

## SEC Proposal Requiring Adoption of Clawback Policies on Executive Compensation

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On July 1, 2015, the SEC proposed rules directing the stock exchanges to expand listing standards to require companies to adopt clawback policies. These clawback policies would require executive officers to pay back incentive compensation that was awarded in error under an accounting restatement. According to SEC Chair Mary Jo White, the express purpose of the rules are “increased accountability and greater focus on the quality of financial reporting, which will benefit investors and markets.” With these proposed rules, the SEC has now addressed all of the executive compensation governance reforms included in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

### **Broad Scope**

The SEC’s proposal amends the Securities Exchange Act of 1934 (the “Exchange Act”) by adding new Exchange Act Rule 10-D1. Other amendments would apply to filings by foreign private issuers and certain investment companies. As a result, the clawback rules will apply to virtually all listed issuers of equity securities, debt and preferred securities, including emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies.

### **New Rule 10-D1**

As proposed, an issuer would be subject to delisting if it fails to (1) adopt a clawback policy that complies with the new requirements, (2) disclose the policy and (3) comply with the policy to recover compensation under an accounting restatement. Under the proposal, clawback of incentive compensation would be required from current and former executive officers who received excess incentives during the three fiscal years prior to the date on which a company is required to prepare an accounting restatement to correct a material

### **WHERE DO WE GO FROM HERE?**

- Most major companies have already implemented clawback policies
- SEC proposal on clawbacks does not align with current market practice
  - Includes current and former executive officers
  - Triggered exclusively by an accounting restatement resulting from an error
  - Triggered regardless of whether executive has committed fraud or misconduct related to the accounting restatement
  - Includes a 3-year look-back period
  - Generally precludes board discretion
  - Accompanied by onerous disclosure rules
- Assess your company’s current clawback policy against the proposed rules
- Brief senior management and the board on the scope of the proposed rules
- Await further developments after the public comment period ends and final rules are issued

error. The clawback provision applies on a “no fault” basis, regardless of whether misconduct occurred and regardless of whether an individual had any responsibility for the error.

The amount subject to clawback would be the amount that exceeds the amount that the executive officer would have received if the incentive compensation had been determined using restated financial statements. The proposed rules direct companies to use reasonable estimates of the effect that an accounting restatement would have on stock price and total shareholder return to determine amounts subject to recovery.

### **Limits on Board Discretion**

Under the proposal, the situations where a Board could elect not to pursue recovery are limited. The SEC specified situations where the direct expense related to enforcing recovery would exceed the amount recovered. However, even in these situations, the Board would have to go through the process of determining the amount subject to clawback and make an attempt at recovery before deciding not pursue enforcement of the recovery. In addition, foreign private issuers could elect not to comply when clawback would violate home country law.

### **Trigger for Recovery**

New Rule 10-D1 would trigger a clawback in the event that the issuer prepares a restatement of previously issued financial statements to correct an error that was material. Note that the requirement to restate financial statements is enough to trigger the clawback provisions, allowing the SEC to avoid the potentially thorny question of what constitutes a material error. Under GAAP, an error may include mathematical mistakes, mistakes in the application of GAAP principles, or oversights or misuse of facts when the financial statements were prepared. The proposal indicates several types of changes to financial statement that are not error corrections and would not trigger clawback, including

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

### **3-Year Look-Back Period**

The proposed clawback will apply to excess incentives during a 3-year period prior to the date on which the issuer is required to prepare an accounting restatement. The proposal defines this date as the earlier of:

- The date the issuer's board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take such action if board action is not required, 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.

The SEC notes that the first proposed date would generally coincide with the filing of Form 8-K, but Form 8-K is not necessary for recovery. Further, the obligation to clawback does not depend on whether or when restated financial statements are filed.

### **Application to Executive Officers**

The proposed clawback rules apply to current or former executive officers who received incentive compensation. Under the proposal, executive officer is defined as the issuer's president, principal financial officer, principal accounting officer (or controller), any vice president to the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs a similar policy-making functions for the issuer.

This proposed definition of executive officer is modeled on the definition used in Section 16, so it will apply to a reasonably large group of senior executives. The proposal also specifies that individuals who served as an executive officer at any time during the performance period for incentive compensation subject to recovery will be subject to clawback. This would include incentive compensation authorized before the individual becomes an executive officer and inducement awards granted in new hire situations.

### **Compensation Subject to Clawback**

The SEC proposal contains a very broad definition of "incentive-based compensation" subject to clawback. As proposed, this 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." The rules would also specify that "financial reporting measures" are measures determined and presented in accordance with the accounting principles used to prepare the issuer's financial statements, any measures derived wholly or in part from such financial information and stock price and total shareholder return.

This definition wraps in accounting-based measures, as well as non-GAAP measures. Notably the SEC proposal includes stock price and total shareholder return. Although these are not accounting-based measures, the SEC included them because these measures are affected by accounting information and subject to current disclosure (i.e., stock performance graph and disclosure of high and low stock prices for each quarter within the two most recent fiscal year and any subsequent interim periods). Importantly, stock options and restricted stock that vest solely based on continued service are not subject to clawback.

The SEC acknowledges the complexities associated with trying to determine the amount of excess compensation related to the relationship between an accounting error and stock price. The SEC recognizes that complex analyses may be required. As a solution, the SEC suggests that issuers be permitted to make reasonable estimates and requires disclosure of these estimates.

The proposal includes examples of compensation that would be subject to clawback, as well as compensation that would be excluded:

incentive-based compensation relating to a prior restatement. In these instances, the proposed disclosure would include:

- For each restatement, the date on which the listed issuer was required to prepare an accounting restatement, the aggregate amount of excess incentives and the aggregate amount that remains outstanding as the end of the most recent completed fiscal year;
- The estimates used to determine the excess incentive compensation related to a stock price or total shareholder return measure;
- The name of each person subject to clawback for whom the listed issuer decided not to pursue recovery, the amount forgone and a description of the reason the issuer decided not to pursue recovery; and
- The name and amount due from each person from who, at the end of the last completed fiscal year, excess incentive-based compensation had been outstanding for 180 days or longer.

| COMPENSATION SUBJECT TO CLAWBACK  | COMPENSATION EXCLUDED FROM CLAWBACK   |
|---|---|
| Non-equity incentive plan awards that are earned based wholly or in part on satisfying a financial reporting measure performance goal   | Salaries  |
| Bonuses paid from a bonus pool, the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal  | Bonuses paid solely at the discretion of the Compensation Committee or Board, not paid from a pool determined wholly or in part on satisfying a financial reporting measure goal  |
| Restricted stock, RSUs, performance shares, stock options and SARS that are granted or become vested wholly or in part on satisfying a financial reporting measure performance goals          | Bonuses paid on subjective standards (e.g., leadership) and/or completion of a specified employment period  |
| Proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal | Non-equity incentive plan awards earned solely upon satisfying one or more strategic measures (e.g., consummating a merger or divestiture) or operational measures (e.g., opening a specified number of stores, completion of a project, increase in market share)  |
|   | Equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more non-financial reporting measures |

### Proposed Disclosure Requirements

Proposed new Rule 10D-1 would require disclosure of the issuer's policy related to clawback of erroneously awarded compensation. The clawback policy would need to be filed as an exhibit to Form 10-K for listed U.S. issuers.

The proposal contains additional disclosure requirements that are extensive when a restatement was completed or an outstanding balance of excess

The proposed disclosure would be included as a separate item, not part of the CD&A. However, companies would have the option of providing the information in the CD&A to provide all information related to the clawback policy in one place.

The proposed rules also include amendments to Summary Compensation Table disclosure. Amounts previously reported would be reduced by the amount recovered by clawback with a footnote explanation.

Finally, the required disclosure would be provided as interactive using XBRL block-text tagging.

### **Other Important Provisions**

The proposed rules are incorporated in a 198 page filing. They are very detailed and complex. This article necessarily serves as a summary of the most important points that we see as being of general interest. But there are other details that shed light on the SEC's thinking, as follows:

- Incentive-based compensation recovery will apply to pre-tax amounts.
- Clawback may occur simultaneously under new Rule 10D-1 and SOX Section 304. If an individual reimburses the Company under Section 304, a credit will be recorded for purposes of new Rule 10D-1.
- Lack of compliance with a clawback policy threatens a company with delisting, depending on the stock exchange's assessment of whether the company was making a good faith effort to clawback compensation.
- Companies may not indemnify executive officers or former executive officers against the loss of erroneously awarded compensation.
- If an executive purchases third-party insurance, companies would be prohibited from paying the premiums for this insurance.

### **TIMING OF NEW RULES**

The SEC's proposal calls for prompt implementation. The current comment period extends for 60 days. After final rules are adopted, the SEC is calling for the stock exchanges to file their proposed amended listing standards within 90 days. Following the effective date of the stock exchange listing standards, each listed company would be required to adopt a clawback policy within 60 days. Clawback would apply to all excess incentive-based compensation received for any fiscal year ending on or after the effective date of new Rule 10D-1. Similarly, disclosure requirements would become effective immediately on or after the date on which the stock exchange listing standards become effective.



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