the transition period occurring during, or immediately following, that three-year period in addition to any excess incentive-based compensation received during the three-year look-back period (i.e., a total of four periods)."

## Recovery Process

The proposed rule addresses certain considerations in the recovery process, including:

- **Determination of Excess Compensation**. Under the proposed rule, excess compensation would be the portion of any incentive-based compensation in excess of what would have been earned, paid or received had the compensation amount been determined based on the restated financial measure. If the incentive-based compensation awarded is based on stock price or total shareholder return, such that precise mathematical calculation of the amount erroneously awarded is not possible, an issuer may use "a reasonable estimate of the effect of the accounting restatement on the applicable measure." Where a

"reasonable estimate" is reached, the issuer would be mandated to maintain and provide documentation of the "reasonable estimate" to the relevant exchange or association. Moreover, under the proposed rule, the recoverable amount would be calculated on a pre-tax basis. Finally, in recognition that the proposed rule overlaps somewhat with Section 304 under the Sarbanes-Oxley Act of 2002, the SEC noted that "[t]he proposed rule is not intended to alter or otherwise affect the interpretation of Section 304 or the determination by the Commission or the courts of when reimbursement is required under Section 304."[7] The SEC clarified that, under the proposed rule, if an executive reimburses an issuer under Section 304, such amounts should be credited for Rule 10D-1 purposes. In addition, "recovery under Rule 10D-1 would not preclude recovery under Section 304 to the extent any applicable amounts have not been reimbursed to the issuer."

- **Extent of Board Discretion in Seeking Recovery**. The proposed rule does not generally allow boards of directors the discretion to determine whether or not to recover erroneously awarded incentive compensation; rather, it requires issuers to recover such compensation except:
  - "to the extent that pursuit of recovery would be impracticable because it would impose undue costs on the issuer or its shareholders" (*i.e.* that the direct costs of enforcing recovery would exceed recoverable amounts); or
  - if recovery would violate home country law adopted prior to the date that proposed Rule 10D-1 is published in the Federal Register.

  With regard to the first of these exceptions, the issuer would be required to first "make a reasonable attempt to recover" the incentive-based compensation at issue, document its recovery attempts and provide such documentation to the exchange, and "disclose why it determined not to pursue recovery." Similarly, before relying on the second exception, "the issuer first would need to obtain an opinion of home country counsel, not unacceptable to the applicable national securities exchange or association, that recovery would result in such a violation." With respect to either exception, the determination must be made by "the issuer's committee of independent directors that is responsible for executive compensation decisions," or, in the absence of such committee, "by a majority of the independent directors serving on the board."

- **Differential Recovery.** Under the proposed rule, boards may not seek differential recovery among executive officers, including in "pool plans," where discretion may have originally been exercised in

[7] Sarbanes-Oxley Section 304 provides that "[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period."

allocating individual grants from the bonus pool. Rather, recovery should be *pro rata* based on the size of the original award.

- **Means of Recovery**. In recognition that "the appropriate means of recovery may vary by issuer and by type of compensation arrangement," the proposed rule would permit issuers to exercise discretion in the means by which they accomplish recovery, provided that recovery is reasonably prompt.[8]

## Compliance with Recovery Policy

Under proposed Rule 10D-1, the relevant exchange would determine whether an issuer's actions constitute compliance with its compensation recovery policy. An issuer found not to be in compliance with its recovery policy is subject to delisting.

## No Fault

Notably, proposed rule 10D-1 requires recovery "regardless of issuer or executive misconduct or the role of the executive in preparing the financial statements."

## Indemnification and Insurance

In the SEC's view, indemnification and reimbursement arrangements would frustrate the purpose of Section 10D. Accordingly, under the proposed rule, issuers would be prohibited from:

- "indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation"; and
- paying or reimbursing the executive for premiums for third-party insurance policies purchased by the executive to fund potential recovery obligations.

## Required Disclosure

Under Section 10D, exchanges and associations must adopt listing standards calling "for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws."[9] The SEC construes this requirement as referring to "disclosure of the listed issuer's policy related to recovery of erroneously awarded compensation." Proposed Rule 10D-1 would require listing standards to mandate that listed issuers disclose their recovery policies and file them in accordance with the federal securities laws, as amended by the proposed rule.

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[8] Suggested methods of recovery by commenters include, among others: (i) deductions from future pay; (ii) deductions from current compensation owing, then from after tax-funds or (iii) cancellation of unvested equity or offsetting against amounts otherwise payable to the executive officer. Release at 75.

[9] Release at 79, quoting Exchange Act §10D(b)(1).

- **Listed U.S. Issuers**. Under proposed Rule 10D-1, each U.S.-listed issuer must disclose its recovery policy as an exhibit to its annual report on Form 10-K. Moreover, the proposed rule would amend Item 402 of Regulation S-K "to require listed issuers to disclose how they have applied their recovery policies." Specifically, "if at any time during its last completed fiscal year either a restatement that required recovery of excess incentive-based compensation pursuant to the issuer's compensation recovery policy was completed or there was an outstanding balance of excess incentive-based compensation from the application of that policy to a prior restatement," new Item 402(w) would require listed issuers to disclose:
  - for each restatement, the date on which the listed issuer was required to prepare the restatement, the total dollar amount of excess incentive-based compensation attributable to the restatement and the total amount of excess incentive-based compensation remaining outstanding at the end of the issuer's last completed fiscal year;
  - the estimates used to determine excess incentive-based compensation attributable to the account restatement, "if the financial reporting measure related to stock price or total shareholder return metric";
  - the name of each person subject to recovery, "if any, from whom the listed issuer decided during the last completed fiscal year not to pursue recovery, the amount foregone for each such person, and a brief description of the reason" the issuer decided not to pursue recovery; and
  - "[t]he 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 issuer determined the amount the person owed" to the issuer.

  The SEC proposes to require this disclosure as a separate item under Item 402, rather than as an amendment to Compensation Discussion and Analysis ("CD&A"); however, an issuer that is required to have a CD&A may decide to include its disclosure "in its CD&A discussion of its recovery policies and decisions."

  The SEC further proposes to add a new instruction to the Summary Compensation Table that "would require that any amounts recovered pursuant to a listed issuer's erroneously awarded compensation recovery policy reduce the amount reported in the applicable column for the fiscal year in which the amount recovered initially was reported, and be identified by footnote." This new instruction would apply to any filing requiring a Summary Compensation Table, including Securities Act registration statements.

  Finally, the SEC proposes that the new Item 402(w) disclosure be provided "in interactive data format using XBRL using block-text tagging."

- **Listed Foreign Issuers**. Under the proposed rule, foreign private issuers "would be required to provide the same information called for in Item 402(w), and to file their erroneously awarded compensation

policies as an exhibit to, the annual reports they file with the Commission" on Form 20-F, Form 10-K, or Form 40-F. Listed foreign issuers would also be required to tag the required disclosure using interactive XBRL format.

## Timing

The SEC set a 60-day period for public comment on its proposed rule. Within 90 days after the publication of the final SEC rule in the Federal Register, the national securities exchanges are required to publish implementing rules that will take effect no later than one year after the publication of the final SEC rule. Listed issuers will then have 60 days following the effective date of the relevant exchange's rules to adopt clawback policies. The SEC also proposes that listed issuers be required to recover excess incentive-based compensation received "as a result of attainment of a financial reporting measure based on or derived from financial information for any fiscal period ending on or before the effective date of Rule 10D-1 and that is granted, earned or vested on or after the effective date of Rule 10D-1 pursuant to the issuer's recovery policy." Finally, the SEC proposes that the mandated disclosures would be required to be included in SEC filings made on or after the date on which the exchange rules become effective.

## Takeaways from the Proposed Rule

- **Update the Board of Directors/Compensation Committee**. Consider updating the board and/or compensation committee on the proposed rule, including its potential implications, and begin contemplating how to address the new proposed requirements.
- **Review Executive Compensation Structure**. Issuers should review the elements of their executive compensation plans to determine which elements are subject to the proposed rule's definition of "incentive-based compensation."
- **Start Considering the Structure or Substance of a New Policy**. Although the SEC's final rule may differ from the proposed rule and the listing standards adopted by the exchanges may be more expansive than those required by the final rule, corporate boards and management may choose to begin thinking about how best to approach, from a structural and substantive perspective, the new policy that they may be required to adopt pursuant to the proposed rule.

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at (212) 455-3815 or yafit.cohn@stblaw.com, any other member of the Firm's Public Company Advisory Practice, or any of the following members of the Firm's Executive Compensation and Employee Benefits Practice:

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