

SEC Proposes Broadened Rules on Clawback of Incentive-Based Compensation

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[Proposed Rules would require increased disclosures on companies' recovery processes and affect the majority of issuers with listed securities.](#)

Background

On July 1, 2015, the Securities and Exchange Commission (the "SEC") proposed rules (the "Proposed Rules") that would require any company with securities listed on the New York Stock Exchange, Nasdaq or other national securities exchanges, including foreign private issuers, smaller reporting companies and emerging growth companies, to have a policy to clawback incentive-based compensation paid to current and former executive officers in the event of a restatement of its financial statements to correct a material error.

The Proposed Rules under the new Section 10D of the Securities Exchange Act of 1934 (the "Exchange Act"), which were approved by a three-to-two vote, would significantly expand the situations in which clawbacks would be used and would require national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with Section 10D's requirements of (i) adopting a clawback policy and (ii) disclosing the policy or enforcing the clawback policy's recovery provisions.¹ The Proposed Rules are part of the SEC's rulemaking prerogatives under Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Public comments on the Proposed Rules must be received within the 60-day period following the Proposed Rules' publication in the *Federal Register*. This Client Alert summarizes the material features of the Proposed Rules and the key considerations for companies listed on national securities exchanges to which the Proposed Rules would apply.

Proposed Rules

Overview

Section 954 of the Dodd-Frank Act requires recovery of incentive-based compensation paid to executive officers and former executive officers of publicly traded companies whose securities are listed on a national securities exchange. Section 954 amends the Exchange Act by adding Section 10D which requires the SEC to adopt rules requiring each such company to "develop and implement" a policy under which the company will recover incentive-based compensation paid to an executive officer if the company is required to restate a financial statement due to material noncompliance with any financial reporting requirement under the securities laws. Unlike clawbacks under the existing Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX"), which trigger recovery only in circumstances involving fraud or misconduct, the Proposed Rules would apply to all restatements and do not require an element of fault.

¹ The full text of the Proposed Rules can be found [here](#).

New Requirements for Listed Companies

The Proposed Rules would direct national securities exchanges to expand their listing standards to require that listed issuers:

- adopt and comply with written policies for the recovery of incentive-based compensation based on financial information required to be reported under the securities laws, applicable to the listed issuers' executive officers, over a period of three years from the date the company was required to prepare the restated financials;² and
- disclose those recovery policies in accordance with newly proposed SEC rules.

Additionally, the Proposed Rules would direct national securities exchanges to delist issuers who fail to:

- adopt a compensation recovery policy that complies with the applicable listing standard;
- disclose the policy in accordance with SEC rules, including filing the policy as an exhibit to the relevant periodic filing and providing the required information in XBRL (eXtensible Business Reporting Language) format; or
- comply with the policy's recovery provisions.

Companies Subject to the Proposed Rules

The Proposed Rules would apply to almost all issuers with securities listed on a national securities exchange including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and issuers who list only debt with a national securities exchange. As currently proposed, the only issuers that would not be subject to the Proposed Rules would be those that only list futures products or standardized options and unit investment trusts, as well as certain registered management investment companies.

Circumstances Triggering the Recovery Policy

Under the Proposed Rules, recovery would be triggered if a company is required to prepare a restatement to correct a material error, such as an error due to mistakes in the application of US Generally Accepted Accounting Principles ("US GAAP") or International Financial Reporting Standards ("IFRS"). Materiality is assessed in light of all relevant facts and circumstances.

Executive Officers Covered by the Proposed Rules

The Proposed Rules would require the recovery provisions to apply to all current and former executive officers of the issuer during the requisite three-year period. The Proposed Rules would include a definition of an "executive officer" that is modeled on the definition of "officer" under Section 16 under the Exchange Act, meaning that an executive officer would be the company's president, principal financial officer, principal accounting officer (or if no such accounting officer exists, the controller), any vice president of the issuer in charge of a principal business unit, division or function, any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the issuer. This definition may include executive officers of parents or subsidiaries of the company if such officer performs a policy-making function for the company.

Incentive-Based Compensation under the Proposed Rules

The Proposed Rules would apply to compensation granted, earned or vested based on financial reporting measures and is defined in a principles-based manner. Under the Proposed Rules, the listing standards would apply to incentive-based compensation that is tied to accounting-related metrics, stock price or total shareholder return ("TSR"). The SEC noted that it proposed to include TSR because of its popularity as a metric used in incentive-based compensation arrangements. The Proposed Rules would, however, exclude certain non-financial or operating metrics, such as opening of a specific number of stores, obtaining regulatory

² The recovery policy must also apply to any transition period resulting from a change in the company's fiscal year within or immediately following the relevant three-year period although a transition period of nine months or more will be deemed a fiscal year.

approval of a product, consummating a merger or completing a restructuring plan. Bonuses paid solely at the discretion of a company's board of directors or service-based equity awards also are expressly excluded.

The Proposed Rules cover both cash and non-cash awards granted as incentive-based compensation. Notably, the Proposed Rules require that recovery policies cover stock option awards. The SEC specifically notes that recovery policies would cover, among other things, (a) bonuses paid from a "bonus pool" where the size of the bonus pool is based on satisfying a financial reporting measure performance goal, (b) stock, options and stock appreciation rights that are granted or vest based on satisfying a financial reporting measure performance goal and (c) proceeds received upon the sale of shares granted or vested based on satisfying a financial reporting measure performance goal.

The Proposed Rules specify that incentive-based compensation is deemed to have been received during the fiscal period during which the financial reporting measure provided for in the incentive-based compensation award is attained, regardless of whether payment or grant occurs after such period.

Determination of the Triggering Date

The trigger for recovery under the Proposed Rules would be the earlier of:

- the date the company's board of directors concludes, or reasonably should have concluded, that the company's previously issued financial statements contain a material error; or
- the date a regulator directs the issuer to restate its previously issued financial statements to correct a material error.

The Proposed Rules indicate that the triggering date generally should coincide with the date of a triggering event under Item 4.02 of Form 8-K (*i.e.*, when previously issued financial statements cannot be relied upon), but would not be predicated on the filing of a Form 8-K. Once such requirement for restatement has been triggered, the company would be required to recover incentive-based compensation awarded during the last three completed fiscal years immediately preceding the date on which the company became required to prepare an accounting restatement.

Recovery of Incentive-Based Compensation

The Proposed Rules would determine the amount of incentive-based compensation to clawback from an executive officer based on the difference between the amount such executive officer received in such incentive-based compensation and the amount he or she would have received if the incentive-based compensation had been determined based on restated financial information. The SEC staff stated that the recoverable amount may be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure (*i.e.*, such as in the case of certain financial metrics that may not be possible to reliably ascertain, including TSR metrics from a previous period or stock price). In such case, the company must also prepare and maintain supporting documentation for the determination of the amount recovered and provide that documentation to the exchange. If the recovery provisions are implemented in the final regulations, it is likely that issuers will rely on third-party valuation firms to justify and support any estimates of recoverable amounts.

For cash bonuses, the amount to be clawed back is simply the difference between the amount of cash award received and that which would have been awarded after applying the restated financial reporting measure. For cash awards paid from bonus pools, the issuer would recalculate the bonus pool based off of the accounting restatement and the difference in compensation would be recovered by the company on a pro rata basis from the executive officers in the pool. For equity awards, if the shares or options are still held at the time of restatement, the recoverable amount would be equal to the number of shares or options received in excess of the number that would have been received applying the restated financial reporting measure. If the options have been exercised or if the shares have been sold, the recoverable amount would be the sale proceeds received by the executive officer with respect to the excess number of shares. It is important to note that the Proposed Rules require recovery on a pre-tax basis.

Board Discretion in Seeking Recovery and Manner Thereof

The Proposed Rules provide limited board discretion in the decision to seek recovery of incentive-based compensation. The Proposed Rules would require that a company recover erroneously awarded compensation in compliance with its recovery policy except (i) to the extent that pursuit of recovery would be

impracticable because the direct cost of recovery (e.g., such as fees paid to third-party advisers to enforce recovery) would be higher than the recoverable amount or (ii) if recovery would violate home country law. In order for an issuer to show impracticability, it would be required to document its attempt to recover compensation and, in order to show violation of home country law, a foreign private issuer would be required to provide such documentation, including an opinion from the home country counsel, to the exchange. Additionally, disclosure would be required where recovery is not sought or successful.

The Proposed Rules provide the board of an issuer with the discretion to seek recovery of compensation on any other legal basis in addition to those specifically enumerated in Section 10D. However, under the Proposed Rules, boards would not be permitted to pursue differential recovery among executive officers, including in “pool plans,” where the board may have exercised discretion as to individual grants in allocating the bonus pool. In this instance, recovery would be required to be pro rata based on the size of the original award rather than discretionary. The Proposed Rules provide for board discretion in determining the manner of recovering incentive-based compensation, but require that it be done in a reasonably prompt manner.

The Proposed Rules would not permit indemnification arrangements to avoid or nullify recovery of incentive-based compensation, although any amount recovered pursuant to Section 304 of SOX for the same compensation would be credited to the executive.

Disclosure of Issuer Policy on Incentive-Based Compensation and Recovery Thereunder

The Proposed Rules would require issuers to disclose their recovery policies. The required information would be included as part of Item 402 of Regulation S-K disclosures, but would not be required to be provided in the Compensation Discussion and Analysis (“CD&A”) section of the relevant filing. Proposed Item 402(w) would require companies to explain in their proxy statements or annual reports how they applied their recovery policies and calculated the excess amounts if in the last completed fiscal year a restatement that triggered a clawback was completed or there was a balance of erroneously awarded compensation from application of the policy to a prior restatement. Explanation would include the names of the executive officers involved, the date of the restatement, the amount of excess compensation, including any recovery amount which the company determined to be impracticable, any balance outstanding as of 180 days following the company’s determination of the amount to be recovered as well as the means of recovery. Any amount recovered would reduce the amount reported for the relevant executive officers (provided they are also named executive officers) in the applicable column of the Summary Compensation Table for the fiscal year in which the excess amount was initially reported. A footnote to the Summary Compensation Table explaining the adjustment would be required. This information would be provided in XBRL format and a copy of the policy would be filed as an exhibit to the company’s Exchange Act annual report on Form 10-K, Form 20-F or Form 40-F, as applicable.

The SEC staff recommends that issuers provide the information as a separate item in their disclosure rather than in conjunction with an issuer’s CD&A because it will apply beyond a company’s “named executive officers” and will apply to companies that are not necessarily required to have a CD&A. However, companies will have an option to include the required information as part of the CD&A.

Foreign private issuers that are exempt from Section 14(a) of the Exchange Act will be required to disclose such information in their annual reports.

Implementation Timeline

Upon publication of the final adopted version of Rule 10D-1 in the *Federal Register*, each exchange would be required to file its proposed listing rules implementing the Proposed Rules no later than 90 days thereafter, and such rules must become effective no later than one year following the publication date. The SEC would then require that recovery policies in compliance with such listing rules be adopted by issuers no later than 60 days following the date on which the exchanges’ rules become effective. The Proposed Rules would require that issuers recover all erroneously awarded incentive-based compensation received by former or current executive officers as a result of attainment of a financial reporting measure based on or derived from financial information for any fiscal period ending on or after 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. Additionally, the Proposed Rules would require that issuers file the required disclosures in the applicable SEC filings required on or after the date on which the exchanges’ rules become effective.

Comments and Related Considerations

While many issuers have recovery policies in place that go beyond the scope of Section 304 of SOX, these policies generally provide for significant board flexibility on whether to pursue recovery of compensation and usually impose a misconduct condition as a trigger to a clawback. The policies required under the Proposed Rules will be significantly more far-reaching and prescriptive. In this context, in sharply criticizing the Proposed Rules, Commissioner Gallagher specifically noted that the SEC failed to give boards of directors broad discretion allowing the boards to determine whether to pursue a clawback, whether to settle a clawback for less than the full amount, whether there is a minimum amount of compensation that is not worth pursuing or whether to recover through an alternative method. For example, compensation based on stock price or TSR metrics is subject to clawback under the Proposed Rules. Calculating this recovery requires determining what the stock price would have been, but for the misstatement or error at the time the compensation was earned. The Proposed Rules expressly notes that this may be difficult and indicates that reasonable estimates may be relied upon in this context. However, this will prove challenging and, in many cases, will require third-party expert advice, which can be costly and therefore impracticable in relationship to the amount of compensation that might be recovered. The Proposed Rules would not provide for any board discretion in seeking recovery (other than in specific situations when a direct expense of recovery would be higher than the recoverable amount), thereby creating inflexible results. If the Proposed Rules are adopted, boards of directors will be subject to pressure to seek recovery for every accounting restatement regardless of impracticality or materiality to the company.

The Proposed Rules differ from the current requirements of Section 304 of SOX in significant respects, including that they would (i) expand the group of executive officers subject to the rule to any current or former executive officer who received compensation during the applicable recovery period, (ii) apply to incentive-based compensation received during the preceding three-year fiscal period, triggering clawback liability regardless of whether the error was due to anyone's fault or misconduct, and (iii) require delisting for failure to comply with the new requirements. Section 304 of SOX will remain and the SEC noted that the Proposed Rules would not preclude recovery under Section 304 of SOX to the extent any applicable amounts have not been reimbursed to the issuer.

Some companies may face enforceability issues in connection with implementing new policies or amending existing policies as a result of limitations imposed by state or foreign jurisdiction laws and regulations. For example, where a covered executive officer is a foreign national, the impact of the laws of the foreign jurisdiction should be considered in assessing the operation and enforceability of the policy. In some states, certain forms of equity compensation may be considered "wages" when earned, thereby creating a potential legal constraint in the recovery of such compensation under a clawback policy. Additionally, at least initially, companies will likely need to change certain contracts with executives to allow for implementation of the proposed clawback policy.

Moreover, the broad impact of these clawback regulations may have a chilling effect on potential issuers, in choosing if and where to list. This especially is likely with respect to foreign private issuers who may have difficulty enforcing clawbacks under their "home country" rules and also historically have had more accounting restatements. Given the lack of clarity on when foreign private issues could forego recovery under the proposed clawback policy and the disclosure requirement, the Proposed Rules may have an unintended chilling effect on future foreign listings in the US.

When finalized, the Proposed Rules would require significant revisions to most companies' existing clawback policies. While the decision on when to adopt or amend clawback policies will depend on a company's particular circumstances, in light of the complex issues and uncertainties raised by the Proposed Rules and the fact that the Proposed Rules are likely to be subject to substantial comment and revision, companies will be best served by waiting until the final rules are adopted before adopting or revising their clawback policies. Nevertheless, companies may consider taking preliminary steps, such as reviewing compensation committee charters to address any new duties regarding clawback policy administration, reviewing organizational documents and existing D&O insurance policies to evaluate whether any impermissible indemnification arrangements are included, reviewing existing contractual arrangements and organizational documents to determine whether amendments to accommodate required recovery must be implemented, as well as evaluating new incentive-based compensation arrangements to consider whether specific clawback provisions must be included in such new contracts.

What companies should consider

Many companies focus on determining the best performance metrics for incentive-based compensation programs for their executive officers. While shareholder advisory services and activists generally prefer the use of stock price and TSR performance metrics, certain companies may wish to examine whether it is appropriate to use non-financial performance measures for at least a portion of incentive-based compensation for certain executive officers in light of the proposed clawback measures.

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