SEC Proposes Compensation Clawback Rules

Recovering Compensation Paid to Executive Officers in the Case of Restatements of Financial Statements

July 7, 2015

On July 1, 2015, nearly five years after the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") was enacted, the Securities Exchange Commission ("SEC"), in a split vote of three to two, proposed rules to implement Section 954 of the Act. Section 954 requires companies to adopt and enforce a policy (a "recovery policy," commonly referred to as a clawback policy) providing for repayment from executive officers of incentive-based compensation ("IBC") when restated financial statements indicate there has been an overpayment.

In general, the proposed rules apply whenever there is a determination that a financial restatement is required. Recovery applies to IBC paid to executive officers in excess of what would have been received if the financial statements in the preceding three fiscal years had been correctly prepared, including IBC based on stock price or TSR metrics. Recovery is mandatory unless the direct cost of enforcing recovery would exceed the recovery or foreign law would be violated.

Within 90 days of the final SEC rule, each national securities exchange/national securities association (a "stock exchange") must publish implementing rules that become effective within one year of the final SEC rule. Registrants will have 60 days after the effective date of the stock exchange rule to adopt a clawback policy that complies with the stock exchange rule. A registrant can be delisted if it fails to adopt and adhere to a recovery policy that complies with the stock exchange rule.

Under the proposed rule, while a registrant need not adopt the new recovery policy until 60 days after the stock exchange rule, the recovery policy must apply to accounting restatements for periods ending after the effective date of the final SEC rule. For example, to take an extreme case, if the SEC finalizes its rule in 2015 and the rule is effective upon finalization, a calendar year registrant[1] must be able to recover IBC in the event the 12/31/15 financials are restated and the restatement affects currently outstanding IBC awards, including long-term incentives granted in prior years in which payment is affected by results in 2015. This contractual right of recovery will be particularly important with respect to executive officers who are no longer employed by the registrant—absent a rule requiring repayment, the registrant may be unable to collect which, under a literal application of the proposed rule, could result in unintentional violation of the listing standards. As a result of the potential

[1] To simplify presentation, the explanation in this memo will assume the fiscal year of the registrant is the calendar year.

retroactive application, companies should immediately consider amending their incentive compensation plans if such arrangements do not already enable enforcement of whatever standard is eventually imposed.

The SEC has solicited comments on the proposed rule and there is a 60-day comment period that ends on September 14, 2015.

Background

Section 954 of the Act, which adds new section 10D to the Securities Exchange Act of 1934, is the third federal law to mandate recovery of incentive compensation that has been paid based on erroneous financials. The first law was section 304(a) of the Sarbanes-Oxley Act of 2002, which gave the SEC a right to bring a recovery action against the CEO or CFO of a registrant in the event of an accounting restatement due to material noncompliance of the registrant, "as a result of misconduct," with any financial reporting requirements. Recovery was limited to incentive-based or equity-based compensation received during the 12 months preceding the erroneous financial statement. There have been numerous criticisms of 304(a), including the lack of a private right of action, the limitation to the CEO and the CFO, the requirement of misconduct, the fact that the amount of recovery was not tied to the degree to which payment was increased due to the erroneous financial statement, and the limited time period to which the recovery right applies.

The second law was section 111(b)(3)(B) of the Emergency Economic Stabilization Act of 2008, which applied to financial institutions that had not yet repaid assistance they received under the Troubled Asset Relief Program ("TARP"). Up to the 25 most senior executives could be affected in the event of "bonus, retention award, or incentive compensation" payments based on materially inaccurate financial statements if the recipient received the right to the payment during the TARP period. The TARP recipient had to exercise its recovery right unless it was "unreasonable" to do so.

In general, section 954 of the Act can be viewed as an extension, with several refinements, of the TARP clawback rules to all listed registrants.[2] This summary begins by describing the timing rules with respect to the implementation of section 954 and then examines the rules themselves in more detail.

Implementation

Implementation will occur in several steps. The first step, publication in the Federal Register of the proposed rule, had not occurred as of July 7. There will be a 60-day comment period from publication, which will be followed at some point by publication of a final SEC rule. It is difficult to predict the timing of a final rule.

Once the final SEC rule is published, a stock exchange will have 90 days in which to publish rules that condition listing upon compliance with the new rule. This listing rule must be approved by the SEC and

[2] There is an exemption for registered investment companies that do not pay IBC.

effective no later than one year after the SEC publishes its final rule. A registrant will then have 60 days after the effective date of the stock exchange rule to adopt a compliant recovery policy, which policy must be filed as an exhibit to the annual report.

It is important to emphasize that, although a registrant may have considerable time in which to adopt a recovery policy, the policy will be retroactive under the proposed rule. It covers financial restatements for periods ending after the effective date of the final SEC rule. So, if the SEC finalizes its rule this year and it is effective upon finalization, a restatement of a registrant's financial statements for the year ending 12/31/15 would require seeking recovery from executive officers to the extent of any overpayment based on the inaccurate financial statements. If, for example, an executive officer received performance share units ("PSUs") in 2013 and the amount of shares earned is based on net income growth over the three years ending 12/31/15, earned PSUs would be paid out typically in early 2016, which would be well in advance of when a registrant would need to adopt its recovery policy.

The most immediate issue facing registrants is whether any steps can and should be taken now to ensure that currently outstanding long-term incentives can be subjected to the new rules if the payment of these long-term incentives could be based on financial statements for periods ending after the publication of the final SEC rules.

Timing of the Triggering Event—Requirement of An Accounting Restatement and Payments Received During the Preceding Three Years

The proposed rule takes the position that any accounting restatement triggers the potential application of the recovery rules. As expected, certain changes in financial statement presentation that are not considered errors do not trigger the recovery rules, such as retrospective application of a change in accounting principles, retrospective reclassification due to a discontinued operation, retrospective revision to reportable segment information due to a change in the structure of a registrant's internal organization, etc.

"Required" and "Received." Section 954 only applies to payments "received" during the three-year period preceding the date on which a registrant is "required" to prepare an accounting restatement. The language of this timing rule is, as some commentators have noted, problematic. One logical reading of the rule is that a restatement is "required" as soon as the inaccurate financial statement is filed. But this would lead to surprising results. For example, an annual bonus for 2016 would typically be paid in 2017 ***after*** the financial statements for 2016 were filed in early March 2017. Suppose the March 2017 statements were inaccurate, so that a restatement is required. If the restatement is "required" on the date the financial statements were filed, the erroneous payments would not be subject to recovery since they were not paid during the three years preceding the filing of the financial statements.

The proposed rule takes the position that a restatement is only "required" when the registrant "concludes, or reasonably should have concluded" that the financial statements contain a material error.[3] Currently a registrant must file Form 8-K when it concludes that previously issued financial statements

[3] There is an earlier date if a court, regulator, or "other legally authorized body" directs the registrant to restate its financials.

should no longer be relied upon because of an error. The proposed rule states the date of such conclusion is generally the trigger date. Recovery applies to IBC received during the three completed fiscal years preceding the trigger date.

In order to widen section 954's net, the SEC has also defined "received" in a fashion that some may find unexpected. A payment of IBC is treated as received in the fiscal period during which the applicable financial reporting measure for the IBC is attained. The rationale for this definition can be seen with the example of PSUs that have a payout based on the amount by which net income has grown by the end of year three. The shares might be granted in early 2015 and would be settled in early 2018 based on comparing 2017 net income to 2014 net income. Assume it is determined in 2019 that net income for 2017 was incorrectly calculated. If the PSUs were "received" when granted in 2015, receipt was before the three-year period began. While looking at the year of payment works so long as the PSUs are actually settled in 2018, if the registrant allows deferral of payout to a later year (for example, the executive can delay payment until termination of service), looking at the year of actual payment will result in section 954 not applying because receipt will be after the three-year period. The SEC's definition of receipt also addresses this problem.

Since each definition is not at all self-evident, neither commentary nor litigation challenging the definitions would be a surprise.

Executive Officers

Section 954 applies to payments to current and former executive officers who received IBC during the three-year period preceding the date the company is required to prepare the accounting restatement. Not unexpectedly, the SEC defines executive officers by incorporating the definition under section 16 of the Securities Exchange Act of 1934, which contains the short-swing trading rules. One issue addressed by the rules is what happens if the individual is only an executive officer for part of the performance period. The proposed rule states the entire payment is subject to the recovery policy.

Defining IBC and Determining the Amount of IBC Subject to Recovery

Perhaps the thorniest issue under the clawback rules is determining IBC and the extent to which it has been overpaid on account of an inaccurate financial statement. Given the limitless varieties of IBC, it was not expected that the proposed rule would answer all possible questions; the proposed rule defines IBC in what it calls a "principles-based manner" that the SEC says can be applied as new forms of compensation and compensation measurements are developed. IBC is defined as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure."

While there remain many unanswered questions, several issues appear to be clarified under the proposed rule.

The rule is clear that IBC will be treated as based upon attainment of a financial reporting measure even if the measure is not an explicit part of the registrant's financial statements. For example, IBC based on sales per square foot or same store sales is subject to recovery if sales are subject to an accounting restatement. Similarly, compensation based on financial ratios such as accounts receivable turnover, liquidity measures like working capital, profitability of one or more operating segments, etc., are all

considered IBC since some of the numbers used to compute these measures are taken into account in producing one or more financial statements.

The most controversial aspect of this definition is the SEC's assertion that performance measures based on stock price or total shareholder return ("TSR") are covered. While the correlation between financial metrics and stock price is not precisely ascertainable, the proposed rule takes the position that because stock price is "affected by accounting-related information," it falls within the recovery rules.

It is unclear how closely a particular form of executive compensation needs to be linked to a financial measure before the recovery rules apply, but it appears that some type of explicit linkage is necessary. For example, SEC commentary notes that none of the following is considered IBC:

- Salaries,
- Bonuses paid at the compensation committee's discretion that are not paid from a bonus pool, the size of which is based upon satisfying a financial reporting measure, and
- Equity awards for which the grant is not contingent on achieving any financial reporting measure and for which vesting is solely contingent on continued employment or one or more non-financial reporting measures.

In each of these cases, it is easy to imagine situations where, despite the lack of any explicit linkage, the amount of the payment could have been less if, at the time, the compensation was paid or awarded, the compensation committee had available to it the information in the restated financial statements. The fact that restated financials might have affected the granting or sizing of the award is not, however, adequate to invoke the recovery rules.

While computing the reduced IBC will be straightforward in many cases, there are many uncertain situations. One uncertainty clarified in the proposed rule is what happens if a financial reporting measure determines the size of a bonus pool, but individual bonuses are awarded on a discretionary basis. The discussion of the proposed rule states that, if the restatement would decrease the size of the pool, bonuses are reduced on a pro rata basis.

One common situation that is not addressed is the application of the recovery rule to the plan-within-a-plan structure commonly used to make an annual bonus plan compliant under section 162(m)'s definition of performance-based compensation. For example, final bonus payments might be based on EPS growth but, because, the plan reserves the right to make adjustments for unexpected events, the registrant is concerned that the definition is not sufficiently objective to comply with 162(m). This is often solved by providing that the executive becomes entitled to the maximum bonus if, for example, a threshold net income target is met, but the compensation committee retains negative discretion to pay less than the maximum bonus and determines the actual payout based on the EPS performance goal. It is unclear whether the recovery rules are triggered in this case if the revised financial statements would lower EPS growth but the threshold net income target is still met.

The most difficult situation will occur when the IBC is based on stock price, where the SEC optimistically notes that "sometimes" it may be difficult to establish the relationship between an accounting error and the stock price. While further acknowledging that determining the alternative stock price may require complex analysis that involves significant technical expertise and specialized

knowledge, the SEC states that these difficulties are mitigated because a registrant will be allowed to use "reasonable estimates" in determining the alternative price.

Method of Recovery

While direct repayment to the registrant is probably the most expected form of recovery, the SEC does not rule out alternative approaches, such as cancelling unvested equity awards or deferred compensation. The SEC states that recovery should occur "reasonably promptly," indicating that techniques like repaying over time or from future pay may not be permissible.

Recovery is to be made on a pre-tax basis, that is, the recovered amount is the full amount of the payment, not the amount the executive nets after taxes. This is not unexpected and, in fact, a contrary position would have even further complicated the recovery calculation since it would embroil an issuer in an examination of the executive officer's tax returns. Assuming the recovered amount is tax deductible (this appears to be the result in most cases), there is still a potential mismatch, however, if the executive's tax rate is different in the year of recovery than the rate in the year of initial payment. Section 1341 of the Internal Revenue Code provides complex rules that would generally avoid this mismatch, but there is some uncertainty as to whether it will always be available.

Finally, the clawed back amount is to reduce the amount reported in the Summary Compensation Table for the fiscal year in which the recovered amount was originally reported.

Exceptions to Recovery and Indemnification

Since the statutory language does not list any exceptions to its recovery requirement, it is not unexpected that the proposed rule has only a very limited exception to the registrant's requirement to pursue recovery—recovery need not be pursued if the "direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered." There is also an exception if recovery would violate "home country law." The SEC discussion clarifies that "home country law" is a reference to laws of foreign countries adopted before the proposed rule was published.

One unaddressed question that we hope the SEC will address in the final rule is what happens if state law forbids recovery. Some legal commentary has suggested that some states have wage protection laws that might prohibit recovery once IBC has been paid. Other commentators have suggested that, so long as the right to recovery has been carefully drafted and explicitly agreed to, state law should not be a problem. Hopefully, this latter interpretation is correct since the proposed rule would literally require delisting of a registrant who was unable to recover because state law prohibited recovery.

As expected, the proposed rule provides that a registrant cannot indemnify an executive officer from recovery although it appears permissible to agree to provide for payment of the officer's expenses in defending against any effort to recover.

Compliance Obligations

The initial compliance obligation will be to adopt a recovery policy within 60 days of the effective date of the stock exchange rule. The proposed rule does not specify what language is required for a compliance policy. Other than specifying who administers the recovery policy, which we would expect to typically be some combination of the compensation committee and the audit committee, it may make

the most sense to have a very short policy that incorporates by cross-reference the relevant language in the SEC and stock exchange rules. As noted, the policy will need to be filed as an exhibit to the annual report.

One important question that registrants will need to decide in connection with adopting the policy is how best to communicate and effectuate the policy. Some lawyers are concerned about enforceability if the registrant only adopts the policy without any explicit agreement by the executive. If there is going to be an explicit agreement, there is still the question whether it should be done by having the executive formally acknowledge and accept the policy or by embedding the policy in the terms of an award agreement (either directly or by cross reference) that the executive executes as a condition to receiving the award or payment. In that regard, the fact that the recovery rules apply if an individual is an executive officer at any time during the performance period means that obtaining agreements from just the executive officers at the time of original award may not be sufficient. We expect this to be an area of comment and hope the SEC will address the potentially unavoidable and often unpredictable practical limitations of enforcing the clawback (especially during the initial compliance period) despite a registrant's reasonable and good-faith efforts to do so.

A new proxy disclosure will be required if during a fiscal year there is either a restatement requiring recovery or unrecovered amounts attributable to a prior restatement. The disclosure is to include:

- The date of each accounting restatement and the excess IBC attributable to the restatement,
- How the excess amount was computed if the IBC involves stock price or TSR,
- The uncollected excess IBC as of the end of the fiscal year,
- With respect to any amounts for which recovery was not pursued, the name of the relevant individual, the foregone amount, and the reason recovery was not pursued, and
- The name of each individual who has had an outstanding balance to be recovered for more than 180 days and the amount of the balance.

The disclosure must be electronically formatted using the XBRL interactive data standard.

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