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EXEQUITY

Independent Board and Management Advisors

Client Alert

SEC Issues Proposed Clawback Rules

At long last, on July 1, 2015, the Securities and Exchange Commission (SEC) issued proposed Rule 10D-1 to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 regarding recovery of erroneously paid compensation, i.e., a clawback requirement.[1] This proposed rule marks the final Dodd-Frank Act executive compensation provision that the SEC was required to address. This Client Alert looks at these proposed rules and the Appendix includes our summary of the status of all the executive compensation provisions of the Dodd-Frank Act.

The Proposed Rule in a Nutshell

Each company must have a ***written policy*** providing that if an ***accounting restatement*** is required due to ***material noncompliance with any financial reporting requirement*** under the securities laws, the issuer ***will recover*** the amount of erroneously awarded ***incentive-based compensation received*** by ***executive officers*** in the ***three completed fiscal years*** immediately prior to the date on which the company was required to prepare an accounting restatement due to a material error.

Details on the Proposed Rule

The following questions and answers address the details surrounding the new proposed clawback rule.

What Is the Trigger for Applying the Required Clawback Policy?

The required clawback policy is triggered if a company is required to prepare a restatement of its previously issued financial statements to correct a material error.

> ***Exequity Comment****: No fraud or wrongdoing is needed for the clawback to apply. This is strict liability for the executives covered regardless of their individual actions if a financial restatement is required due to a material error.*

What Is a Material Error That Necessitates a Restatement of Financial Statements for Purposes of the Proposed Clawback Rules?

The SEC did not provide specific guidance on what constitutes a "material" error. Instead, the SEC observed that materiality: (1) is a determination that must be analyzed in the context of particular facts and circumstances, and (2) has received extensive and comprehensive judicial and regulatory attention (citing TSC Industries, Inc. v. Northway, 426 U.S. 438 (1978) and Basic v. Levinson, 485 U.S. 224 (1988)). The SEC also noted that companies 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.

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[1] SEC Release 33-9861, Listing Standards for Recovery of Erroneously Awarded Compensation (July 1, 2015), available at: http://www.sec.gov/rules/proposed/2015/33-9861.pdf.

What Accounting Changes Do Not Trigger the Clawback Rules?

The following causes for an accounting restatement do **not** trigger the recovery provisions of the proposed clawback rules:

- Retrospective application of a change in accounting principle;
- Retrospective revision to reportable segment information due to a change in the structure of a company's internal organization;
- Retrospective reclassification due to a discontinued operation;
- Retrospective application of a change in reporting entity;
- Retrospective adjustment to provisional amounts in connection with a prior business combination; and
- Retrospective revision for stock splits.

What Is the Date on Which a Company Is Required to Prepare an Accounting Restatement?

The date on which a company is required to prepare an accounting restatement is the earlier to occur of:

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

What Compensation Is Subject to the Clawback Policy?

Compensation that must be subject to a company's required clawback policy is ***incentive-based compensation*** received during the three completed fiscal years immediately preceding the date a company is required to prepare a financial restatement to correct a material error. Incentive-based compensation is any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure. A financial reporting measure is a measure that is determined and presented in accordance with the accounting principles used in preparing a company's financial statements, any measures that are derived wholly or in part from such measures, and stock price and total shareholder return (TSR). A financial reporting measure need not be presented within a company's financial statements or included in an SEC filing. Additionally, incentive-based compensation received during any transition period (as a result of a change in a company's fiscal year) within or immediately following those three completed fiscal years is covered.

Compensation Subject to Recovery	Compensation Not Subject to Recovery
• Equity awards whose grant or vesting is based wholly or in part upon the attainment of a financial goal, including a stock price or TSR goal, including equity awards that generally have time-based vesting but also have a performance metric attached in order to qualify the award for deductibility under Section 162(m) • Non-equity incentive plans based wholly or in part upon satisfying a financial performance goal • Bonuses paid from a "bonus pool," the size of which is based wholly or in part upon satisfying a financial performance goal, including a stock price or TSR goal • For retirement benefits under pension plans, the amounts based on compensation earned (e.g., final average compensation that includes actual bonuses)	• Salaries • Stock options, restricted stock, or restricted stock units which vest solely on the passage of time, or attaining one or more non-financial measures • Bonuses paid solely on the basis of discretion, or paid upon satisfying one or more subjective standards, strategic measures, or operational measures

What Amount of Incentive-Based Compensation Is Recoverable?

The amount of incentive-based compensation received that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement, computed without regard to any taxes paid, is the amount recoverable.

When Is Compensation Deemed to Be Received for Purposes of the Clawback Policy?

Incentive-based compensation is deemed received in the company's 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 the period.

> ***Exequity Comment:*** *Ministerial acts or other conditions necessary for payment do not affect the date when incentive-based compensation is received. Thus, incentive-based compensation that utilizes a fiscal year as the performance period is "received" for purposes of the clawback rules at the end of that fiscal year, even if the attainment of such performance goal needs to be certified by the compensation committee prior to payout and that occurs in the following year.*

How Is the Amount of Incentive-Based Compensation Based on Stock Price or TSR Determined?

The amount is based on a reasonable estimate of the effect of the accounting restatement on the stock price or TSR upon which the incentive-based compensation was received. The company must maintain documentation of the determination of that reasonable estimate and provide it to its national securities exchange or association.

How Is Excess Erroneously Awarded Incentive-Based Compensation Determined for Equity Awards?

The treatment of equity awards is determined based on whether the award is still held, whether they have been exercised, or whether the underlying shares have been sold:

- If shares, stock options, or stock appreciation rights (SARs) are still held at the time of recovery, the recoverable amount is the number received in excess of the number that should have been received.
- If stock options or SARs have been exercised but the underlying shares have not been sold, the recoverable amount would be the number of shares underlying the excess stock options or SARs.
- If the shares have been sold, the recoverable amount would be the sales proceeds attributable to the excess number of shares.

Who Must Be Covered by the Clawback Policy?

The required written clawback policy must cover a company's "**executive officers**," which includes current and former executive officers. The proposed rule defines executive officers as the "president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president…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." The proposed rule also indicates that executive officers of parents and subsidiaries may also be deemed executive officers of a company if they perform policy-making functions for the company.

Can the Company Exercise Any Discretion When Deciding to Claw Back Compensation?

There are two very limited exceptions that permit limited discretion in applying the required clawback policy if the recovery would: (1) be impracticable, which only occurs if the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered, or (2) violate home country law.

However, before concluding that it would be impracticable to recover any amount of erroneously awarded compensation, a company must first make a reasonable attempt to recover such compensation from current and former executive officers. Companies must document their reasonable attempt(s) to recover and provide that documentation to their national securities exchange or association.

Before a company concludes that it would be impracticable to recover any amount of erroneously awarded compensation based on violation of home country law, the company must obtain an opinion of home country counsel, not unacceptable to the company's exchange, that recovery would result in such a violation, and shall provide such opinion to the exchange. Additionally, the home country law must have been adopted in such home country prior to the date of publication of the proposed clawback rules in the *Federal Register*.

The determination that recovery would be impracticable is to be made by the company's compensation committee (independent directors) or in the absence of such a committee, a majority of the board of directors.

Can the Company Exercise Discretion in the Manner of Recovery?

Companies are not permitted to pursue differential recovery among executive officers in bonus pool plans. Any recovery from such plans must be done on a pro rata basis.

Companies can use discretion in how to accomplish recovery, but recovery must be “reasonably prompt.”

What Happens if a Former Executive Officer Erroneously Received Incentive-Based Compensation That Is Subject to Clawback?

If a former executive officer was erroneously awarded incentive-based compensation that becomes subject to a clawback policy, the company must still make a reasonable attempt to recover such compensation. If the former executive does not pay back the erroneously awarded compensation, then the company has to determine whether the direct expense paid to a third party to assist in recovering such compensation would exceed the amount of compensation to be recovered. If so, then the company can decide not to pursue recovery, but then must comply with the extensive disclosure obligations regarding such decision.

What Disclosure Obligations Apply Under the Proposed Clawback Rules?

Once the rules are finalized by the exchanges/associations, companies will face the following disclosure obligations:

- **Written Clawback Policy**—Companies will be required to file their written clawback policy as an exhibit to their annual reports.

- **Action to Recover Erroneously Awarded Compensation**—Companies will be required to include in their proxy statements the following information if at any time during the last completed fiscal year either a restatement that required recovery of excess incentive-based compensation was completed or there was an outstanding balance of excess incentive-based compensation from the application or the policy to a prior restatement:

  — The date on which the company was required to prepare an accounting restatement;

  — The aggregate dollar amount of excess incentive-based compensation attributed to such restatement;

  — The estimates that were used in determining the amount of excess incentive-based compensation if the financial measure related to stock price or TSR; and

  — The aggregate dollar amount of excess incentive-based compensation that remains outstanding at fiscal year-end.

> ***Exequity Comment****: As indicated in the proposed rules, disclosure is required if there is an outstanding balance of excess incentive-based compensation owed to the company. There is no time limit on that disclosure, so presumably disclosure would continue until either the amount was recovered or the company made a determination that it would not pursue recovery, at which time disclosure of the decision not to pursue recovery would be made. If the decision to not pursue recovery was made during the last fiscal year, presumably, no further disclosure in subsequent fiscal years would be required.*

- **Decisions Not to Pursue Recovery**—If during the last completed fiscal year a company decided not to pursue any required recovery from any individual, the name and amount forgone and a brief description of the reason the company decided not to pursue recovery must be disclosed in the proxy.

- **Outstanding Excess Compensation Recovery Balances**—If a company has had a restatement that would trigger recovery of erroneously awarded compensation, it must then report the name of each individual from whom, as of fiscal year-end, excess incentive-based compensation had been outstanding for 180 days or longer since the date the company determined the amount the individual owed, and the dollar amount of such compensation for each individual.

***Note**: The above disclosures must be provided in the same format as the rest of the Regulation S-K, Item 402 disclosures and must be electronically formatted using the eXtensible Business Reporting Language (XBRL) interactive data standard (block-text tagged).*

- **Impact of Recovered Amounts on the Summary Compensation Table**—If a company has recovered erroneously awarded compensation pursuant to the proposed clawback rules, the recovered amounts reduce the reported amount in the applicable column of the Summary Compensation Table for the fiscal year in which the amount was initially reported.

Can a Company Indemnify Executive Officers for Erroneously Awarded Compensation That Is Recovered?

No, a company may not indemnify executive officers (current or former) for the loss of any erroneously awarded compensation as a result of the application of the company's clawback policy. Furthermore, if an executive officer purchases an indemnification policy for such compensation from a third party, a company may not pay for or reimburse the executive for the premiums on that policy.

What Companies Are Exempt From These Proposed Clawback Rules?

All companies with listed securities are subject to the proposed clawback rules except for security futures products, standardized options, and securities of registered investment companies which have not awarded incentive-based compensation to any executive officer in any of the last three fiscal years.

Emerging growth companies, smaller reporting companies, foreign private issuers, and controlled companies are **not** exempt from the proposed clawback rules.

Implementation and Timing

The proposed clawback rules have a 60-day comment period after they are published in the *Federal Register* (which should run through early September 2015). Once final rules are adopted by the SEC, national securities exchanges and associations have 90 days to comment and their rules must be effective within one year following publication of the SEC's final rules in the *Federal Register*. Once the listing rules are effective, companies will have 60 days to adopt a compliant, written clawback policy.

Recovery would apply to erroneously awarded incentive-based compensation received for any fiscal years ending on or after the effective date of the SEC's final rules and that is granted, earned, or vested after the effective date.

Suggested Next Steps

We suggest that companies review all of their policies, award agreements, employment agreements, other compensation-related agreements, and indemnification policies to determine what revisions and amendments would be necessary in order to comply with the proposed clawback rules. Companies may also wish to evaluate potential design changes to mitigate the impact of recovery of compensation in the event of a restatement, but that may prove somewhat problematic given countervailing considerations including shareholders and proxy advisory firms' desire to see companies utilize performance-based compensation for a significant portion of their executives' total compensation.

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Appendix: Status of Dodd-Frank Legislation Pertaining to Executive Compensation

Section and Topic	951 Say-on-Pay	952 Independence Standards	953 Pay-for-Performance	953 CEO Pay Ratio	954 Clawbacks	955 Hedging
Brief Description	Companies required to hold a non-binding say-on-pay vote at least every 3 years. Also requires a non-binding vote on golden parachute payments in connection with an acquisition, merger, etc.	Covers (a) independence of compensation committees of boards of directors, (b) independence of compensation consultants and other advisers to compensation committees, (c) compensation committee authority with respect to compensation consultants, (d) authority of compensation committees to engage other advisers including their own legal counsel, and (e) authority of compensation committees to provide for funding by the issuer of appropriate compensation for such consultants and other advisers.	Companies required to disclose in tabular format relationship between CEO compensation disclosed in the Summary Compensation Table and CEO compensation "actually paid"; similar disclosure required for the average of the other named executive officers. Additionally, the annual TSR of the company and peer group companies must be disclosed in the table.	Companies required to disclose the ratio of "the annual total compensation" of the CEO to the median "annual total compensation" of all employees.	Companies required to develop policies to claw back the incentives in the event of an accounting restatement due to material noncompliance with financial reporting requirements. Recovery required without regard to fault and applied to incentive compensation tied to accounting metrics, stock price, or shareholder return. Recovery would apply to incentive compensation in the 3 years preceding the restatement. Recovery limited to the amount over the amount that would have been paid had there been no restatement.	Companies required to disclose whether their employees or directors are permitted to engage in hedging transactions relating to equity securities of the issuer. Does *not* require issuers to (a) prohibit hedging transactions, (b) adopt policies or procedures addressing hedging, or (c) disclose specific hedging transactions.
Proposed Rules	10/18/10	N/A	04/29/15	09/18/13	07/01/15	02/09/15
Final Rules	01/25/11	06/20/12	***Pending***	***Pending***	***Pending***	***Pending***
Status	Adopted/Implemented	Adopted/Implemented	Comment period ended on July 6, 2015. If rules finalized in 2015, disclosure may be required in 2016 proxy statement.	SEC timetable for regulatory action states final rules expected in April 2016, which would mean the ratio would be measured in 2017 for disclosure in the 2018 proxy. However, latest rumors from the SEC indicate rules are expected to be finalized in August 2015, which would mean disclosure in the 2017 proxy.	In comment period which lasts for 60 days after proposed rules are published in the *Federal Register* (through early September 2015).	Comment period ended on April 20, 2015. SEC timetable for regulatory action states final action expected April 2016, which would result in disclosure in 2017 proxy.