SEC Proposes Compensation Recovery ("Clawback") Rules

The final remaining executive compensation-related provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act requiring formal rulemaking requires the Securities and Exchange Commission and the national securities exchanges to prohibit the listing of companies that do not adopt and enforce a compensation recovery ("clawback") policy that applies to the incentive-based compensation provided to their executive officers.

On July 1, 2015, the SEC initiated this rulemaking process, proposing rules that will direct the national securities exchanges to enact listing standards requiring public companies to adopt and disclose their written clawback policy to maintain their listing status. Public comment on the SEC's proposed rules must be submitted within 60 days of their publication in the Federal Register, which we expect will take place shortly. Accordingly, comments will be due by mid-September.

This Thoughtful Pay Alert summarizes the key aspects of the SEC's proposed rules and provides our initial observations about the likely impact of this new requirement on technology and life sciences companies.

Four Things Technology and Life Sciences Companies Should Know about the SEC's Proposed Rules on the New Compensation Recovery ("Clawback") Requirement

- **General Requirement**. Companies listed on a national securities exchange would be required to adopt a compensation recovery ("clawback") policy containing certain specified features.
- **Clawback Policy Features**. The clawback policy would be required to:
  - Apply to current and former executive officers (that is, Section 16 officers)
  - Apply to any accounting restatement resulting from a material error – misconduct not required
  - Apply to incentive compensation (including stock options) if granted, earned, or vested based, in whole or in part, on the attainment of a financial reporting measure
  - Recover excess compensation received during three completed fiscal years preceding the date that the restatement is required
  - Compel recovery unless the direct costs of recovery exceed excess compensation
- **Required Disclosure**. Listed companies would file their clawback policy with their annual report on Form 10-K and disclose details about the recovery of excess compensation in their proxy statement.
- **Implementation and Effective Date**. Rulemaking will involve a two-step process:
  - The SEC is likely to finalize its rules directing the national securities exchanges to take action by the end of 2015
  - The national securities exchanges will have one year from the date the final SEC rules are published to adopt listing standards requiring companies to adopt a compliant clawback policy – listed companies will then have 60 days to adopt such a policy
  - Depending on when these events occur, the new listing standards and required disclosure are likely to be effective for the 2017 proxy season.

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Background

To enhance the oversight of executive compensation programs, Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added new Section 10D to the Securities Exchange Act of 1934.

Section 10D requires the SEC to direct the national securities exchanges to prohibit the listing of any company that has not developed and adopted a policy providing that:

- if the company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws,
- the company will recover from any of its current or former executive officers,
- who received incentive-based compensation (including stock options) during the three-year period preceding the date the company is required to prepare the accounting restatement based on the erroneous data,
- the amount in excess of what would have been paid to the executive officer under the accounting restatement.

Largely as a result of its other rulemaking projects under the Dodd-Frank Act and the Jumpstart Our Business Startups (“JOBS”) Act, it has taken almost five years for the SEC to formally propose rules to implement this disclosure requirement.

Proposed Rules

On July 1, 2015, the SEC proposed rules that would direct the national securities exchanges to begin the process of enacting listing standards to impose this compensation recovery (“clawback”) requirement. The SEC’s proposed rules would also require listed companies to disclose specific information about their clawback policy and its enforcement in their proxy or information statement.

Clawback Policy Requirement

Rather than leave the substantive rulemaking to the national securities exchanges, the SEC’s proposed rules set forth the specific terms of the required clawback policy that must be reflected in the exchanges’ listing standards. These terms, which, in some instances, go beyond the requirements of new Section 10D, provide as follows:

Executives Subject to Clawback Policy

The clawback policy would apply to a listed company’s current and former “executive officers,” who would be defined to include its:

- president;
- principal financial officer;
- principal accounting officer (or if there is none, 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 for the company.

In addition, executive officers of the company’s parent or subsidiaries would be deemed executive officers of the company if they perform such policy making functions for the company.

Observations. The required listing standard would define the term “executive officer” in a manner modeled after the definition of the term “officer” as used for purposes of Section 16 of the Exchange Act. Further, the clawback policy would apply to any individual who served as an executive officer and received incentive-based compensation at any time during the three-year period preceding the date of the financial restatement. This would include, for example, incentive-based compensation derived from an award approved before the individual became an executive officer, and inducement awards granted in new hire situations, as long as the individual served as an executive officer of the listed company at any time during the award’s performance period.

Given this broad scope and because the policy would be applied without regard to individual “fault” or “misconduct” or even an executive officer’s responsibility for the erroneous financial statements, a potentially large number of individuals would be subject to the policy, potentially reshaping how a compensation committee considers the design and mix of the compensation arrangements for its executive officers. In addition, listed companies would need to develop a means for tracking former employees

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who served as an executive officer and received incentive-based compensation to be able to enforce their clawback policy in the event of a subsequent financial restatement.

Accounting Restatement Trigger

The clawback policy would define an "accounting restatement" as "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." As consistently applied under the federal securities laws, whether an error is "material" is a determination that must be analyzed under all the relevant facts and circumstances. In its Proposing Release, the SEC sets forth a list of changes to a company's financial statements, such as retrospective application of a change in accounting principle, which would not be considered a "material error" triggering recovery of incentive-based compensation.

Observations. Unlike similar policies (such as the compensation recovery required by Section 304 of the Sarbanes-Oxley Act), the clawback in the required listing standard would be triggered on a "no fault" basis – that is, the sole trigger for a clawback would be an accounting restatement to correct a material error. Recovery would not be based on the finding of any misconduct or even an executive officer being found responsible for the accounting error leading to the financial statement.

Three-Year Recovery Period

The clawback policy would apply to all excess incentive-based compensation received during the three completed fiscal years preceding the date upon which a listed company is required to prepare an accounting restatement. The required listing standard would provide that this date would be the earlier to occur of:

- the date the board of directors, a committee of the board of directors, or the officer or officers authorized to take such action if board action is not required, 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 its previously issued financial statements to correct a material error.

The required listing standard would also specify how the three-year "look-back" period is to be measured, providing that this period would comprise the three completed fiscal years immediately preceding the date a company is required to complete an accounting restatement. For example, if a company with a calendar year fiscal year concludes in November 2018 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2019, the clawback policy would apply to incentive-based compensation received in 2015, 2016, and 2017.

Finally, the required listing standard would provide that incentive-based compensation would be deemed "received" in the fiscal period during which the financial reporting measure specified in the award is attained, even if the payment or grant of the award occurs after the end of that period. In addition, an award that is subject to a financial reporting measure and a service-based vesting condition (such as a performance-based equity award with a time-based vesting "tail") is considered received when the financial reporting measure is achieved, even if the award continues to be subject to the time-based vesting condition.

Observations. In the case of a listed company's decision to undertake a restatement, the date of this decision would be determined objectively; that is, the appropriate date for measuring the three-year "look-back" period would be the date when a reasonable company, based on the facts available, would have concluded that the previously issued financial statements contained a material error. Generally, it is expected that this date will coincide with the date upon which a company would be obligated to file a current form on 8-K notifying investors that its previously issued financial statements may no longer be relied upon.

Compensation Subject to Recovery

The clawback policy would apply to any "incentive-based compensation," which would be defined as "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure." This definition would encompass both cash and equity, including stock options and other equity awards whose grant or vesting is based, in whole or in part, upon the attainment of any measure based upon or derived from financial reporting measures.

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For purposes of the required listing standards, a “financial reporting measure” would be defined as:

- any measure that is determined and presented in accordance with the accounting principles used in preparing the company’s financial statements;
- any measure derived, in whole or in part, from such financial information;
- stock price; and
- total shareholder return (“TSR”).

The inclusion of “stock price” as a financial reporting measure introduces several challenges in determining excess incentive-based compensation because of the complexities involved in determining the impact of accounting errors on stock price movement. In recognition of these potential issues, the SEC's proposed rules would permit companies to use reasonable estimates to assess the effect of an accounting restatement on stock price and TSR and require that these estimates be disclosed.

Observations. Based on the proposed definition, compensation subject to the clawback policy would include (but not be limited to):

- non-equity incentive plan awards that are earned based, in whole or in part, on satisfying a financial reporting measure performance goal;
- bonuses paid from a “bonus pool,” the size of which is determined based, in whole 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 that are granted or become vested based, in whole 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, in whole or in part, on satisfying a financial reporting measure performance goal

Compensation that would not be considered “incentive-based compensation” would include annual base salary, wholly time-based compensation (such as time-based stock options and other equity awards), incentive-based compensation that would be earned entirely using subjective criteria, non-financial measures (such as strategic or operational measures), and compensation paid solely on a discretionary basis.

Determination of Excess Compensation

The clawback policy would provide that recoverable compensation would be calculated as “the amount of incentive-based compensation received by the executive officer … that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement.” Applying this approach, following an accounting restatement a listed company would:

- recalculate the applicable financial reporting measure and the amount of incentive-based compensation based thereon; and
- then determine whether, based on that financial reporting measure as calculated relying on the original financial statements and taking into account any discretion that the compensation committee had applied to reduce the amount originally received, the executive officer received a greater amount of incentive-based compensation than would have been received applying the recalculated financial reporting measure.

Further, the recoverable compensation would be calculated on a pre-tax basis.

For incentive-based compensation based on stock price or TSR, where the amount of excess compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the recoverable amount may be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. For these measures, the company would be required to maintain documentation of the determination of that reasonable estimate and provide such documentation to the applicable exchange.

Consistent with Section 10D, the required listing standard would provide that recovery of any excess incentive-based compensation would be mandatory. Nonetheless, in a welcome surprise, the required listing standard would also provide that recovery is not required either because:

- the direct costs of enforcing recovery would exceed the recoverable amount; or

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- recovery would violate the company’s home country law.

Before relying on the former exception, a company would first need to make a reasonable attempt to recover that incentive-based compensation. In addition, the company would be required to document its attempts to recover, provide that documentation to the applicable exchange, and disclose in its proxy statement why it determined not to pursue recovery. Similarly, before concluding that it would be impracticable to recover the compensation because doing so would violate home country law, the company first would need to obtain an opinion of home country legal counsel that recovery would result in such a violation.

Observations. While the determination of recoverable compensation to cash awards would likely, in most instances, be fairly straightforward, we agree with the SEC that the determination for equity awards would involve different, and potentially more challenging, considerations. As the SEC notes, in the case of equity awards:

- if the shares, stock options, or SARs are held at the time of recovery, the recoverable amount would be the number of shares received in excess of the number that should have been received applying the restated financial reporting measure;
- if the stock options or SARs have been exercised and the underlying shares are still held, the recoverable amount would be the number of shares underlying the excess options or SARs applying the restated financial reporting measure; and
- if the shares have been sold, the recoverable amount would be the sale proceeds received with respect to the excess number of shares (less any exercise price paid to purchase the shares).

The complexity of these computations will be compounded where the relevant financial reporting measure is based on stock price or TSR. As previously noted, the challenges inherent in estimating the effect of an financial restatement on stock price will likely necessitate that most companies incur the cost and uncertainties of undertaking an analysis requiring significant technical expertise and specialized knowledge. As we move towards the adoption of these rules, these challenges will likely need to be taken into consideration when designing an incentive compensation program and, as a practical matter, when assessing the feasibility of seeking recovery of excess incentive-based compensation from executive officers, particularly former executive officers.

Filing and Disclosure Requirements

In addition to adopting and enforcing a compliant clawback policy, each listed company would be required to do the following:

- file its clawback policy as an exhibit to its annual report on Form 10-K; and
- disclose in its proxy or information statement how they have applied their clawback policy if, at any time during the last completed fiscal year, either:
  - a financial restatement that triggered the clawback policy was completed; or
  - there was an outstanding balance of excess incentive-based compensation from the application of the policy to a prior restatement.

Content of Required Disclosure

Where a listed company completes the financial restatement that triggered the clawback policy, it would be required to disclose the following details about the pending recovery:

- the date on which the company was required to prepare the restatement;
- the aggregate dollar amount of excess incentive-based compensation attributable to the restatement;
- if the incentive-based compensation was determined based on a stock price or TSR-related financial reporting measure, the estimates used to determine the excess incentive-based compensation attributable to the restatement;
- the aggregate dollar amount of such excess incentive-based compensation that remains outstanding at the end of its last completed fiscal year; and
- the name of each person subject to recovery of excess incentive-based compensation attributable to the restatement, if any, from whom the company decided not to seek recovery, the amount forgone for each such person, and a brief description of the reason the company decided in each case not to seek recovery.

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Where a listed company has an outstanding balance of excess incentive-based compensation from the application of the policy to a prior financial restatement, it would be required to disclose the following information:

- 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.

Location of Required Disclosure

Since the required clawback policy would apply to all executive officers, not just named executive officers, the SEC is proposing that this information be provided in a separate disclosure item, and not as part of the Compensation Discussion and Analysis. The SEC has noted, however, that inclusion in the CD&A would be permitted as part the listed company’s compensation recovery policy disclosure.

Impact on Subsequent Summary Compensation Table Disclosure

To the extent that excess incentive-based compensation is recovered, the amount subsequently reported in the Summary Compensation Table for the fiscal year in which the amount recovered initially was reported (if subject to disclosure) would be reduced by the recovered amount, and be identified by footnote.

Disclosure to be Provided in Interactive Form

Companies would be required to tag the new disclosure in an interactive data format using eXtensible Business Reporting Language (“XBRL”).

Other Aspects of Proposed Rules

Companies Subject to Listing Standard

The required listing standard would apply to any company listed on a national securities exchange, including smaller reporting companies, emerging growth companies, foreign private issuers, and controlled companies. As proposed, only registered investment companies would be exempt from the requirement.

Securities Subject to Clawback Policy

Based on the broad scope of the statutory language, the required listing standard would apply to all of a listed company’s listed securities, including common equity securities, debt securities, and preferred securities. As proposed, only security futures products, standardized options, and the securities of certain registered investment companies would be exempt from the requirement.

Indemnification and Insurance

The required listing standard would prohibit a listed company from indemnifying any current or former executive officer against the loss of excess incentive-based compensation. Further, while an executive officer may be able to purchase an insurance policy to fund potential recovery obligations, the listed company would be prohibited from paying or reimbursing the executive officer for premiums for such a policy.

Consequences of Non-Compliance

Noncompliance with the required listing standard, the SEC’s disclosure rules, or a company’s own compensation recovery policy would subject the company to delisting.

Concurrent Application with Section 304 of the Sarbanes-Oxley Act

Given the overlapping scope of the two provisions, there may be circumstances in which both the required listing standard and Section 304 of the Sarbanes-Oxley Act could apply to the same incentive-based compensation. The SEC notes that the new listing standards will not alter or otherwise affect decisions under Section 304 as to when reimbursement is required. Thus, if an executive officer makes reimbursement under Section 304, this amount should be credited to the extent that a clawback policy requires repayment of the same compensation. Further, recovery under a clawback policy would not preclude recovery under Section 304 to the extent any applicable amounts have not been repaid to the listed company.

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Comment Period and Possible Effective Date

Comment Period

The SEC is soliciting public comment on its proposed rules for 60 days from the date that they are published in the Federal Register. Assuming publication by early next week, the comment period is likely to run until mid-September.

Approval of Listing Standards

Although the Dodd-Frank Act does not specify a deadline for the national securities exchanges to act, the SEC's proposed rules would require them to:

- submit their proposed listing standards to the SEC within 90 days of the date that its final rules are published in the Federal Register, and
- have their listing standards become effective no later than one year after the date that the SEC's final rules are published in the Federal Register.

Thereafter, each listed company would have 60 days from the date the applicable listing standard became effective to adopt a compliant clawback policy.

Observations. Given the time that will be needed to process the expected public comments, as well as the normal give and take of the rulemaking process, it is possible, although, not certain, that the SEC will adopt final rules directing the national securities exchanges to begin the process of enacting the required listing standards by the end of this year. Assuming that the exchanges need the full period allowed by the SEC to complete their efforts, it is reasonable to assume that the new listing standards will not be in effect until 2017.

Need Assistance?

Compensia has extensive experience in helping companies understand how the corporate governance and executive compensation-related disclosure provisions of the Dodd-Frank Act will affect the design, operation, and disclosure of their executive compensation program. If you would like assistance in analyzing how the proposed rules are likely to impact your executive compensation program and disclosure, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Mark A. Borges. ■

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