COVINGTON

SEC Proposes Rules on Clawback Policies

July 6, 2015

Securities

On July 1, 2015, the U.S. Securities and Exchange Commission (SEC) proposed a long-awaited rule, which will require companies with stock exchange listed securities to adopt so-called "clawback" policies to recover incentive-based compensation following certain accounting restatements. The rule requires national securities exchanges to implement listing standards requiring their listed companies to adopt these policies.[1]

Background

Since 2002, the SEC has had authority, under Section 304 of the Sarbanes-Oxley Act of 2002 ("Sarbanes Oxley Act"), to require chief executive officers and chief financial officers of public companies to reimburse their company for certain bonus and incentive-based compensation when the company is required to restate its financial statements due to material noncompliance, as a result of misconduct, with financial reporting requirements. The SEC has used its authority under Section 304 of the Sarbanes-Oxley Act sparingly, and there is no private right of action under Section 304. Perhaps in response to the limitations of Section 304, Congress wrote Section 954 of the Dodd-Frank Act more broadly, and the proposed rules reflect this broader reach. Against the backdrop of these two statutory provisions, a growing number of public companies have implemented some form of clawback policy.[2]

Highlights of the Proposed Rules

Proposed new Rule 10D-1 under the Securities Exchange Act of 1934 ("Exchange Act") would require national securities exchanges to implement listing standards requiring listed companies to adopt a clawback policy meeting specified criteria. A company's clawback policy would need to provide that the company will recover incentive-based compensation from current and former executive officers who received such incentive-based compensation during the three fiscal years preceding the date on which the company is required to prepare an accounting

[1] The proposed rule would implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

[2] The SEC's proposing release estimates that approximately 23 percent of all SEC filers have disclosed some form of executive compensation recovery policy, although the percentages are substantially lower in the case of smaller reporting companies, emerging growth companies and foreign private issuers. A 2013 study reported that between 2006 and 2013 the number of Fortune 100 companies with publicly-disclosed clawback policies grew from 17.6 percent to 89.4 percent. *See* Equilar Clawback Policy Report (2013). Many of these policies will need to be updated to comply with the clawback policy listing standards, once they are finally approved.

restatement to correct a material error. The compensation that must be recovered is the amount in excess of what would have been paid based on the restated results.[3]

Under the proposed rule, recovery would be required on a "no fault" basis, that is, without regard to whether any misconduct occurred (by anyone) and without regard to an executive officer's responsibility for the erroneous financial statements.[4] Thus, a restatement triggered by an individual employee's incorrect application of generally accepted accounting principles could potentially require the claw back of incentive-based compensation paid to all of the company's executive officers, including those with no responsibility for the preparation of financial statements.[5]

The SEC also proposed new disclosure requirements, including a requirement annually to file the company's clawback policy with the SEC and to make new disclosures regarding actions taken by the company to recover compensation pursuant to such policy.

Companies Covered

As proposed, the new clawback policy requirement would generally apply to all listed companies, with limited exceptions such as for registered investment companies that do not provide incentive-based compensation to their employees. Thus, the new requirement would apply to foreign private issuers, controlled companies, smaller reporting companies, emerging growth companies and companies with only preferred or debt securities listed.

Key Definitions

Incentive-based compensation means any compensation that is granted, earned or vested based wholly or in part on the attainment of any financial reporting measure. The words "in part" mean that incentive-based compensation includes awards based in part on the attainment of a financial reporting measure and in part on the attainment of some other metric, such as an operational target. The definition is also intended to include awards for which the amount earned is initially determined based on attainment of a financial reporting measure but is subject to subsequent discretion by the compensation committee to either increase or decrease the amount.

---

[3] Section 954 of the Dodd-Frank Act also requires that there be "material noncompliance of the issuer with any financial reporting requirement under the securities laws" in order to trigger recovery. Proposed Rule 10D-1 essentially interprets this element of the statutory test to mean that any error that is material to previously issued financial statements constitutes such "material noncompliance" by the issuer.

[4] In this sense, the proposed rule is consistent with the SEC's (and courts') interpretation of Section 304 of the Sarbanes-Oxley Act. Although that section requires that the restatement be a result of "misconduct," this has been interpreted not to require personal misconduct by the officer against whom recovery of compensation is sought. *See*, *e.g.*, In the Matter of William Slater, CPA and Peter E. Williams, III (Admin. Proceeding File No. 3-16381 (Feb. 10, 2015); SEC v. Jenkins, 718 F. Supp.2d 1070 (D. Ariz. 2010).

[5] Further, the proposed rules would prohibit companies from indemnifying current or former executive officers against the loss of erroneously paid compensation.

Financial reporting measure is defined to mean (i) measures that are based on the accounting principles used in preparing the company's financial statements, (ii) any measures derived wholly or in part from such financial information, and (iii) stock price and total shareholder return. The proposing release states that the second prong of this definition is intended to include, but is not limited to, non-GAAP financial measures such as EBITDA, free cash flow, and the like.

Executive officer. Although Section 954 of the Dodd-Frank Act does not define the term "executive officer," proposed Rule 10D-1 defines the term using the definition of "officer" in Rule 16a-1(f) under the Exchange Act.[6] Thus, those officers who are designated as "Section 16 officers" would be the same group of officers subject to the clawback policy. Compensation would be subject to recovery if it was received by an individual who served as an executive officer at any time during the performance period for that compensation (with receipt deemed to occur in the fiscal period during which the relevant financial reporting measure is attained).

Restatement Determination

Under proposed Rule 10D-1, a company's clawback policy would apply to any incentive-based compensation received during the three completed fiscal years immediately preceding the date that the company is *required to prepare* a restatement of its previously-issued financial statements to correct a material error. Under the proposed rule, the date a company is required to prepare a restatement is the earlier of (i) the date the company's board, a board committee or authorized officers concludes, or reasonably should have concluded, that the company's previously issued financial statements contain a material error; or (ii) the date a court, regulator or other body directs the company to restate its previously issued financial statements to correct a material error. The proposed rule includes an instruction stating that the date in clause (i) generally is expected to coincide with the event that would trigger a report under item 4.02(a) of Form 8-K, but that the dates specified in the proposed rule are not predicated on if or when a Form 8-K is filed.[7] Further, the proposed rule clarifies that a company's obligation to recover erroneously paid compensation is not dependent on if or when the restated financial statements are filed.

Proposed Rule 10D-1 would define an accounting restatement 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.[8] Thus, the proposed rule would *not* appear to

---

[6] This definition includes the company's president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division or function, and any other person who performs policy-making functions for the company.

[7] A Form 8-K under item 4.02(a) is required when a company's board, board committee or authorized officers concludes that any previously issued financial statements should no longer be relied upon because of an error in such financial statements.

[8] The proposing release identifies a number of other types of changes to previously filed financial statements that do not represent error corrections, and therefore would not trigger application of a clawback policy under the proposed rule, including: (i) retrospective application of a change in accounting principle; (ii) retrospective revision to reportable segment information due to a change in the structure of the company's internal organization; (iii) retrospective

require the recovery of compensation in the case of a so-called "revision" restatement, i.e., where a company corrects immaterial errors in previously-issued financial statements by correcting the financial statements for prior periods in a current period report, without reissuing the historical financial statements.[9] However, the proposing release cautions that companies should consider whether a series of immaterial error corrections, whether or not they resulted in filing amendments to previously filed financial statements, could be considered a material error when viewed in the aggregate.

Calculating the Recovery Amount

Under proposed Rule 10D-1, the amount to be recovered would be the amount of incentive-based compensation received by an executive officer that exceeds the amount the executive officer would have received had the incentive-based compensation been determined based on the restated results. Recovery amounts are to be calculated excluding any taxes paid by the executive.

In the case of incentive-based awards that are based on stock price or total shareholder return, proposed Rule 10D-1 would permit companies to use a "reasonable estimate" of the effect of the restatement on the applicable measure to determine the amount to be recovered. The SEC proposes to permit this flexibility because, it says, these types of awards are not subject to mathematical recalculation from the information contained in a restatement.[10] Companies would be required to maintain documentation evidencing their method of reasonable estimation, and they would be required to provide such documentation to the exchange.

While the calculation of the amount to be recovered should be straightforward in some cases, such as a cash-based incentive award based solely on the achievement of one or more financial reporting measures, it will be less obvious in other situations. The SEC's proposing release

---

reclassification due to a discontinued operation; (iv) retrospective application of a change in reporting entity, such as from a reorganization of entities under common control; (v) retrospective adjustment to provisional amounts in connection with a prior business combination; and (vi) retrospective revision for stock splits.

[9] In recent years, the number of "revision" restatements has increased as compared to reissuance restatements. A 2014 report by Audit Analytics found that approximately 69 percent of all restatements in 2013 were "revision" restatements. *See Audit Analytics, 2013 Financial Restatements: A Thirteen Year Comparison*, 1 (Apr. 2014). Although the proposed rule would not appear to require the recovery of compensation in the case of a "revision" restatement, companies could, if desired, design their clawback policies to require recovery in such event.

[10] The proposing release notes that there may be a number of potential methods, with different levels of complexity, to determine the amount of compensation to be recovered in respect of these awards. The SEC acknowledges that companies may need to engage in complex analyses that require significant technical expertise and specialized knowledge to determine the stock price impact of a material restatement, and that it may be difficult to establish the relationship between an accounting error and the stock price.

includes fairly detailed guidance on how the recovery amount should be calculated under a company's clawback policy in a number of specific scenarios, including the ones noted below:[11]

- Where the award is based on both the achievement of a financial reporting measure and the application of discretion by the compensation committee, the amount originally determined based on the financial measure should be re-calculated using the restated results, and the amount to be recovered should then take into account any discretion applied by the compensation committee to reduce or increase the amount of the award.
- For bonus pools, after re-calculating the aggregate pool amount that would have been determined under the restated results, the recovery should be pursued on a pro rata basis from all pool participants, even where individual awards may have originally been determined based on the compensation committee's discretion.
- For incentive-based awards in the form of shares, options or SARs, the proposing release includes separate guidance for situations where shares or unexercised options or SARs are still held by the executive officer at the time of recovery, where options or SARs have been exercised, and where shares received upon exercise have already been sold by the executive at the time of recovery.

Limited Discretion to Decline to Seek Recovery

In crafting the proposed rules, the SEC took note of the language in Section 954 that a clawback policy must provide that the issuer "will recover" erroneously paid compensation. As a result, proposed Rule 10D-1 provides that a company *must* recover erroneously paid compensation in compliance with its clawback policy, except to the extent it would be impracticable to do so. However, the proposed rule states that recovery would be impracticable in only two narrow circumstances: (i) where the *direct* expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered, and (ii) where recovery would violate home country law.

- Where impracticality is based on expense, the company would be required first to make a reasonable attempt to recover the compensation, and to document such attempts and provide such documentation to the exchange.
- Where impracticality is based on a violation of home country law, the company would be required to obtain an opinion of home country counsel and provide such opinion to the exchange, and the home country law must have been adopted prior to the publication date of proposed Rule 10D-1.

In either case, the company's independent directors responsible for executive compensation decisions would be required to make any determination that recovery would be impracticable. It is worth noting that the proposed rule would not permit a listed company's board of directors to

[11] The proposing release requests comment on whether the proposed rule articulates an appropriate standard for calculating the recovery amount, as well as whether the rule itself should include specific instructions for how to compute the recovery amount of specific forms of incentive-based compensation.

decline to seek recovery of compensation based on the board's determination that to do so would be inconsistent with its fiduciary duties under applicable law.[12]

The enforcement of clawback policies, especially against former officers, will likely raise a variety of practical issues involving, for example, questions of contract law and the adequacy of consideration. It is helpful, therefore, that the proposing release expresses the SEC's belief that companies should be able to exercise discretion in *how* to accomplish recovery of erroneously paid compensation (e.g., recovering compensation over time or from future pay, through forfeiture of unvested awards, or by offsetting against amounts otherwise payable to the officer).

Proposed New Disclosure Requirements

Under the proposed rules, all listed companies would be required to file a copy of their clawback policy as an exhibit to their annual report filed under the Exchange Act.

In addition, proposed new Item 402(w) of Regulation S-K would apply if, during its last completed fiscal year, the company either prepared a restatement that required recovery of excess incentive-based compensation pursuant to its clawback policy, or there was an outstanding balance of excess incentive-based compensation relating to a prior restatement.[13] In these circumstances, the company would be required to disclose:

- the date on which it was required to prepare each accounting restatement, the aggregate dollar amount of excess incentive-based compensation attributable to the restatement and the aggregate dollar amount that remained outstanding at the end of its last completed fiscal year;
- the estimates used to determine the excess incentive-based compensation attributable to such restatement, if the incentive payment related to a stock price or total shareholder return metric;
- the name of each person subject to recovery from whom the company decided not to pursue recovery, the amounts due from each such person, and a brief description of the reason the company decided not to pursue recovery; and
- if amounts of excess incentive-based compensation are outstanding for more than 180 days, the name of, and amount due from, each person at the end of the company's last completed fiscal year.[14]

Listed companies would be required to block tag the disclosures described in the bullet points above in an interactive data format using eXtensible Business Reporting Language (XBRL).

---

[12] The proposing release requests comment on a number of questions regarding the limited discretion of the board of directors to decline to pursue recovery.

[13] The proposed rules would add corresponding requirements to Forms 20-F and 40-F.

[14] For issuers other than foreign private issuers, this disclosure would be required only in proxy or information statements that call for disclosure under item 402 of Regulation S-K and annual reports on Form 10-K. Foreign private issuers would include this disclosure in annual reports on Form 20-F or 40-F.

Comparison with Clawback Authority under Sarbanes Oxley

The scope of the clawback policy that would be required to be adopted by listed companies under proposed Rule 10D-1 is broader than the scope of the SEC's recovery authority under Section 304 of the Sarbanes-Oxley Act, in several respects. For example:

- Section 304 of the Sarbanes-Oxley Act does not require public companies to take any action to recover compensation, whereas proposed Rule 10D-1 would make listed companies responsible for pursuing recovery of erroneously paid compensation.
- Section 304 of the Sarbanes-Oxley Act may only be used to recover compensation from a company's chief executive officer or chief financial officer, whereas the clawback provision contemplated by proposed Rule 10D-1 would call for recovery from *any* current or former executive officer.
- The Sarbanes Oxley Act clawback authority is limited to compensation paid in the year following the issuance of the misstated financial statements, whereas proposed Rule 10D-1 calls for recovery of compensation paid in the three years prior to the date the company became required to restate the financials.
- Finally, the clawback provisions of the Sarbanes-Oxley Act only permit the recovery of compensation in circumstances where there has been "misconduct," which is not required under proposed Rule 10D-1.

Implementation Timeline

The comment period for the proposed rules will run for 60 days after publication in the *Federal Register*. If the SEC adopts the proposed rules, the national securities exchanges would then need to propose new listing standards implementing the clawback policy requirement within 90 days of the publication of the adopted version of Rule 10D-1 in the *Federal Register*. Those proposed new listing standards would be subject to public comment, and would be required to become effective within a year of the publication of the adopted version of Rule 10D-1 in the *Federal Register*. Given this dual-track nature of the process, it may be some time, possibly as long as the 2017 proxy season, before new listing standards requiring clawback policies are in effect.

Under the proposed rules, listed companies would be required to adopt clawback policies meeting the requirements of Rule 10D-1 within 60 days of the date on which the listing exchange's listing standards become effective. The proposed rules also contemplate that listed companies would be required to recover all excess incentive-based compensation received by current and former executive officers on or after the effective date of Rule 10D-1 that results from attaining a financial reporting measure based on financial information for any fiscal period ending on or after the effective date of Rule 10D-1.

Listed companies would be required to comply with the new disclosure requirements in proxy or information statements and Exchange Act annual reports filed on or after the effective date of the new listing standards.

****

If you have any questions concerning the material discussed in this advisory, please contact the following members of our Securities and Capital Markets practice group:

David Engvall	+1 202 662 5307	dengvall@cov.com
Matt Franker	+1 202 662 5895	mfranker@cov.com
Keir Gumbs	+1 202 662 5500	kgumbs@cov.com
Reid Hooper	+1 202 662 5984	rhooper@cov.com
David Martin	+1 202 662 5128	dmartin@cov.com

This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

Covington & Burling LLP, an international law firm, provides corporate, litigation and regulatory expertise to enable clients to achieve their goals. This communication is intended to bring relevant developments to our clients and other interested colleagues. Please send an email to unsubscribe@cov.com if you do not wish to receive future emails or electronic alerts.