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Seciurities and Exchange Commission—Proposed Clawback Rules—Technical Insights

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On July 1, 2015, the Securities and Exchange Commission ("SEC") released proposed rules (http://www.sec.gov/rules/proposed/2015/33-9861.pdf) addressing the final executive compensation regulation required under Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). Proposed Exchange Act Rule 10D-1 requires the SEC to adopt rules directing the national securities exchanges and associations to prohibit the listing of any security of an issuer that does not develop and implement a policy providing for the disclosure and recovery of excess incentive-based compensation received by a current or former executive officer whenever the issuer is required to prepare an accounting restatement in order to correct erroneous financial data.

Unlike Section 304 of the Sarbanes-Oxley Act ("Sarbanes Oxley") which requires issuers to recover all incentive-based compensation received by their chief executive officer and chief financial officer in the 12-month period following the filing or public issuance of a financial document that is required to be restated as a result of "*misconduct*," the proposed Section 954 Dodd-Frank rules would apply to compensation that was erroneously awarded due to "*no-fault*" computational errors in the financial statements.

The purpose behind the proposed clawback rule is the recovery of erroneously awarded incentive-based compensation that is received in excess of what would have been received had it been determined based on an accounting restatement.

A summary of key elements included in the proposed rules include:

- Recovery triggered under a "no fault" accounting restatement to correct a material error.
- The following financial statement changes would not trigger any recovery policy:
  - Retrospective application of a change in accounting principles;
  - Retrospective revision to reportable segment information due to a change in accounting principles;
  - 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.
- Applies to almost all listed issuers with only limited exceptions. Emerging growth companies, smaller reporting companies, foreign private issuers, and controlled companies are not exempt.

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- Covers any current or former employee who served as an officer under Section 16 of the Exchange Act during the relevant period.
- Recovery policy would apply to incentive-based compensation received during the three completed fiscal years immediately preceding the date on which the issuer is required to prepare a restatement to correct a material error.
- Applies to incentive-based compensation "that is based on financial information required to be reported under the securities laws," as well as stock price and total shareholder return.
- Exempts equity awards that vest solely on the basis of time (including time-vested options).
- Exempts base salary, discretionary bonuses, bonuses paid solely upon satisfying one or more subjective standards, non-financial measures (such as strategic or operational measures), or completion of a specified employment period.
- The recovery amount is determined on a pre-tax basis and is the amount of incentive-based compensation that exceeds the amount that otherwise would have been received had it been determined based on the accounting restatement.
  - For incentive-based cash awards, the recoverable amount is the difference between the amount that was received and the amount that should have been received applying the restated financials.
  - For bonus pools, the size of the aggregate bonus pool from which individual bonuses are paid would be reduced based on applying the restated financial reporting measure. If the reduced bonus pool is less than the aggregate amount of individual bonuses that were received from it, then the excess amount is reduced pro rata among the executive officers:
    - No recovery would be required if the reduced bonus pool is still greater than the aggregate bonus received from it; and
    - Issuers using an umbrella plan to avoid the deduction limits of Section 162(m) of the Internal Revenue Code should assume that amounts paid pursuant to the underlying plan would be recoverable to the extent they are awarded due to the attainment of financial performance metrics.
  - For incentive-based equity awards:
    - If the shares, options, or SARs are still held at the time of recovery, the recoverable amount would be the number of shares, options, or SARs received in excess of the number that should have been received applying the restated financial reporting measure;
    - If the 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 options or SARs (less any exercise price paid); and
    - If the shares have been sold, the recoverable amount would be the sale proceeds of the excess shares (less any exercise price paid).
- Issuers are permitted to use reasonable estimates when determining the impact of an accounting restatement on stock price and total shareholder return, provided issuers publicly disclose those estimates.
- Issuers must recover erroneously awarded compensation except to the extent it would be impracticable to do so (such as where the cost to recover exceeds the amount to be recovered or, if recovery would violate a home country law).

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- If an issuer decided not to pursue recovery from an individual, it must disclose the individual's name, the amount forgone, and a brief description of the reason for deciding not to pursue recovery.
- Examples of potential means of compensation recovery include:
  - Recovery over time or from future pay;
  - Recovery from current compensation owing, and then after-tax funds;
  - Forfeiture of an award earned but not yet paid;
  - Forfeiture of unvested awards; and
  - Offsetting against amounts otherwise payable, such as deferred compensation (however, this could lead to a Code Section 409A additional tax penalty for impermissible payment acceleration).
- Any fiscal year during which an issuer completed a restatement that required recovery of erroneously awarded incentive-based compensation, or there was an outstanding balance of excess incentive-based compensation from a previous year, the issuer must disclose:
  - The date on which the issuer was required to prepare an accounting restatement;
  - The aggregate dollar amount of excess incentive-based compensation attributable to the accounting restatement, or an explanation of the reasons why the amount has not yet been determined;
  - The estimates that were used in determining the excess incentive-based compensation attributable to the accounting restatement, if the financial reporting measure related to a stock price or total shareholder return metric;
  - The aggregate dollar amount of excess incentive-based compensation that remained outstanding at the end of the last fiscal year; and
  - The name of any individual who, as of the end of the last fiscal year, had erroneously awarded compensation outstanding for a period of 180 days or longer, as well as the dollar amount of the outstanding erroneously awarded compensation.
- Requires issuers to revise prior years' compensation disclosures in their current proxy to reflect amounts recovered pursuant to a recovery policy by reducing the amount reported in the applicable Summary Compensation Table column for the fiscal year in which the amount recovered was initially reported as compensation, along with a footnote explanation.
- Prohibits an issuer from indemnifying any executive officer against the loss of recovered compensation.
- Requires the recovery policy be filed as an exhibit to the issuer's annual report.
- Failure of an issuer to adopt, disclose, and comply with its recovery policy would subject the issuer to delisting from any national securities exchange or association.

Comments on the proposed rules are required to be submitted on before 60 days after the date of publication in the Federal Register. Each national securities exchange and association must file its proposed listing standards with the SEC no later than 90 days after the publication of the final rules in the Federal Register. These rules must become effective within one year following the publication date of the final rules, and each listed issuer must adopt its recovery policy no later than 60 days from the effective date of the exchanges' rules becoming effective. Under the proposed rules any incentive-based

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compensation received for performance periods ending after the SEC finalizes its rules is subject to clawback.

Securities and Exchange Commission Proposed Clawback Rules—
Frequently Asked Questions

General Questions

1. What companies are subject to the application of the SEC's proposed clawback rules?

   As proposed, the rules would apply to nearly all issuers including smaller reporting companies, emerging growth companies, foreign private issuers, controlled companies, and companies listing only debt and other non-equity securities. The proposed rules do not apply to companies with securities traded only on OTC market, listed registered investment companies that have not awarded incentive-based compensation to any executive officers within the last three fiscal years, unit investment trusts, and companies listing securities futures products and standardized options cleared by a clearing agency.

2. What is the penalty for failure to implement and enforce a clawback policy?

   A listed company that does not adopt, disclose, and comply with its recovery policy will be subject to delisting from its exchange.

3. What is the applicable timeline as to when the final rules will become effective?

   On July 1, 2015, the SEC issued proposed clawback rules, with comments due on September 14, 2015.

   Listing Exchanges are required to file proposed listing rules within *90 days after publication of the final SEC rules.* Further, the Exchanges' rules must be effective within *one year after publication of the final SEC rules*.

   Companies must adopt a recovery policy within *60 days after the effective date of their exchange's rules*. Companies will be required to recover all excess incentive-based compensation resulting from an accounting restatement for any fiscal period ending *on or after the effective date of the final SEC rules*. Companies must also 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*.

4. What event(s) is required in order to trigger a clawback?

   If the company is required to prepare an accounting restatement to correct an error that was material to previously issued financial statements, or if the company experiences a series of immaterial error corrections (whether or not they resulted in amendments to previously filed financial statement) if viewed as material in the aggregate. Such a triggering mechanism opens the door for questioning a company's decision-making if it decided that in the aggregate the series of immaterial errors were not sufficient to require a restatement.

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Restatement Triggers and Clawback Years Questions

5. How does a company determine the applicable required restatement date ("RRD")?

   The RRD is identified as the earlier of the date the company concludes, or reasonably should have concluded that a restatement to correct a material error is necessary or when a court or regulator directs the company to restate previously issued financial statements to correct a material error. A Form 8-K filing is not determinative of the trigger date.

6. What fiscal years are subject to the application of the clawback?

   The three most recently completed fiscal years that ended prior to the RRD (the "clawback years"). For example, a calendar company determines a RRD in December 2019 that a restatement is required for 2018 and files it in March 2020, the applicable clawback years will be 2016, 2017, and 2018.

7. What if a company's RRD occurs after the SEC publishes the final rules, but prior to the effective date of the exchanges' listing standards?

   Technically, adopting a recovery policy is not required until 60 days after the exchanges' listing standards become effective. However, if the RRD occurs after the SEC clawback rules were finalized, but before the effective date of the exchanges' listing standards, we believe enforcement of the clawback rules may be required.

Executive Officer Questions

8. Which employees at the company are subject to the proposed rules?

   All current and former employees deemed "executive officers" at any time during the 3-year clawback period.

9. Who is considered an "executive officer" under the proposed rules?

   Any current/former executive officer who is/was either the president, principal financial officer, principal accounting officer or controller, a vice president in charge of a principal business unit, division or function, or any other officer who performs a significant policymaking function for the company.

   Companies will have to maintain careful records of who constitutes an executive officer on a year-over-year basis, including when someone initiated or ceased being an executive officer, in the event a clawback is triggered for the 3-year period that is covered by the restatement, and identification of current/former executive officers subject to the clawback is required for effective enforcement. Consider reviewing your list of Section 16 officers for application under the proposed clawback listing requirement, as well as, any early adopted clawback policies where application is intended to cover a broader population.

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10. What if you were not an executive officer at the time incentive-based compensation was awarded to you but subsequently became an executive officer during the 3-year clawback period?

    Any excess incentive-based compensation you received is subject to clawback.

11. What if you were not an executive officer at the time the company decides to file a restatement, but you were an executive officer during the 3-year clawback period?

    Any excess incentive-based compensation you received is subject to clawback.

Incentive-Based Compensation Questions

12. What type of compensation is subject to clawback under the proposed rules?

    Any incentive-based compensation granted (even if there's additional vesting required), earned, or vested based wholly or in part on the attainment of a *financial reporting measure.*

13. What is the definition of a financial reporting measure?

    A financial reporting measure refers to an accounting-related metric that is determined and presented in accordance with the accounting principles used in preparing the company's financial statements, as well as any measure derived wholly or in part from such measure, or stock price and total shareholder return (TSR).

    A financial reporting measure need not be presented within the financial statements or included in a filing with the SEC. Examples of financial reporting measures include: revenues, net income, operating income, EBITDA, earning per share, financial ratios, operating cash flow, stock price and TSR.

14. Can financial reporting measures include non-GAAP financial measures?

    Yes, measures derived wholly or in part from such financial reporting measures could include non-GAAP financial measures.

15. What type of compensation is <u>not</u> subject to clawback under the proposed rules?

    Any compensation that is discretionary-in-nature, purely service-based, or earned based on non-financial, strategic or subjective standards is not subject to clawback. Examples include: base salary, discretionary bonuses, time-based awards that vest solely upon completion of a period of employment, bonuses paid out upon attainment of subjective standards.

16. When is compensation considered to be received?

    Incentive-based compensation is deemed "received" (and subject to clawback) 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 (i.e., actual payment date does not matter).

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17. How is the amount of excess incentive-based compensation received calculated?

    First determine which, if any, of the incentive-based compensation amounts would have been affected if the restated financial information had been used to determine the amount received. Second, calculate the recoverable amount by determining the excess of the amount of the incentive-based compensation that the executive officer has received less the amount that the executive officer would have received had the incentive-based compensation been determined based on the values in the restated financial statements. Reduce any recoverable clawback amount by the amount of any compensation that has already been recovered under Sarbanes-Oxley.

18. How do you determine the recoverable amount to the extent there is incentive-based compensation received that is based on stock price and/or TSR (where the erroneously awarded compensation cannot be directly calculated from the restatement)?

    The company can make a reasonable estimate of the impact of the restatement on the share price and thus, the amount of erroneously awarded compensation. The company must maintain documentation of the methodology and determination of the estimate and provide it to its exchange.

Recovery and Repayment Options

19. Are there any exceptions to the proposed rules that mandate a required clawback of any excess incentive-based compensation?

    Yes, the proposed rules stipulate that a company must recover erroneously awarded compensation except to the extent it would be *impracticable* to do so either because the cost to enforce the clawback exceeds the amount to be recovered or, if recovery would violate a home country law adopted before the publication of the final SEC rules.

    Prior to any conclusion that recovery is “impracticable” a company must first “make a reasonable attempt to recover” the excess incentive-based compensation, document its attempt(s), and provide the documentation to its exchange.

20. In what manner and form is the recovery of excess incentive-based compensation accomplished?

    Repayment of excess incentive-based compensation is required on a pre-tax basis. The manner and timing of recovery may differ for each affected executive officer.

    For equity granted or vested based on financial performance, the amount recoverable would be the number of options/shares that exceeds the number that would have been granted or vested under the restated financials.

    For options exercised and shares still held, the number of shares attributable to the excess options would be the recoverable amount.

    For shares that have already been sold, the recoverable amount would equal the proceeds of the sales attributable to those shares.

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21. How does the use of positive or negative discretion on the determination of cash awards affect the calculation of the recoverable clawback amount (i.e. the difference between the amount that was received, and the amount that should have been received after applying the restated financials)?

    If an award amount is decreased due to the exercise of negative discretion, then the amount "received" would equal the amount actually paid, and not the amount owed as a result of satisfying the performance measure.

    If an award amount is increased due to the exercise of positive discretion, then the amount "received" would equal the amount owed as a result of satisfying the performance measure.

22. Can the company or the executive purchase insurance to protect the executive officer against the loss of any erroneously awarded compensation?

    Companies are prohibited from indemnifying or purchasing insurance for any executive officer or former executive officer against the loss of any erroneously awarded compensation. Executive officers could personally purchase third-party insurance to fund potential recovery obligations, but companies would not be permitted to pay, or reimburse the executive officer for such premiums.

Disclosure Questions

23. Is a company required to disclose its clawback policy, and if so, where should it be disclosed?

    A company is required to file its clawback policy as an exhibit to its annual report.

24. What is required to be disclosed in the proxy statement following the triggering of a clawback?

    For a reporting year in which a restatement was completed, disclose the date of the required accounting statement and the aggregate excess compensation attributable to the restatement.

    For a reporting year in which there exists an outstanding balance, disclose the name of any executive officer from whom excess compensation outstanding for at least 180 days has not been recovered and the amount yet to be recovered, and information on any executive officers from whom the company determined not to pursue recovery (e.g., name, reason for not pursuing, amount forgone).

    For any amount of incentive-based compensation recovered based on stock price and TSR, disclose the approach and assumptions used in determining the estimate of the compensation recovery amount.

    All proxy disclosures would need to be electronically formatted using XBRL and must be "block-text tagged."

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25. Will a company have to file an amended proxy for the year in which excess incentive-based compensation is recovered?

    The proposed rules do not require the filing of any amended proxy, rather a company is required to revise prior years' compensation disclosures in the current proxy to accurately reflect amounts recovered pursuant to a recovery policy by reducing the amount reported in the applicable Summary Compensation Table column for the fiscal year in which the amount recovered initially was reported as compensation, along with a footnote explanation.

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