SEC Proposes Dodd-Frank Clawback Rules

hugheshubbard.com — eALERT

On July 1, the SEC issued proposed rules implementing the clawback provision mandated by the Dodd-Frank Act. In broad terms, the proposed rules require the stock exchanges to adopt listing standards that require every listed company to (1) adopt and implement a clawback policy providing for the recovery, under certain circumstances, of incentive compensation paid to executive officers prior to an accounting restatement, and (2) disclose information regarding its clawback policy as required by SEC rules. The listing standard requirement would be codified as new Rule 10D-1 and the disclosure requirements are contained in new Item 402(w) of Regulation S-K as well as amendments to existing provisions.

The rule as proposed would apply to all listed companies, including emerging growth companies, smaller reporting companies, foreign private issuers (with a limited caveat), and controlled companies, as well as companies whose only listed securities are debt securities or preferred stock. (The only exemptions from the rule would be for security futures products, standardized options, and certain registered investment companies.) The stock exchanges would not have discretion to exempt either categories of listed companies or securities.

Under the proposed rule:

- the stock exchanges would be required to file their proposed listing standards no later than 90 days after publication of final Rule 10D-1 in the Federal Register;
- the exchange listing standards would be effective no later than one year after publication of final Rule 10D-1; and
- listed companies would be required to adopt complying clawback policies no later than 60 days after their exchange's listing standard becomes effective.

Clawback would be required of all recoverable incentive compensation (within the meaning of the rule) received for financial performance for any fiscal years ending on or after the effective date of Rule 10D-1. The proposing release states that the clawback policy would apply to any recoverable compensation that is granted, earned, or vested on or after this effective date, including compensation paid pursuant to an agreement entered into before the effective date. The clawback-related disclosures would be required to be provided in all applicable SEC filings required on or after the effective date of the applicable exchange listing standard.

Required Content of Clawback Policy

Trigger for Clawback. Under the Dodd-Frank provision, clawback is required in the event of an accounting restatement due to "material noncompliance" with a financial reporting requirement. The proposed rules clarify the term "material noncompliance" to include any error that is material to previously-issued financial statements. The SEC proposing release clarifies that changes to previously-issued financial statements that are not viewed as error correction under applicable accounting standards – such as where accounting standards require retroactive application of a change in accounting principles – would not trigger a clawback. The proposed rule does not address when an error is "material," leaving that determination to be made based on the facts and circumstances. But the SEC release notes that a series of immaterial errors could in some circumstances be considered material when viewed in the aggregate.

The Dodd-Frank provision requires recovery of excess incentive compensation during the three-year period before "the date on which the issuer is required to prepare an accounting restatement." The proposed rule defines this trigger date as the earlier of (1) the date the company's board, board committee, or authorized officers conclude (or reasonably should have concluded) that the previously-

issued financial statements contain a material error, or (2) the date a restatement is ordered by a court or regulator to correct a material error. The proposing release notes that the first of these dates is generally the trigger for filing a Form 8-K under Item 4.02(a) to report that previously-issued financial statements should no longer be relied on.

The proposed rule specifies that the three-year look-back period for the recovery of excess incentive compensation is the three completed fiscal years that immediately precede the date the company is required to prepare a restatement. For example, if a calendar year issuer determines in November 2018 that a restatement is required and files the restated financial statements in 2019, the clawback policy would apply to compensation received in 2015, 2016, and 2017.

Officers subject to Clawback. The Dodd-Frank provision requires the clawback policy to apply to current and former "executive officers." The proposed rule defines the term "executive officers" to cover the same individuals who are subject to Section 16. Incentive compensation would be subject to clawback if the individual served as an executive officer at any time during the performance period for that incentive compensation. This would include incentive awards granted before the individual became an executive officer (as well as inducement awards to new hires), so long as the individual served as an executive officer at some time during the performance period. A person who became an executive officer after the end of the performance period, but who is an executive officer at the time clawback is otherwise required for that compensation, would not be subject to the clawback for that compensation.

Compensation subject to Clawback. The proposed rule defines the compensation which is subject to clawback using a principles-based approach. The term "incentive-based compensation" is defined as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure." Financial reporting measures are defined as (i) measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, (ii) measures derived wholly or in part from such information, and (iii) stock price and total shareholder return (TSR). A metric meeting this definition would be included even if the amount was not included in the company's financial statements or filed with the SEC. The proposing release gives the example of compensation based on same store sales or regional sales volume; this compensation would be included in the definition of incentive-based compensation – and subject to clawback in the event of a restatement relating to revenue recognition – even though the particular sales amount was not disclosed in an SEC filing.

Because the Dodd-Frank Act specifies that compensatory stock options should be subject to clawback, the proposed rule includes as incentive-based compensation stock options and other equity awards, but limits such awards to those whose grant or vesting is based wholly or in part on attainment of metrics based on or derived from financial reporting measures. As a result, most time-vested equity awards would be excluded from the definition. If shares are subject to clawback under this standard, the proceeds from the sale of such shares would also be subject to clawback.

Excluded from the definition of incentive-based compensation is compensation based on performance metrics that are not financial reporting measures. The proposing release gives as examples the opening of a specified number of stores, obtaining regulatory approval of a product, and completion of a merger or divestiture. Similarly, bonuses paid solely at the discretion of the compensation committee would not be subject to clawback. However, discretionary bonuses paid out of a bonus pool whose size is determined wholly or in part based on a financial reporting measure would be subject to clawback. While salaries would not be subject to clawback, the release states that any salary increase earned wholly or in part based on attainment of a financial reporting measure would be subject to clawback.

Amount to be Clawed Back. The Dodd-Frank Act requires clawback of excess compensation "received" in the three years before an accounting restatement is required. Under the proposed rule, incentive-based compensation is deemed received during the fiscal year in which the applicable performance goal for the compensation is attained, even if the payment occurs in a later year. For equity awards whose grant is based on attainment of a performance metric, the award would be deemed to have been received in the year the performance metric was attained; awards whose vesting is based on attainment of a performance metric would be deemed received in the year of vesting. Awards that are subject to additional time-based vesting after attainment of a performance measure would nevertheless be deemed received in the year the performance measure was attained.

The amount of compensation to be recovered by the company is the amount that "exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement." The release explains that the company would first recalculate

the applicable performance metric under the restated financials and the amount of incentive compensation based on such metric. The company would then consider the effect of any discretionary increase or decrease to that amount applied by the compensation committee or of any portion of the compensation based on non-financial goals.

The release provides two examples of how this would work. In the first example, an executive is entitled to a payment of $3000 based on the original financial statements, but the company uses negative discretion to reduce the payment to $2000. After the restatement, the corrected financial measurement would entitle the executive to a payment of $1800. Taking into account the company's exercise of negative discretion, the amount to be clawed back by the company is $200 (the $2000 actually paid minus the $1800 to which the executive was entitled under the restated financial statements).

In the second example, the executive is entitled to a payment of $3000 based on the original financial statements, and the company uses positive discretion to increase the payment by $1000, for a total of $4000. After the restatement, the corrected financial measurement would entitle the executive to a payment of $1800. Taking into account the company's exercise of positive discretion, the amount to be clawed back by the company is $1200 ($3000 minus $1800), letting the executive retain the additional $1000, provided that based on the revised financial measurement the additional $1000 payment was still permitted under the terms of the plan.

For awards paid from bonus pools where the size of the pool is determined by a financial reporting measure, the company would first calculate the amount of the pool as determined by the restated financial measure. If the bonus pool as so reduced would have been sufficient to cover all bonuses actually paid, no clawback would be required. If the reduced bonus pool would not have been sufficient, the amount to be clawed back from each executive officer would be a pro rata portion of the deficiency.

With respect to equity awards, if the shares, options or SARs are still held by the executive at the time recovery is required, the amount to be recovered would be the number of shares, options, or SARs received in excess of the number that should have been received. If options or SARs have been exercised but the shares received upon exercise have not been sold, the company would recover the number of net shares reflecting the excess options or SARs received by the executive (i.e., only the number of shares reflecting the option spread on the excess options or SARs would be clawed back). If the shares have been sold, the amount to be clawed back would be the sale proceeds received by the executive with respect to the excess number of shares.

For incentive-based compensation that is based on stock price or total shareholder return, the amount of erroneously-awarded incentive compensation cannot be calculated directly from the information in the accounting restatement. In these circumstances, the company would need to determine the recoverable amount based on a "reasonable estimate" of the effect of the accounting restatement on the stock price (or TSR). The proposed rule allows the company discretion to decide the methodology to be used in making this estimate.

The proposing release mentions two possible methods for estimating the effect of a restatement on a company's stock price. One method is an "event study" that uses a complex model to separate the effect of the restatement from changes in the stock price due to market factors or other news affecting the company. A less complex methodology noted in the release involves using publicly available historical estimates of beta to capture the correlation of the stock's return with the overall return of the market over a certain period of time.

Under any methodology, the company would need to make assumptions regarding a number of inputs, such as a proxy for market returns, the date and time that investors learned about the restatement, and the length of time it took for the information in the restatement to be reflected in the stock price. Companies would be required to provide their stock exchange with documentation of the estimates used.

The amount to be clawed back is to be calculated on a pre-tax basis (i.e., without regard to any taxes paid by the executive on the larger amount).

Company Discretion regarding Clawback. Under the proposed rule, a company would be required to recover compensation paid based on erroneous financial information unless recovery would be impracticable because the direct costs of enforcing the clawback policy (i.e., amounts paid to a third party, such as legal fees) would exceed the recoverable amount or, in the case of a foreign issuer, the clawback would violate the company's home country law. The release expressly states that neither an

executive's lack of responsibility for the financial statement errors nor the clawback policy's conflicts with existing compensation contracts would be a basis for finding recovery to be impracticable. A company would need to make a reasonable attempt to recover the excess compensation and provide documentation of its attempt to the stock exchange. Before concluding that enforcing its clawback policy would violate home country law, a company would need to obtain an opinion of home county counsel to that effect. Any determination that clawback would be impracticable would need to be made by an independent compensation committee and the reasons for that determination would need to be disclosed by the company.

The proposed rule does not mandate a particular means of recovery. The proposing release notes that commenters had suggested a variety of approaches that a company might want to take, including recovery over time or from future pay, through forfeiture of outstanding equity awards, by reduction of deferred compensation, as well as repayment by the executive. The release states that while companies should be able to exercise discretion in this area, recovery should be "reasonably promptly" in order to effectuate the purpose of the clawback provision. The stock exchange on which the company is listed would determine whether the company's actions constitute prompt recovery of the excess compensation.

Disclosure Requirements

U.S. Companies. The proposed rules would require each domestic listed company to file its clawback policy as an exhibit to its annual report on Form 10-K. In addition, Item 402 of Regulation S-K would be amended (by adding a new Item 402(w)) to require listed companies to disclose (in proxy statements and annual reports) how they have applied their clawback policies. This disclosure item would be triggered if during the last completed fiscal year there was either a restatement that required recovery of excess incentive compensation or an outstanding balance of excess compensation that was required to be recovered based on a prior restatement. Specifically, the company would be required to disclose:

- for each restatement, the date the company was required to prepare the restatement, the aggregate dollar amount of excess incentive compensation attributable to the restatement, and the amount of excess compensation that is unpaid as of the end of the last completed fiscal year;
- the estimates used to determine the amount of excess incentive compensation related to measures of stock price or total shareholder return;
- the name of each person subject to clawback from whom the company has decided not to pursue recovery, the amount forgone for each such person, and the reason the company decided not to pursue recovery; and
- the name of each person from whom, at the end of the last completed fiscal year, excess compensation had been outstanding for 180 days or more since the date the company determined the amount owed by such person, and the dollar amount of excess compensation due from such person.

The disclosure required by Item 402(w) would also be required to be provided in interactive data format, using XBRL with block-text tagging. The interactive data would be required to be provided as an exhibit to the proxy statement and Form10-K.

The Summary Compensation Table would also be revised to require that amounts reported in the table as paid in a prior year be reduced by the amount clawed back, with footnote disclosure of the amount recovered. This disclosure would apply only if the clawback related to compensation paid in a year covered by the table.

Foreign Issuers. Foreign issuers would be required to file their clawback policies as exhibits to their annual reports on Form 20-F. The Form 20-F would also require disclosure parallel to that called for by S-K Item 402(w), including the requirement to tag the disclosure in an interactive data format when the tagging requirement becomes applicable to financial statements of such issuers.

Indemnification and Insurance

The proposed rule would prohibit a listed company from indemnifying any current or former officer against loss of compensation that is required to be clawed back. The proposing release explains that

indemnification would undermine the purpose of the statutory provision, which is to prevent an executive officer from retaining compensation that the executive would not have received if the accounting had been done properly.

An executive officer would be permitted to purchase third party insurance to fund potential clawback repayments. However, the release states that the rule's indemnification provision would prohibit the company from paying or reimbursing the executive for premiums for such an insurance policy.

For further information, please contact:

Gary Simon, *Partner*
(212) 837-6770
gary.simon@hugheshubbard.com

Sarah Downie, *Partner*
(212) 837-6590
sarah.downie@hugheshubbard.com

Erin DeCecchis, *Counsel*
(212) 837-6450
erin.dececchis@hugheshubbard.com

Ellen Friedenberg, *Partner*
(212) 837-6465
ellen.friedenberg@hugheshubbard.com

Spencer Harrison, *Partner*
(212) 837-6858
spencer.harrison@hugheshubbard.com

Corporate Governance Practice

Employee Benefits & Executive Compensation Practice

July 2015

Hughes Hubbard & Reed LLP
One Battery Park Plaza | New York, New York 10004-1482 | 212-837-6000

Attorney advertising. Readers are advised that prior results do not guarantee a similar outcome.

© 2015 Hughes Hubbard & Reed LLP