Client Alert

July 2015

SEC Proposes Executive Officer Compensation "Clawback" Rules

On July 1, 2015, the Securities and Exchange Commission (the "SEC") proposed rules to enact the compensation disclosure and recovery requirements under Section 10D of the Securities Exchange Act of 1934 (the "Exchange Act"), as added by Section 954 of the Dodd-Frank Act. The proposed rules would direct the national securities exchanges to establish listing standards requiring each issuer to develop and implement a policy:

(1) providing for the disclosure of the issuer's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws, and

(2) providing that in the event an issuer is required to prepare an accounting restatement due to material noncompliance by the issuer with financial reporting requirements under the securities laws (i.e., any error that is material to previously issued financial statements), the issuer will recover from current or former executive officers who received incentive-based compensation based on the erroneous data during the three-year period preceding the date the issuer is required to prepare the accounting restatement, the amount in excess of what would have been paid to the executive officer under the restatement.

The proposed rules will be open for public comment until September 14, 2015.

Overview

The SEC is proposing to add new Rule 10D-1 under the Exchange Act and proposing rule amendments to Regulation S-K, to the forms foreign private issuers use to file their Exchange Act annual reports, and for certain investment companies, to Form N-CSR and Schedule 14A. The proposed rules and amendments would require exchanges and national securities associations to adopt listing standards that would require listed issuers to adopt and comply with clawback policies to recover incentive-based compensation that was erroneously awarded to executive officers when an issuer is required to prepare an accounting restatement to correct a material error to previously issued financial statements. The proposal would apply generally to all listed issuers, with limited exceptions, and the recovery policies would apply generally to all executive officers. Failure to comply with these listing standards could result in an issuer's being delisted from an exchange or national securities association. Recovery of erroneously awarded compensation under such policies would be no-fault, meaning that listed issuers would be required to seek recovery of such amounts regardless of whether or not an executive officer is responsible for the financial errors requiring restatement.

In addition to adopting and complying with a recovery policy, a listed issuer would have to disclose its actual policy and how it has applied its recovery policy. The proposed disclosure would require the recovery policy to be filed as an exhibit to the issuer's annual report on Form 10-K, and revisions to Summary Compensation Table disclosure would be required to reflect any amounts recovered. Some of the disclosure information would be required to be provided in interactive data format using XBRL block-text tagging.

Under the proposal, issuers would not be permitted to reduce their obligations under Section 10D through indemnification agreements, and they would not be permitted to indemnify executive officers for any amounts recovered.

Issuers Covered

The proposed disclosure and recovery policies would apply to all issuers, with limited exceptions. Foreign private issuers would not be exempt, but exchanges would be allowed to permit foreign private issuers to forgo recovery as impracticable if the recovery of erroneously awarded compensation would violate the home country's laws, so long as other conditions are met. Registered management investment companies would only be subject to Rule 10D-1 to the extent that they pay incentive-based compensation to executive officers.

Restatements Triggering Application of Recovery Policy

Rule 10D-1 would require issuers to adopt and comply with a written policy providing that in the event the issuer is required to prepare an accounting restatement to correct an error that is material to previously issued financial statements, the obligation to prepare the restatement would trigger the application of the recovery policy. An 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.

The proposal would require the recovery of excess incentive-based compensation "during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement." The date on which the issuer is required to prepare an accounting restatement would be the earlier to occur of: (i) the date the issuer's board of directors, a committee of the board of directors or the officer or officers of the issuer authorized to take such action conclude, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error; or (ii) the date a court, regulator or other legally authorized body directs the issuer to restate its previously issued financial statements to correct a material error.

Application of Recovery Policy

Executives Covered Under the Recovery Policy

The proposal's mandatory recovery policy would apply to all executive officers of the issuer, as opposed to a limited subset of executive officers, regardless of whether the executive officer's responsibilities include preparing the issuer's financial statements. Under the proposed definition of "executive officer" under Section 10D, which is modeled on the definition of "officer" in Rule 16a-1(f), an executive officer would be the issuer's president; principal financial officer; principal accounting officer (or if there is no such accounting officer, 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. Executive officers of the issuer's parent or subsidiary would be deemed executive officers of the issuer if they perform such policy-making functions for the issuer. Additionally, the proposal would require listed issuers to recover any excess incentive-based compensation received by an individual who served as an executive officer of the issuer at any time during the performance period for that incentive-based compensation.

Incentive-Based Compensation Subject to the Recovery Policy

Under the proposal, "incentive-based compensation" would be defined as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure." This definition would include options or equity awards whose grant or vesting is based wholly or in part on the attainment of any financial reporting measure. The proposed definition would also state

that "financial reporting measures" are 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.[1] When determining a restatement's effect on stock price and total shareholder return, issuers would be allowed to use reasonable estimates and would be required to disclose the estimates used. Incentive plan awards that are granted, earned or vested based solely on the occurrence of certain nonfinancial events, such as satisfaction of one or more strategic or operational measures, would not be considered "incentive-based compensation," because such measures of performance would not be financial reporting measures. Likewise, salaries, certain bonuses and other awards that are not contingent on satisfying financial reporting measures would not be "incentive-based compensation" for this purpose.

On the other hand, the following types of compensation would be subject to recovery:

- Nonequity incentive plan awards that are earned based wholly or in part on satisfying a financial reporting measure performance goal;
- Bonuses paid from a bonus pool, the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal;
- Restricted stock, restricted stock units, performance share units, stock options and stock appreciation rights that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal; and
- Proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal.

Time Period Covered by Recovery Policy

The recovery policy's three-year lookback period would be the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement. In instances in which an issuer has changed its fiscal year-end during the three-year lookback period, the issuer must recover any excess incentive-based compensation received during the transition period (i.e., the time between the closing date of the previous fiscal year-end and the opening date of the new fiscal year) occurring during, or immediately following, the three-year period in addition to any excess incentive-based compensation received during the three-year lookback period.

When Incentive-Based Compensation Is Deemed "Received"

Incentive-based compensation would be deemed received in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant of the compensation occurs after the end of such fiscal period. Thus, the exact date of receipt would be based on the terms of the award.

Incentive-based compensation would be subject to the recovery policy to the extent that it is received while the issuer has a class of securities listed on an exchange or national securities association. An incentive-based compensation award granted before the issuer has a class of securities listed on an

[1] Some examples of financial reporting measures would include revenues; net income; operating income; profitability of one or more reportable segments; financial ratios; net assets or net asset value per share; EBITDA; funds from operations; liquidity measures such as working capital or operating cash flow; return measures such as return on invested capital or return on assets; earning measures such as earnings per share, sales per square foot, same-store sales, revenue per user, cost per employee; any financial reporting measures relative to a peer group; and tax-basis income.

exchange would still be subject to the recovery policy if the compensation was received while the issuer had a class of listed securities.

Recovery Process

Determination of Excess Compensation

Under the recovery policy, the recoverable amount is the amount of incentive-based compensation received by the current or former executive officer in excess of the amount that otherwise would have been received had it been determined based on the accounting restatement. To determine the recoverable amount, after an accounting restatement, the issuer would recalculate the applicable financial reporting measure and the amount of incentive-based compensation based thereon. Based on the financial reporting measure as originally calculated and accounting for any discretion the compensation committee had applied to reduce the amount originally received, the issuer would then determine whether the executive officer received a greater amount of incentive-based compensation than would have been received using the recalculated financial reporting measure. For incentive-based compensation based only in part on achieving a certain financial reporting measure performance goal, the issuer would determine the portion of the original incentive-based compensation that was based on the financial reporting measure that was restated. The issuer would need to recover the difference between the larger amount erroneously received based on the original financial statements and the smaller amount that would have been received under the restatement. The recoverable amount would be calculated on a pretax basis.

If incentive-based compensation is based on stock price or total shareholder return, where the amount of erroneously awarded compensation is not subject to recalculation directly from the information in an accounting restatement, the recoverable amount may be determined based on a reasonable estimate of the accounting restatement's effect on the stock price or total shareholder return, as applicable. The issuer would be required to document the method used to determine the reasonable estimate and provide such documentation to the exchange or national securities association.

For awards paid from bonus pools, the size of the aggregate bonus pool from which bonuses are paid would be reduced based on the restated financial reporting measure. Recovery would be required only if the aggregate amount of individual bonuses paid was greater than the reduced bonus pool, in which case the excess amount of an individual bonus would be the pro rata portion of the deficiency. For equity awards, if the shares, options or SARs are still held by the executive officer 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 the equity awards have been exercised but the underlying shares have not been sold, the recoverable amount would be the number of shares underlying the excess options or SARs using the restated financial measure.If the equity awards have been exercised and the underlying shares have been sold, the recoverable amount would be the proceeds received with respect to the excess number of shares.

Board Discretion Regarding Whether to Seek Recovery

The proposal would require an issuer to recover erroneously awarded compensation in accordance with its recovery policy except to the extent that pursuing recovery would be impracticable because it would impose undue costs on the issuer or its shareholders or would violate home country law. The issuer would first have to make a reasonable attempt to recover the excess incentive-based compensation before concluding that it would be impracticable to recover based on the costs of enforcing recovery. The issuer would be required to document its recovery attempts, provide such documentation to the exchange and disclose why it chose not to pursue recovery. A foreign private issuer who concludes that recovery is impracticable because it would violate home country law must first obtain an opinion of home country counsel that recovery would result in a violation. Additionally, the relevant home country law must have been adopted prior to the date that proposed Rule 10D-1 is published in the Federal Register. A

determination that recovery would be impracticable must be made by the issuer's compensation committee of independent directors or, in the absence of a compensation committee, by a majority of independent directors on the board. Any such determination would be subject to review by the listing exchange.

The proposal does not allow issuers to settle for less than the full recovery amount unless full recovery is impracticable, in which case the same conditions would apply as those applicable to a determination to forgo recovery. Issuers may exercise discretion in determining the means of pursuing recovery, provided that recovery should be reasonably prompt.

Compliance with Recovery Policy

Failure to adopt and comply with a compensation recovery policy would subject an issuer to delisting. There is no specified timeline under the proposal by which the recovery process must be completed. An exchange would determine whether the steps taken by an issuer constitute compliance with its recovery policy. If an issuer has been delisted for failing to comply with its recovery policy, the issuer cannot be relisted on an exchange or listed by another exchange until it comes into compliance with the recovery policy.

Disclosure of Incentive-Based Compensation Policy

Proposed Rule 10D-1 would provide for listing standards to require listed issuers to disclose their recovery policies and to put their compensation recovery policies in writing and file the policies with the SEC. The disclosure regarding the issuer's recovery policy would also be required to be filed in accordance with the disclosure requirements of federal securities laws.

The proposal would amend Item 601(b) of Regulation S-K to require that a listed issuer file its recovery policy as an exhibit to its annual report on Form 10-K. The proposal would also amend Item 402 of Regulation S-K to create Item 402(w), which would require listed issuers to disclose how they have applied their recovery policies. Item 402(w) would apply if at any time during an issuer's last completed fiscal year either a restatement was completed that required recovery of excess incentive-based compensation under the issuer's recovery policy or there was an outstanding balance of incentive-based compensation from applying the recovery policy to a prior restatement. A listed issuer that complies with Item 402(w) disclosure requirements would not have to disclose any incentive-based compensation recovery under Item 404(a) of Regulation S-K. For registered management investment companies subject to proposed Rule 10D-1, information mirroring the Item 402(w) disclosure would be included in annual reports on Form N-CSR and in proxy statements and information statements relating to the election of directors. Disclosure under Item 402(w) would be required to be provided in interactive data format using XBRL block-text tagging, and interactive data would have to be provided as an exhibit to the definitive proxy or information statement filed with the SEC and as an exhibit to the annual report on Form 10-K.

The proposal would amend the Summary Compensation Table disclosure requirements under Item 402 to include a new instruction requiring that any amounts recovered pursuant to an issuer's recovery policy reduce the amount reported in the applicable column for the fiscal year in which the amount recovered was initially reported and that recovered amounts be identified by footnote. This requirement would apply to any filing requiring Summary Compensation Table disclosure that covers the affected fiscal year, including in registration statements under the Securities Act of 1933.

Foreign private issuers would be required to disclose the same information required by Item 402(w) in the annual reports they file on Form 20-F, Form 10-K and Form 40-F. Foreign private issuers would also be required to tag the disclosure in interactive data format.

Indemnification and Insurance

The SEC expressed its belief that any indemnification agreement that purports to reduce the issuer's obligation under Section 10D and the proposed rules and amendments would be unenforceable. The issuer may not indemnify an executive officer against the loss of erroneously awarded compensation. An executive officer may be able to purchase insurance to cover potential recovery obligations, but the issuer may not pay for or reimburse the executive officer for any such insurance policy premiums.

Transition Period

The proposal calls for each exchange to file its proposed listing rules within 90 days after the publication of the final adopted version of Rule 10D-1 in the Federal Register, and that the proposed listing rules be effective no later than one year after that publication date. Issuers would then have 60 days to adopt an appropriate recovery policy. The proposal also calls for each listed issuer to be required to recover erroneously awarded compensation 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. A listed issuer would be required to file the required disclosures on or after the effective date of the exchanges rules.

Conclusion

The proposing release seeks public comments on all facets of the proposed rules and amendments, including whether the proposal should apply generally to all listed issuers, which executive officers should be subject to the recovery policy, and the appropriate scope of discretion not to pursue recovery. The proposal includes a number of unusually prescriptive provisions, so depending on the tenor of public comments it is possible that any final rules could differ significantly from the proposal. Given the sequence of events necessary to proceed to final stock exchange listing requirements, it is not likely that any final rules would be effective for issuers before the latter half of 2016.

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