Executive Compensation Alert: SEC Proposes “Clawback” Rules for Executive Compensation

JULY 7, 2015

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On July 1, 2015, the Securities and Exchange Commission (the “**SEC**”) proposed rules directing the national securities exchanges (NYSE, NASDAQ, etc.) to create listing standards requiring listed companies to implement policies that obligate a listed company to recover or “claw back” incentive-based compensation received by its executive officers as a result of materially incorrect financial statements. These proposed rules are mandated by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and are the last of the compensation-related rules required by the Dodd-Frank Act.

Highlights of Proposed Rules

- A “clawback” under the proposed rules would be mandatory in the event a company is required to restate a financial statement to correct material non-compliance with a financial reporting requirement. A “clawback policy” would require the company to recover excess “incentive-based compensation” received by its current and former executive officers during the three fiscal year period prior to the date on which the company is required to prepare the restatement.
- For purposes of the proposed rules, incentive-based compensation includes compensation based, in whole or in part, on a company’s financial measures (described below). The incentive-based compensation to be recovered by a company would be the amount that the executive officer received based on materially incorrect financial statements that *exceeds* the amount such executive officer would have received had the compensation been based on the restated financial statements.
- Recovery of the excess incentive-based compensation must be enforced on a no fault basis – a company may not consider the responsibility or misconduct of the executive officer in enforcing the policy.
- All listed companies would be required to implement a clawback policy, including smaller reporting companies, emerging growth companies, foreign private issuers and controlled companies.
- A company may be subject to de-listing if it does not adopt, disclose and enforce a compliant clawback policy.

Current and Former Executive Officers Covered by Proposed Rules

A clawback policy must apply to current and former “executive officers,” which the proposed rules define as a company’s president, chief financial officer, principal accounting officer, any vice-president in charge of a principal business unit or any other person in a company policy-making position. The SEC debated including only named executive officers under the proposed rules, but it opted to include this broader group, which generally aligns with the “Section 16” definition of officers.

The proposed rules would also cover executive officers who provided services at any time during the three-year look back period (described below) even if they are not executive officers at the time the restatement is required or when the company seeks to recover the excess incentive-based compensation. All incentive-based compensation “received” (described below) by such former executive officer during the three-year look back period would be subject to clawback.

Financial Restatements Triggering Clawback

A company must recover incentive-based compensation (described below) in the event the company is “required” (described below) to prepare a restatement to correct an error that is “material” to the previously issued financial statement. Materiality is not defined; rather companies must determine materiality based on the facts, circumstances and relevant legal guidance. The proposed rules, however, do exclude certain corrections under generally accepted accounting standards, such as the retrospective application of a change in an accounting principle.

Compensation Subject to Clawback

Under the proposed rules, the “incentive-based compensation” that is subject to clawback is compensation that is granted, earned or vested based on the attainment of any financial reporting measure, which includes:

- Measures based on accounting principles used in preparing financial statements, and measures derived at least in part from such financial information;
- Stock price; and
- Total shareholder return (“**TSR**”).

Importantly, the proposed rules *exclude* the following compensation from clawback as they are not deemed to be based on financial reporting measures:

- Service-based awards such as stock options or restricted stock units (“**RSUs**”) that are granted or vest *solely* upon completion of a service period, even though their value will fluctuate based on the company’s stock price;
- Awards based on non-financial strategic or operating metrics such as the consummation of a merger;
- Serviced-based retention bonuses;
- Discretionary compensation; and
- Salary.

These exclusions are significant and may affect the recent trend toward more performance-based equity compensation.

The amount of recoverable incentive-based compensation is the amount received by the executive officer based on the materially incorrect financial statements that *exceeds* the amount such executive would have received had the compensation been determined based on the financial restatement.

In the proposal, the SEC notes that it will be acceptable to use reasonable “*estimates*” and / or “*event studies*” to determine the impact of a financial restatement on stock price and TSR. Likewise, the proposed rules indicate that use of an outside expert may be appropriate for this purpose.

How a company claws back the excess compensation attributable to equity awards will depend upon whether the awards have been exercised and whether exercised shares remain outstanding. (If shares have been sold and/or exercised, the clawback may be imposed on proceeds received upon sale of the shares.) We expect significant comments and discussion regarding the calculation of equity awards to be clawed back, as well as the method of recoupment. In particular, how the clawback will be imposed on awards based on TSR will be complicated, in part because it will often be less than clear whether any incentive-based compensation was based on materially incorrect financial statements.

The Three-Year Look Back Period

A clawback policy must require recovery of excess incentive-based compensation “received” during the three fiscal years prior to the year in which it is determined that the company is “required” to prepare an accounting restatement.

The date on which a company is “required” to prepare a restatement is the earlier of:

- The date that a company’s board of directors, a committee of independent directors or authorized officers conclude, or reasonably should have concluded, that the financial statements includes a material error; and
- The date that a court or other legal body directs the company to restate its financial statements to correct a material error.

Incentive-based compensation is deemed “received” at the time the financial measure is achieved, even if the payment or grant occurs on a later date, or there are additional payment requirements such as time-based vesting or certification by the compensation committee that have not yet been satisfied. For example, if the number of shares earned under a performance-based RSU is determined based on a company’s TSR over the three-year performance period ending in 2016 (and such award is determined to be based on materially incorrect financial statements), but the RSU then remains subject to a two-year time-based vesting requirement, the RSU is deemed “received” in 2016 at the end of the relevant performance period. Regardless of when the restatement occurs, as long as the RSUs are received within three fiscal years prior to when the restatement was “required,” the RSUs will be subject to clawback even though they remain subject to time-based vesting.

The compensation to be recovered would be calculated on a pre-tax basis.

No-Fault Standard and Limited Discretion to Not Clawback

The proposed rules do not permit a company to consider the fault or responsibility of the executive officers. A company may exercise discretion to not enforce its clawback policy in only two situations:

- The expense of enforcing the recovery would exceed the amount recovered; and
- Enforcing the recovery would violate non-U.S. local law.

A company must make a reasonable attempt to recoup erroneously paid compensation (and document such attempt) prior to asserting that the expense of recovery exceeds the potential recoverable amount. Likewise, it is important to note that only direct costs (such as legal fees) may be taken into account. The decision to not recoup the compensation, which must be made by the company's compensation committee or the majority of its independent directors, must be publicly disclosed and would be subject to review by the applicable exchange.

All Listed Companies Subject to Proposed Rules with Very Limited Exceptions

Generally, all listed issuers would be required to comply with the proposed clawback rules with the limited exception of registered investment companies and issuers of securities futures products or standardized options. Notably, there is no exception for emerging growth companies, smaller reporting companies or foreign private issuers. This lack of any exceptions has been (and will continue to be) an important issue and we expect that it will be the subject of many comment letters.

Required Disclosure

The proposed rules would require the following disclosures:

- Filing of the clawback policy with a company's Form 10-K "Annual Report;"
- If a triggering restatement occurs and/or there remains an outstanding balance of compensation subject to clawback that relates to a prior year's restatement, a company must disclose the date on which the restatement was required, the aggregate amount of recoverable incentive-based compensation, a description of estimates used and any outstanding balance of compensation to be repaid (and if the amount to be repaid by an individual remains outstanding for more than 180 days, the company must identify the recipient);
- If a company decides not to pursue recoupment based on cost impracticalities, the company must disclose an explanation, as well as identify the recipients of the compensation;
- If a company uses reasonable estimates to determine the amount of erroneously paid incentive-based compensation attributable to the company's stock price or TSR metrics, the company must disclose how it calculated the estimates and may be required to provide supporting documentation to the applicable exchange; and
- The proposed rules contemplate that the amount recovered would reduce the amount reported in a company's summary compensation table for the fiscal year in which the recovered amount was reported, and be summarized in the table's footnotes.

Timing for Compliance

Companies may need to comply with the proposed rules as early as the end of 2016, though this timing will depend on when the SEC's proposed rules are finalized, and will likely be in early 2017.

Once the SEC issues final rules, which will be no earlier than September 2015 to allow for a 60-day comment period for the proposed rules, the exchanges will have 90 days to issue their proposed listing rules. The exchanges' listing rules must be effective no later than one year following the publication of the SEC's final rules. Companies would then be required to adopt a clawback policy no later than 60 days following the effectiveness of the exchanges' rules.

What's Next?

The comment period for the proposed rules will remain open for 60 days after its publication in the Federal Register. We anticipate that comments will include, among other things, (1) how to determine whether compensation is based in whole or in part on materially incorrect financial statements, especially in the case of TSR-based metrics, (2) whether emerging growth and small reporting companies should be subject to the rules, and (3) how to recover amounts attributable to materially incorrect financial statements.

Likewise, it is possible that the impact of subjecting performance-based equity awards to a no-fault clawback policy may encourage companies to shift away from performance-based compensation to non-performance payments, such as increased salaries, discretionary bonuses or time-based equity awards. This possible shift could result in misalignment of a company's executive compensation with its shareholders' interests, run afoul of the stated preferences for performance-based compensation of proxy advisory firms, such as ISS, and negatively impact a company's say-on-pay vote.

In the meantime, companies should consider taking the following actions:

- Add clawback provisions to new incentive-based compensation arrangements, or amend existing arrangements, to subject the compensation to clawback policies to be adopted in the future;

- Review company bylaws, D&O insurance and executive officers' indemnification agreements to remove indemnification with respect to compensation subject to the clawback rules (indemnification by the company would be prohibited under the proposed rules); and
- Review compensation committee charters to determine whether the charters address the new duties required by the proposed rules and/or consider whether a separate independent committee should be established for these purposes.

Additional Information

The SEC's Fact Sheet describing the proposed rules can be found here: http://www.sec.gov/news/pressrelease/2015-136.html

The SEC Release can be found here: http://www.sec.gov/rules/proposed/2015/33-9861.pdf

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