SEC Proposes Mandatory Compensation Clawbacks

- Would Require Clawback of Excess Incentive-Based Compensation Earned by Executive Officers During the Three Fiscal Years Preceding an Accounting Restatement to Correct for Material Error
- Does Not Appear to Require Issuers to Reassess Discretionary Award Determinations (Positive or Negative) in Light of Restatement

As expected, last week the SEC proposed to direct the national securities exchanges to require listed companies to implement policies mandating the recovery or “clawback” of excess incentive-based compensation earned by a current or former executive officer during the three fiscal years preceding an accounting restatement to correct a material error. The excess compensation would be based on the amount the executive officer would have received had the incentive-based compensation been determined using the restated financials, but the proposal does not appear to require the listed company to reassess discretionary award determinations (either positive or negative). The proposal would apply to all listed companies without regard to the types of securities listed, other than certain registered investment companies, clearing agencies and unit investment trusts.

Consistent with other recent compensation-related SEC proposals, the clawback proposal was approved by a 3 to 2 vote, with Chair White being joined by Commissioners Aguilar and Stein in voting for the measure and Commissioners Gallagher and Piwowar voting against. The dissenting Commissioners raised concerns regarding the number of executives covered and the “no-fault” nature of the proposal.

Comments are due 60 days after publication of the proposal in the Federal Register.
BACKGROUND
In 2010, Section 954 of the Dodd-Frank Act added Section 10D to the Securities Exchange Act of 1934, which requires the SEC to adopt a rule directing national securities exchanges to establish listing standards providing:

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

- For the disclosure of the listed issuer’s policy on incentive-based compensation based on financial information required to be reported under the securities laws.

There is no deadline in Section 954 for the SEC’s rulemaking.

The requirements of Section 954 are in addition to existing provisions that relate to the clawback of executive compensation, such as Section 304 of the Sarbanes-Oxley Act of 2002 and Item 402 of SEC Regulation S-K. Section 304 requires the Chief Executive Officer and Chief Financial Officer of an issuer to reimburse the issuer for certain incentive-based and equity-based compensation if the issuer is required to prepare an accounting restatement due to material noncompliance, resulting from misconduct, with any financial reporting requirement under the securities laws. Item 402(b) of Regulation S-K requires an issuer’s Compensation Discussion & Analysis to discuss, if material, its policies and decisions regarding the adjustment or recovery of awards to named executive officers if the relevant performance measures are restated or otherwise adjusted.

The proposal would implement Section 954 by adding Rule 10D-1 under the Exchange Act, adding new compensation-related disclosure as Item 402(w) of Regulation S-K and making a number of conforming modifications to other SEC rules.¹

REQUIRED CLAWBACK OF INCENTIVE-BASED COMPENSATION
The proposal would require listed issuers to adopt and comply with a written policy providing that, in the event the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from its current and former executive officers the amount of erroneously awarded incentive-based compensation received during the three completed fiscal years immediately preceding the date the restatement is required. Clawback would be on a “no-fault” basis, without regard to any misconduct or responsibility of the executive for the erroneous financial statements.

The proposal takes the form of a direction that the national securities exchanges adopt listing standards to implement the proposed clawback requirement. The SEC notes that the proposal would establish minimum standards and, accordingly, that the securities exchanges could adopt listing standards more stringent than those required by the proposal. The SEC also notes that any listed issuer could adopt policies that are more extensive than those called for by the final listing standards applicable to it.

**Executives Subject to Mandatory Clawback**

The proposed clawback requirement would apply to a universe of “executive officers” that is modeled on the definition of “officer” under Section 16 of the Exchange Act. The Section 16 definition is potentially broader than the group of executive officers identified pursuant to Item 401(b) of Regulation S-K because it specifically includes the principal financial officer and principal accounting officer (or controller, if there is no principal accounting officer), in addition to the president, any vice-president in charge of a principal business unit, division or function, any other officer who performs policy-making functions for the issuer, or any other person who performs similar policy-making functions. Consistent with the definition under Section 16, any person identified as an executive officer under Item 401(b) would be presumed to be an executive officer for purposes of the proposed clawback requirement.

The proposed rule would include both current and former executive officers. However, recovery would not apply to an individual who was not an executive officer at any time during the performance period for the incentive-based compensation potentially subject to clawback. Accordingly, mandatory clawback would only apply to incentive-based compensation earned at least in part during a period that an executive officer served in that capacity.

**Incentive-Based Compensation Covered**

The proposed clawback requirement would apply to any compensation that is granted, earned or vested based wholly or in part on the attainment of any financial reporting measure. “Financial reporting measure” would be defined as comprising measures that are determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return. These measures would be encompassed by the definition of “financial reporting measure” whether or not they were actually included in a document filed with the SEC.

The SEC states that “in part” is included in the definition of covered incentive-based compensation to clarify that incentive-based compensation need not be based solely on the attainment of a financial reporting measure to be covered. The SEC provides as an example of covered incentive-based compensation a payment that is 60 percent earned if a certain revenue level is achieved (which is a financial reporting measure) and 40 percent earned if a certain number of new stores are opened (which is not a financial reporting measure).
On the other hand, the SEC expressly recognizes that not all forms of compensation would be subject to clawback under the proposed requirement and provides the following examples of compensation that would not be covered:

- Salaries (although a salary increase based on a financial reporting measure could be subject);
- Discretionary bonuses (unless paid from a “bonus pool” that is determined by reference to a financial reporting measure);
- Bonuses based solely on satisfying one or more subjective measures (e.g., demonstrated leadership), strategic measures (e.g., a merger or divestiture) and/or operational measures (e.g., increase in market share) or on completion of a specified employment period; and
- Equity awards for which grant and vesting is not contingent upon achieving any financial reporting measure performance goal (including, potentially, stock options subject to service-based vesting).

In the case of discretionary bonuses paid from a “bonus pool” determined by reference to a financial reporting measure, the SEC notes that the pool should be reduced based on applying the restated financial measure. If the aggregate pool as reduced would still have been sufficient to cover the individual bonuses paid from it, then no clawback would be required.

A similar analysis should apply to certain compensation arrangements intended to qualify as “performance-based” under Internal Revenue Code Section 162(m). In some cases, these arrangements establish a maximum incentive amount based on a financial reporting measure and then permit the compensation committee of the issuer the discretion to reduce the amount actually earned. The SEC states that awards of this type should be viewed as being based “in part” on the attainment of a financial reporting measure and therefore covered by the proposal. Consistent with the treatment of discretionary bonuses from a bonus pool, however, if the financial reporting measure as restated would permit the individual bonus as originally determined using the negative discretion of the compensation committee, mandatory clawback should not be required under the proposal.

Restatement Triggers
The proposed rule would trigger clawback if a listed issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws.

“Accounting restatement” would be defined 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. This proposed definition is similar but not identical to the definition of restatement under U.S. Generally Accepted Accounting Principles.

Although Section 954 and the proposed rule both contemplate that clawback would be required only by an accounting restatement due to “material noncompliance with any financial reporting requirement,” the proposal deems any restatement to correct an error that is material to previously issued financial
The SEC does not provide any guidance regarding any type or characteristic that could cause an error to be considered material because materiality is a determination that “must be analyzed in the context of particular facts and circumstances” and that “has received extensive and comprehensive judicial and regulatory attention.” The SEC also notes that listed issuers 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.

The SEC specifically discusses a number of changes to an issuer’s financial statements as not representing error correction and therefore not triggering application of the mandatory clawback policy: (1) retrospective application of a change in accounting principle, (2) retrospective revision to reportable segment information due to a change in the structure of an issuer’s internal organization, (3) retrospective reclassification due to a discontinued operation, (4) retrospective application of a change in reporting entity, such as from a reorganization of entities under common control, (5) retrospective adjustment to provisional amounts in connection with a prior business combination and (6) retrospective revision for stock splits.

**Three Fiscal Year Clawback Period**

Clawback would be required for any excess covered compensation received during the *three completed fiscal years* immediately preceding the *date on which an issuer is required to prepare an accounting restatement*. For example, if a calendar year issuer concludes in November 2018 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2019, the recovery policy would apply to compensation received in 2015, 2016 and 2017.

The proposed rule would deem covered compensation “received” in the fiscal period during which the relevant financial reporting measure is satisfied, even if payment or grant occurs after the end of that period. For example, an annual bonus award would be deemed received in the fiscal year for which the executive earns the award even if it is not actually paid until March of the following year. In addition, compensation would be deemed received even if it was subject to ongoing service-based vesting or other conditions after the financial reporting measure is satisfied. Many long-term incentive plans fit this profile.

For this purpose, “the date on which an issuer is required to prepare an accounting restatement” is the earlier of:

- The date that the issuer’s board of directors (or officers, if board action is not required) concludes or reasonably should have concluded that the issuer’s previous financial statements contain a material error, or
The date a court, regulator or other legally authorized body directs the issuer to restate its financial statements.

A note to the proposed rule indicates that the first date is generally expected to coincide with the disclosure requirement of Form 8-K Item 4.02(a). In the addition, the SEC notes that, while not dispositive, a listed issuer should consider carefully any notice received from its independent auditor that previously issued financial statements containing a material error.

**Determination of Excess Compensation**

A listed issuer would be required to clawback the amount of incentive-based compensation received during the look-back period by the covered executive officer that exceeds the amount of incentive-based compensation that would have been received if it had been determined based on the accounting restatement. The recoverable amount would be calculated on a pre-tax basis.

The SEC states that, after an accounting restatement, an issuer would first recalculate the applicable financial reporting measure and then the amount of incentive-based compensation based on the measure as recalculated. The issuer would then determine whether the executive officer received a greater amount of incentive-based compensation than would have been received based on the recalculated measure.

**Effect of Discretion.** The proposal suggests that a listed issuer should take into account any discretion that had been applied to increase or decrease the amount originally received in determining the recoverable amount. To illustrate this principle, the SEC provides two examples in which an award would be $3,000 based on a financial reporting measure as originally reported and $1,800 following a restatement using the corrected financial reporting measure. In the first example, the issuer originally exercised negative discretion to pay out only $2,000. Taking into account the exercise of discretion, the SEC states that the recoverable amount would only be $200 (i.e., $2,000 - $1,800). In the second example, the issuer exercised positive discretion to increase the $3,000 earned amount by $1,000, paying out a total of $4,000. The SEC concludes that the recoverable amount in this example would only be $1,200 (i.e., $3,000 - $1,800) so long as, based on the revised measurement, the exercise of positive discretion to increase the amount by $1,000 was still permitted under the terms of the plan.

For discretionary cash awards paid from bonus pools determined in whole or in part by reference to a financial reporting measure, the size of the aggregate bonus pool would be reduced based on applying the restated financial reporting measure. As discussed above under “Incentive-Based Compensation Covered,” if the aggregate reduced bonus pool would have been sufficient to cover the individual discretionary bonuses actually received from it, then no recovery would be required. If the reduced bonus pool would be less than the aggregate amount of individual bonuses, the proposal states that the excess amount of an individual bonus would be the pro rata portion of the deficiency based on the size of the original award. The proposal would not permit clawback policies that contemplate recovery of less than
the pro rata amount from each covered executive because the SEC believes permitting discretion in these instances would be inconsistent with the no-fault standard of the proposed rule. Companies could, however, seek to recover additional amounts on any other legal basis.

In no case does the proposal require listed companies to reevaluate their discretionary decisions in light of the accounting restatement. Many advance commenters expressed concern that the proposal would require such after-the-fact reevaluation or require arbitrary, formulaic reduction of discretionary amounts.

**Equity Awards.** For equity awards, if the awards were still held at the time of recovery, the recoverable amount would be the number received in excess of the number that should have been received applying the restated financial reporting measure. If 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. 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. In any case in which the shares have been obtained upon exercise and payment of an exercise price, the recoverable amount would be reduced to reflect the applicable exercise price paid.

**Performance Conditions Based on Stock Price or TSR.** For compensation earned based on stock price or total shareholder return, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly, the recoverable amount must be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. As discussed below under "Clawback Policy – Related Disclosure Requirements," an issuer would be required to publicly disclose the basis for its determination. In addition, it would need to maintain documentation of its determination and provide the documentation to the relevant exchange.

**Interaction with Sarbanes-Oxley Section 304.** The proposal permits crediting of amounts an executive officer reimburses an issuer pursuant to Sarbanes-Oxley Section 304, but only to the extent that the proposed rule would require repayment of the same compensation by that executive officer.

**Exceptions to the Clawback Obligation**

Listed issuers would be required to clawback excess covered compensation unless it would be impracticable to do so, which is defined to include only (1) if the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered or (2) in the case of a foreign private issuer, if recovery would violate home country law. A determination that clawback is impracticable must be made by the issuer’s independent compensation committee, and, in any event, the issuer must first make and document a reasonable attempt to recover the covered excess compensation and provide the documentation to the relevant exchange. In addition, as described in “Clawback Policy – Related Disclosure Requirements” below, the issuer would be required to publicly disclose the name of any executive officer from whom it has determined not to pursue recovery and why, together with the amount at issue.
Before a foreign private issuer may conclude that recovery would violate home country law, the issuer must provide to its securities exchange an opinion of counsel, not unacceptable to the exchange. In addition, the exception is available only for laws adopted before the final version of Rule 10D-1 is published in the Federal Register. The SEC states that this qualification is designed to minimize any incentive countries may have to change their laws in response to the proposed requirement. No exception is provided for local law (outside of an issuer’s home country) that may apply to an executive and prohibit clawback.

The SEC notes that it does not view inconsistency between its proposal and existing compensation contracts, in itself, as a basis for finding recovery to be impracticable, because it states that issuers could amend those contracts to accommodate recovery.

**Manner of Recovery**

The proposal provides issuers with discretion as to how to clawback excess compensation. The proposal does not provide examples of permitted means of clawback but does note that several commentators suggested cancellation of unvested equity and non-equity awards or offsetting against amounts otherwise payable. Regardless of the manner of clawback, listed issuers would be required to recover excess compensation reasonably promptly (with undue delay constituting a violation of the policy). In addition, a delay of more than 180 days would potentially require the issuer to publicly disclose the name of any executive officer from whom a balance is outstanding, as described in “Clawback Policy – Related Disclosure Requirements” below.

**Prohibition on Indemnification or Issuer-Paid Insurance**

The proposal would prohibit a listed issuer from indemnifying any current or former executive officer against the loss of excess covered compensation. In addition, it is the SEC's position that Section 29(a) of the Exchange Act would render any indemnification agreement unenforceable to the extent it purported to undermine a listed issuer’s right (and obligation) to recover excess compensation.

The SEC recognizes that executive officers may be able to purchase third-party insurance to fund potential recovery obligations. The prohibition on indemnification would also prohibit a listed issuer from paying or reimbursing an executive for premiums for such a policy.

**CLAWBACK POLICY–RELATED DISCLOSURE REQUIREMENTS**

Although not required by Section 954, the SEC is proposing to require listed issuers to disclose how they have applied their policies and, in certain instances, would require an issuer to identify the name and excess incentive-based compensation of individual executives.
Proposed Item 402(w) of Regulation S-K\(^2\) would require the following disclosure if at any time during an issuer’s last completed year either (1) an accounting restatement requires clawback of excess compensation under the issuer’s clawback policy or (2) there was an outstanding balance of excess incentive-based compensation relating to an earlier restatement:

- The date when the accounting restatement was required, the aggregate amount of excess incentive-based compensation resulting from the restatement and the aggregate amount of unrecovered excess incentive-based compensation at the end of the year; and
- The estimates used to determine the amount of recovery if the recovery was related to incentive-based compensation based on stock price or total shareholder returns.

In addition, disclosure would be required of individual executive officers by name, if:

- During the last fiscal year the listed issuer determined not to pursue recovery from the executive, in which case the disclosure must include the amount forgone for the executive and a brief description of the basis for not pursuing recovery; or
- At the end of the last completed fiscal year there is a balance of excess incentive-based compensation that has been outstanding for more than 180 days, in which case the disclosure must include the amount owed.

Each listed issuer also would be required to file its clawback policy as an exhibit to its Exchange Act annual report.

The SEC would require the Item 402(w) disclosure to be provided in interactive data format using eXtensible Business Reporting Language (“XBRL”). The interactive data would be provided as an exhibit to the definitive proxy or information statement filed with the SEC and as an exhibit to the issuer’s Exchange Act annual report. This requirement would generally apply to all listed issuers, except that the SEC anticipates foreign private issuers reporting under International Financial Reporting Standards would not be expected to submit the new interactive data files until the SEC requires interactive data files generally with respect to such issuers.

**ISSUERS SUBJECT TO THE PROPOSED RULE**

The proposed requirements would generally apply to all listed issuers, including emerging growth companies, smaller reporting companies, foreign private issuers (including Canadian MJDS filers) and controlled companies, without regard to the type of security issued. The SEC proposes to implement only the following “limited exceptions”:

- Registered investment companies, including closed-end management investment companies and certain open-end management investment companies, that have not awarded incentive-based compensation during the last three fiscal years, or in the case that the issuer has been listed for less than three fiscal years, since the initial listing of the issuer;

---

\(^2\) The requirements for listed foreign private issuers and registered management investment companies subject to the proposal would mirror the proposed Item 402(w) disclosure.
SEC Proposes Mandatory Compensation Clawbacks

July 7, 2015

SULLIVAN & CROMWELL LLP

- Unit investment trusts; and
- Security futures products cleared by, and standardized options issued by, a clearing agency that is registered under Section 17A of the Exchange Act (or, in the case of securities futures products, exempt from registration).

EFFECTIVENESS

The proposal would require the exchanges to propose conforming listing standards within 90 days of the final rule’s publication in the Federal Register and would require the standards to become effective no later than one year after publication of the final rule. Each listed issuer would then be required to implement its clawback policy within 60 days after its exchange’s listing standard has become effective.

Importantly, the clawback obligation would apply to any excess incentive-based compensation received on or after the effective date of the final rule (even if listing standards have not been finalized) that results from attaining a financial reporting measure based on financial information for any fiscal period ending on or after the effective date of the final rule. Listed issuers would be required to comply with the proposed rule regardless of whether the contracts under which incentive-based compensation is to be awarded were entered into prior to, on or after the effective date of the listing standard.

Issuers would be required to comply with the disclosure requirements set forth above for any proxy or information statements or Exchange Act annual reports filed on or after the listing standard for their exchange becomes effective.

CONCERNS OF THE DISSenting COMMISSIONERS

As noted above, Commissioners Gallagher and Piwowar dissented from the proposal of the rule. Commissioner Gallagher expressed concerns about the resource opportunity costs of the SEC implementing and ensuring compliance with the proposed rule, and suggested that the focus of the SEC should instead be on implementation of other proposals such as the disclosure review project. On the substance of the proposal, each expressed the view that the scope of the definition of “executive officer” under the rule was too broad. Commissioner Gallagher raised concerns that such a broad definition of executive officer, when coupled with a strict liability “no-fault” regime, would result in clawback from persons with little control over the financial reporting measures of the issuer. Instead, Commissioner Gallagher suggested that he would likely support a proposal where either a “no fault” regime or a broad definition of executive officer was implemented, but not both combined.

* * *
SEC Proposes Mandatory Compensation Clawbacks
July 7, 2015
SEC Proposes Mandatory Compensation Clawbacks
July 7, 2015
SEC Proposes Mandatory Compensation Clawbacks
July 7, 2015
SC1:3898938v4A