Understanding The SEC's Compensation Clawback Proposal

Law360, New York (July 27, 2015, 5:46 PM ET) -- On July 1, 2015, the U.S. Securities and Exchange Commission proposed rules that would direct the stock exchanges to adopt listing standards requiring listed companies to develop and implement incentive-based compensation recovery (clawback) policies. The SEC also proposed related disclosure requirements. The proposed rules would implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is the last remaining executive compensation provision for which rules had not yet been proposed or finalized (following upon proposed rules with respect to pay ratio, pay-for-performance and hedging policies). Interestingly, although Dodd-Frank was enacted in response to the financial crisis, the proposed clawback rule would not have applied to any of the most notorious bailout recipients, as none were required to restate their financials.

Alessandra K. Murata

New Listing Standards

All listed companies (including foreign private issuers, controlled companies, smaller reporting companies and emerging growth companies, but excluding certain registered investment companies) would be required to adopt a clawback policy that requires the company to recover incentive-based compensation "received" by any current or former executive officer during the three-year period preceding the year in which the company is required to prepare an accounting restatement resulting from material noncompliance with financial reporting requirements, regardless of whether the noncompliance is the result of misconduct. Under the proposed rules, a company would be subject to delisting if it does not adopt a clawback policy that complies with the applicable listing standard, disclose the policy in accordance with SEC rules or comply with the policy's recovery provisions.

Broad Definition of "Executive Officer"

The proposed rule models its definition of "executive officer" after the definition applicable under Section 16 of the Securities Exchange Act of 1934, which includes the issuer'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 similar policymaking functions. Accordingly, issuers should carefully consider whom they classify as an executive officer, particularly for individuals who serve in positions other than those specifically enumerated in the proposed rule. For example, general counsels are sometimes treated as executive officers and other times not, depending on their specific duties and responsibilities.

To the extent classified as an executive officer, an issuer's general counsel will be subject to potential clawback under the proposed rules. The rule would apply to all incentive awards granted to these executive officers, including awards granted at a time when the individual was not serving as an executive officer, so long as the executive officer served as such during any portion of the relevant performance period.

Incentive-Based Compensation

Compensation that is granted, earned or vested based in whole or in part on the attainment of any financial reporting measure, including accounting-related metrics, stock price and total shareholder return, is considered "incentive-based compensation" subject to clawback under the proposed rule. Notably, incentive compensation does not include awards based solely on continued employment for a specified period of time (e.g., time-vesting awards, including time-vesting stock options). Incentive-based compensation also does not include base salary, compensation awarded solely at the board's discretion or compensation awarded upon the achievement of subjective, strategic or operational measures.

In its current form, the proposed rule may encourage issuers to avoid or minimize application of the rules by increasing their use of time-based awards, awards earned upon achievement of nonfinancial measures and higher base salaries, and reducing their reliance on awards based on financial metrics, stock price and total shareholder return — metrics that are generally thought to more closely align executive compensation with stockholder interests.

Incentive Compensation Required to Be Recovered

Incentive compensation must be subject to clawback if it is "received" during any of the three fiscal years completed before the date on which the issuer was required to prepare a financial restatement. Incentive compensation is deemed "received" during the fiscal period in which the applicable performance metric is attained, not the date on which the award is granted, vested or paid. An award subject to both time-based and performance-based vesting conditions is considered received upon satisfaction of the performance metric even if the award continues to be subject to time-based vesting criteria. Where clawback is required, the amount of compensation required to be recovered equals the excess of:

- the amount of incentive-based compensation actually paid during the fiscal period when the applicable financial reporting measure is attained, over

- the amount of incentive-based compensation that would have been paid had the financial statements been correct in the first instance.

To the extent the performance metric was based on stock price or total shareholder return, issuers would be permitted to use (and would be required to disclose) a reasonable estimate of the restatement's impact on the stock price or total shareholder return. The amount of incentive compensation subject to recovery also would include any 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 performance metric.

Exceptions for Recovery

The new listing standards would provide two narrow exceptions to recovery, where the compensation committee determines that (1) pursuing such recovery would be impracticable because the direct expense of seeking recovery would exceed the recoverable amounts, or (2) in the case of a foreign private issuer, pursuing such recovery would violate applicable home country law. The exception applicable to clawbacks that would violate home country law applies only to laws in effect prior to July 14, 2015 (the publication date of the proposed rules in the Federal Register), potentially putting companies in the position of having to decide between complying with the listing standards by clawing back compensation in accordance with the rule or complying with a foreign law adopted after publication of the proposed rules that make such clawbacks illegal.

Similarly, it appears that the "home country law" exception applies only to the law of the issuer's home country, not the law of another country that might prohibit clawbacks with respect to executive officers located in that country. This presents the possibility that a company could be forced to claw back compensation from an executive officer, even if doing so violates the laws of the executive officer's country of residence, so long as the clawback does not violate applicable law in the issuer's home country.

Prohibition on Indemnification and Insurance

Listed companies would be prohibited from indemnifying or reimbursing any current or former executive officer against the loss of erroneously awarded compensation. Companies also would be prohibited from paying the premiums on an insurance policy that would cover an executive's potential clawback obligations.

New Disclosure Requirements

The proposed rules include new disclosure requirements on how the clawback policy is implemented, including a requirement to describe:

- recovery of excess incentive-based compensation due to a restatement during the last completed fiscal year;
- any outstanding balance of excess incentive-based compensation from a prior restatement; and
- any instances during the last completed fiscal year where recoverable compensation was not repaid within 180 days or the company did not pursue recoverable compensation.

Such disclosure would be required as a new component of the executive compensation disclosure provisions in Item 402 of Regulation S-K.

XBRL

The new disclosure would have to be tagged in interactive block text tag format using eXtensible Business Reporting Language (XBRL). Similar to the SEC's proposed pay-for-performance rules, if adopted, this would be the second requirement of XBRL tagging outside the financial statements.

New Exhibit Filing

The proposed rules would require the clawback policy to be filed as an exhibit to the annual report on Form 10-K or 20-F.

Effect on Existing Clawback Rules

The Dodd-Frank provisions expand upon, but do not replace, the clawback provisions enacted as part of the Sarbanes-Oxley Act of 2002, which provide that, if a company is required to prepare an accounting restatement because of “misconduct,” the CEO and chief financial officer (but no other individuals) are required to reimburse the company for any incentive- or equity-based compensation and profits from selling company securities received during the year following issuance of the inaccurate financial statements. If a company’s CEO and CFO are required to reimburse an issuer pursuant to Section 304 of SOX, any amounts recovered would be credited against any amounts owed under the proposed rule.

When the Proposed Rules Take Effect

Companies would be required to comply with the rule only after the stock exchanges adopt their new listing standards, which is to occur no later than one year after the final SEC rule is published in the Federal Register. Accordingly, it seems unlikely that the new clawback listing standards will be effective before late 2016. Companies will be required to adopt a clawback policy no later than 60 days after effectiveness of the new listing standards and comply with the disclosure requirements in their first annual report or proxy or information statement required to be filed after the effective date of the new listing standards. The clawback policy will apply to incentive-based compensation that is granted, earned or vested based on financial measures that relate to any fiscal period ending on or after effectiveness of the final SEC rule. Accordingly, if the SEC publishes its final rule in December 2015 and the exchanges adopt new listing standards in 2016, incentive compensation based on 2015 fiscal performance metrics would be subject to clawback.

What Companies Should Do Now

Listed companies that would be subject to the new requirements should consider the following actions:

- Review existing clawback policies to consider what changes likely will be required;
- Consider which aspects of their compensation plan design should be reviewed and possibly changed in light of the clawback mandate;
- Review their executive officer determinations in light of the new significance of this designation; and
- Consider submitting a comment letter to the SEC to influence the final design of these crucial rules.

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Comments on the proposed rules are due on or before Sept. 14, 2015, and comments may be submitted on the SEC’s website.

—By Alessandra K. Murata and Neil M. Leff, Skadden Arps Slate Meagher & Flom LLP

Alessandra Murata is a counsel in Skadden's Palo Alto, California, office. Neil Leff is a partner in the firm's New York office.

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