# SEC Proposes Broad Clawback Rules for Executive Compensation

On July 1, 2015, a divided Securities and Exchange Commission (the "SEC") proposed rules to implement the clawback provisions of Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] The proposal, if adopted, would require public companies to implement policies to broadly recover incentive-based compensation paid to current or former executive officers based on materially misstated financial statements. For this purpose, incentive-based compensation is defined as compensation that is granted, earned, or vested based wholly or in part on attainment of a financial reporting measure, including stock price and total shareholder return.[2]

The proposed rules would effectively expand the current Sarbanes-Oxley requirement[3] by, among other things, (i) requiring reimbursement from *any* executive officer of a listed issuer, not merely the chief executive officer and chief financial officer, (ii) requiring reimbursement of incentive-based compensation for *any* restatement resulting from material noncompliance with reporting requirements, regardless of whether there was misconduct by the company, (iii) requiring reimbursement of incentive-based compensation received by executive officers during the three years prior to the discovery of a need to file an accounting restatement, which is a different time period than required by Sarbanes-Oxley, and (iv) requiring listed companies to disclose and comply with specific policies for the recovery of executive compensation published in their annual reports.

## I. Companies Required to Adopt Mandatory Compensation Clawback Policies and Disclosures

The proposed rules would require national securities exchanges and associations to adopt listing standards requiring the filing of and compliance with a policy for receiving incentive-based compensation reimbursement from executive officers in the event of an accounting restatement. The listing standards also would require the disclosure of certain details of past and outstanding compensation reimbursements under an issuer's filed policy. These rules would apply to most issuers, including foreign private issuers, emerging growth companies,

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[1] *See Listing Standards for Recovery of Erroneously Awarded Compensation*, Release Nos. 33-9861; 34-75342; IC 31702; File No. S7-12-15 (July 1, 2015) ("Proposing Release"), available at http://www.sec.gov/rules/proposed/2015/33-9861.pdf. *See also* Chair Mary Jo White, *Statement at Open Meeting on Listing Standards for Clawing Back Erroneously Awarded Executive Compensation* (July 1, 2015), available at http://www.sec.gov/news/statement/listing-standards-for-clawing-back-erroneously-awarded-executive.html; Commissioner Luis A. Aguilar, *Making Executive Compensation More Accountable – To Keep It, It Should Be Earned* (July 1, 2015), available at http://www.sec.gov/news/statement/making-executive-compensation-more-accountable-.html; Commissioner Kara M. Stein, *Statement on Proposed Rule and Rule Amendments on Listing Standards for Recovery of Erroneously Awarded Compensation* (July 1, 2015), available at http://www.sec.gov/news/statement/statement-on-proposed-rule-and-rule-amendments-on-listing-standa.html; Commissioner Michael S. Piwowar, *Statement at Open Meeting on Clawbacks of Erroneously Awarded Compensation* (July 1, 2015), available at http://www.sec.gov/news/statement/statement-at-open-meeting-on-clawbacks-of-erroneously-awarded-co.html; Commissioner Daniel M. Gallagher, *Dissenting Statement at an Open Meeting to Propose Compensation Clawback Listing Standards* (July 1, 2015), available at http://www.sec.gov/news/statement/dissenting-statement-compensation-clawback-listing-standards.html.

[2] The proposed rules would not consider time-vested stock options that were not granted contingent on attainment of financial reporting measures as incentive-based compensation.

[3] Current regulations, enacted under Section 304 of the Sarbanes-Oxley of 2002, already provide that if an issuer is required to restate its financial statements as the result of misconduct by the issuer, then the issuer's chief executive officer and chief financial officer, regardless of individual fault, must reimburse the issuer for any incentive-based or equity-based compensation received in the 12-month period following the issuance of the inaccurate financial document to be restated. 15 U.S.C. §7243.

controlled companies, smaller reporting companies, and companies with only listed debt securities outstanding.[4] Failure to comply with the disclosure and implementation requirements would result in delisting until the company comes into compliance.

## II. Recovery Conditions and Determination

Companies subject to the proposed rules would be required to seek reimbursement from individuals who served as an executive officer at any time during the performance period for the incentive-based compensation in the event of accounting restatements due to material noncompliance with reporting requirements.[5] However, companies would not be required to seek reimbursement when costs of recovering the compensation would exceed the recovered amount or when home country foreign law adopted prior to publication of the proposed rule prohibits recovery, in either case as determined by independent members of the board of directors.

Restatements due to material noncompliance would trigger a three-year lookback for reimbursements from the date the restatement is first required. For purposes of the proposed rules, the date when the restatement is considered required would be the earlier of (i) the date that the board of directors, board committee, or officers authorized to take such action conclude that the issuer's prior financial statements contain a material error, and (ii) the date that a court, regulator or other legal authority directs the issuer to restate a financial statement due to a material error.

Within the three-year lookback period, any incentive-based compensation received by executive officers[6] that would have been less based on the restated financial statements, as opposed to the initial erroneous data, would be subject to recovery. This would include incentive-based compensation based directly on accounting metrics, such as revenues and net income, as well as compensation tied to performance measures that are affected by accounting information, such as stock price and total shareholder return.[7] Compensation would be considered received by the executive in the first fiscal period when the conditions for the award have been satisfied, such as when a particular financial performance target is first achieved, even if the actual payment occurs on a later date.

The reimbursement amount due to the issuer would be based on the excess of the initial incentive-based compensation received by a given executive over the compensation that would have been received by that executive based on the restated financial information, computed without regard to taxes paid. In the case of cash awards paid from bonus pools, the company would be required to seek the reimbursement on a pro rata basis from each executive based on the incentive-based compensation received by that particular executive and not "pool" or

[4] The following issuances would not subject their issuers to the proposed rule: (i) futures securities products and standardized options issued by a clearing agency, (ii) securities issued by a unit investment trust, and (iii) securities issued by management companies, provided the issuer has not awarded incentive-based compensation to any executive for at least three years.

[5] Changes to financial statements that are not due to an error, such as a retrospective application of a change in an accounting principle, retrospective adjustments for business combinations or discontinued operations, and retrospective revisions for stock splits, would not trigger a required reimbursement from executives.

[6] For the proposed rules, executive officers would be determined in manner modeled on Rule 16a-1(f) under the Securities Exchange Act of 1934, so-called "Section 16 officers," without regard to the executive officer's role in preparing the financial statements. *See* 17 CFR 240.16a-1(f).

[7] The proposed rules would not require reimbursement of bonuses paid solely at the discretion of the compensation committee or board, so long as those bonuses are not part of a bonus pool, the size of which is determined wholly or in part by the achievement of a financial performance target. Also, incentive-based compensation tied solely to non-financial measures, such as store openings, completion of a project, or consummation a merger, would not be subject to recovery under the proposed rules.

divide the reimbursement costs in any other manner. When incentive-based compensation is based on stock prices or other measures that cannot be directly recalculated in retrospect, the issuer would need to use, and publicly disclose, a reasonable estimate of the corrected compensation amount.

## III. Prohibition on Indemnity or Insurance Coverage by the Company

Any amount that is recovered under the proposed rules may not be repaid to the affected executive pursuant to an indemnity obligation. Similarly, companies would be prohibited from paying the premiums for any insurance policy for executives that would cover the reimbursements required by the proposed rules.[8]

## IV. Timing of the Proposed Rules

Before any action is required from issuers, the proposed rules need to be finalized, and there will be a 60-day comment period beginning once the proposal is published in the Federal Register. Then, under the current proposal if adopted, the exchanges would be required to file their proposed listing standards within 90 days, which standards must become effective within one year. Once the new listing standards are effective, companies would have 60 days to adopt a policy in compliance with such listing standards. However, companies would be required to comply with the new policy for any incentive-based compensation distributed after the effective date of the final rules, as opposed to the date the company implements its new policy.

If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Bradley J. Bondi at 212.701.3710 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com; or Chase Dalton at 212.701.3732 or cdalton@cahill.com.

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[8] The proposed rules would not prohibit an executive from independently purchasing third-party insurance against the loss of erroneously awarded compensation.