SEC Proposes Dodd-Frank Clawback Rule

July 8, 2015

On July 1, 2015, in a 3-2 vote, the SEC proposed a rule implementing Section 954 of the Dodd-Frank Act, which requires listed companies to implement clawback policies to recover incentive-based compensation received by current or former executive officers in the event of certain financial restatements.[1]

Specifically, the proposed rule directs the stock exchanges to adopt listing standards that would require all listed issuers (including foreign private issuers, emerging growth companies, controlled companies and companies with only listed debt securities) to adopt and comply with a written clawback policy to recover any excess incentive-based compensation erroneously paid to any current or former executive officer because of material non-compliance with financial reporting requirements that resulted in a financial restatement.

In addition, the SEC is proposing to revise its disclosure rules to require that each listed company:

- file a copy of its written clawback policy as an exhibit to the issuer's annual report; and
- in the event of a restatement, disclose how much incentive-based compensation was subject to recovery, how much has remained outstanding for 180 days or longer, and, if the issuer decides not to recover excess compensation as permitted in limited cases, the names of the executive officers from whom the issuer did not seek recovery and the reasons for this decision.

Background and the Proposed Rule

Section 954 of the Dodd-Frank Act added Section 10D to the Securities Exchange Act of 1934 (the "**Exchange Act**"), which directs the national securities exchanges to adopt a listing rule for issuers providing:

> "(i) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
>
> (ii) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement."

The SEC's proposed rule implementing Section 954, Rule 10D-1, is fairly prescriptive and goes beyond a number of the requirements mandated by the statute. Notably, the proposed rule:

- applies to all listed issuers, including foreign private issuers, emerging growth companies, controlled companies and issuers of debt and other non-equity securities, with limited exceptions;
- includes all Section 16 officers in the definition of executive officer;

[1] The full text of the release is available here; the SEC's fact sheet is available here; and the Commissioners' statements are available here: Chair White, Commissioner Aguilar, Commissioner Gallagher, Commissioner Piwowar, Commissioner Stein.

- requires the issuer to recover incentive-based compensation for all executive officers on a no-fault basis;
- includes compensation based on any financial reporting measure used in the issuer's financial statements, including non-GAAP measures;
- includes compensation based on stock price and total shareholder return as incentive-based compensation and requires the issuer to estimate the effect of the financial restatement on these measures;
- requires the issuer to enforce the recovery policies without providing discretion to the issuer or its board of directors to forgo, reduce, settle or make alternative arrangements for recovery, with limited exceptions;
- prohibits the issuer from indemnifying or repaying the executive officer the amount subject to recovery; and
- requires disclosure of specified information regarding completed, ongoing and forgone recoveries, including executive officer names and specified amounts.

Coverage and Effectiveness of the Proposed Rule

Q: Which issuers are covered by the proposed rule?
A: Every company that is listed on a national securities exchange is covered by the proposed rule, with limited exceptions.

Any issuer that has securities listed on a national securities exchange that is registered under Section 6 of the Exchange Act must comply with Rule 10D-1. This includes:

- foreign private issuers;
- emerging growth companies;
- smaller reporting companies;
- controlled companies; and
- issuers of debt and other non-equity securities.

The proposed rule would exclude from coverage:

- registered investment companies, but only to the extent that such companies have not granted incentive-based compensation to any executive officer in any of the last three fiscal years (or since the initial listing if the company has been listed for fewer than three years);
- unit investment trusts; and
- clearing agencies that issue only "securities futures products" and/or standardized options.

In the proposed rule, the SEC noted that it decided not to use its authority to exempt additional specific categories of issuers.

Q: When will issuers need to comply with the clawback rule?
A: Issuers will need to comply with the rule following the effectiveness of the listing standards issued by the national securities exchanges. These listing standards will be required to be issued within 90 days after the final SEC rule is published in the Federal Register and must become effective within one year after the final SEC rule is published in the Federal Register.

Once the listing standards are effective, issuers will have 60 days to adopt the recovery policy mandated by Rule 10D-1 and must provide the disclosures required under the rule in relevant SEC filings made after the effective date. The recovery policy adopted by issuers must apply to all incentive-based compensation that is based on the attainment of financial reporting measures that relate to any fiscal period ending after the effective date of the SEC's final Rule 10D-1.

Example. If the SEC's Rule 10D-1 is finalized on November 30, 2015 and the listing standards are finalized and become effective on March 1, 2016, then issuers would be required to adopt the mandated recovery policy by no later than April 30, 2016. Additionally, a bonus based on performance for the year ending December 31, 2015 would be recoverable in the event of a restatement, as the SEC's Rule 10D-1 had been finalized prior to the end of the bonus' performance period.

Q: Which financial changes will trigger a recovery of incentive-based compensation?
A: An issuer is required to recover incentive compensation if the issuer is required to issue a financial restatement in order to correct a material error.

The SEC does not define what constitutes a "material error." However, the SEC made clear that not every financial restatement will trigger the recovery of incentive-based compensation. The following are examples listed in the proposed rule of instances in which a financial restatement has been issued and an issuer would not be required to recover incentive-based compensation:

- retrospective application of a change in accounting principles;
- retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization;
- retrospective reclassification due to a discontinued operation;
- retrospective application of a change in reporting entity, such as from a reorganization of entities under common control;
- retrospective adjustment to provisional amounts in connection with a prior business combination; and
- retrospective revision for stock splits.

Recovery Policy Details and Mechanics

Q: Which officers are subject to the rule?
A: All of an issuer's current or former executive officers who served as executive officers at any time during the relevant performance period for the incentive compensation.

The definition of "executive officer" is modeled after the definition of "officer" under Section 16 of the Exchange Act and includes the issuer's president, principal financial officer, principal accounting officer or controller, any vice president of the issuer in charge of a business unit, division or function, and any other officer or person who performs a significant policy-making function for the issuer. All of these executive officers are subject to the recovery policy, even absent any misconduct and regardless of their role in the financial restatement.

An individual's incentive-based compensation is subject to recovery if the individual served as an executive officer of the issuer at any time during the performance period applicable to that incentive-based compensation award. This would include awards granted prior to the hiring of the individual (*e.g.*, incentive awards and new hire grants) so long as the individual officer serves as an executive officer at some point during the performance period applicable to the award.

Example. An employee of an issuer serves as the vice president of an important business unit on an interim basis for three months in May, June and July of 2017. However, the employee returns to his position as a non-executive officer shortly thereafter. A portion of the employee's compensation is awarded in the form of a long-term incentive award with a performance period from January 1, 2016 through December 31, 2018. In May 2019, the company is required to issue a financial restatement for its 2018 financial statements. As a result of the restatement, the company is required to recover excess incentive-based compensation from its executive officers, including under long-term incentive awards in respect of the performance period ending December 2018. Despite the fact that the employee was not an executive officer at the time that the financials were restated, nor at the time that the long-term incentive award was granted, the employee's long-term incentive award would be subject to recovery because he was an executive officer at some point during the award's performance period.

Q: What time period is covered by the recovery policy in the event of a financial restatement?
A: Incentive-based compensation must be subject to recovery 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.

The date on which an issuer is required to prepare an applicable financial restatement under the proposed rule is the earlier of:

- the date that the issuer's board of directors or a similarly authorized decision-making body concludes, *or reasonably should have concluded*, that the issuer's previously issued financial statements contain a *material error*; or
- the date on which a court, regulator or other similarly authorized body causes the issuer to restate its financial information.

The first standard is expected to generally coincide with part of an issuer's Form 8-K obligation of non-reliance upon previously issued financial statements.

The SEC explicitly rejected using the filing date of the erroneous financial statement as the starting point for the look-back period, which seemed to provide the clearest trigger, out of concern that the recovery would then not apply to any incentive compensation received after that date, despite the fact that the amount of such compensation was affected by the error. The SEC also declined to use the filing date of the restatement, since that would be later than the time that the issuer is "required to prepare" it and also because of concern that issuers would game the timing of the restatement filing to avoid recovery.

Incentive-based compensation is deemed to have been "received" not when it is granted, vested or paid, but rather during the fiscal period when the performance measure that must be achieved based on the terms of the award is attained. An award that is subject to both a financial performance measure and a service vesting condition is considered received when the performance measure is satisfied, even if the award continues to be subject to service vesting conditions. Applying this standard to multiyear performance awards may prove difficult, since it may not be clear when during the performance period the various performance metrics are attained.

Example. An issuer's executive officers earn annual bonuses based on the issuer's performance each year, which are paid in June of the following year. The issuer is required to prepare a financial restatement on May 15, 2019. Bonuses to executive officers for 2016, 2017 and 2018 would all be subject to recovery, including the 2018 bonus, even though the 2018 bonus would be paid after the financial restatement in May 2019 (although there may be no excess 2018 bonus to actually recover, assuming the 2018 bonus has been calculated based on corrected information). Bonuses paid in June 2016 for the 2015 fiscal year would not be subject to recovery.

Q: Which types of incentive-based compensation *are* subject to the recovery policy?
A: Incentive-based compensation is covered if it is based on the achievement of a financial reporting measure, stock price or total shareholder return.

The definition of incentive-based compensation includes any compensation, including cash and equity, that is granted, earned or vested based wholly or in part upon the achievement of a "financial reporting measure," which includes any measure that is determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements (and any measures that are derived wholly or in part from such measures), as well as stock price and total shareholder return.

The measure need not be included in any SEC filing and may be presented outside the financial statements, such as in MD&A. Examples provided include not only the more obvious measures such as revenues and net or operating income, but also financial ratios, EBITDA and liquidity and return measures. Measures such as cost per employee, sales per square foot or revenue per measure are also considered financial measures, as well as any measure determined relative to a peer group.

The inclusion of compensation based on stock price and total shareholder return will likely be particularly challenging to implement, since, as is described further below, an issuer will be required to estimate the impact on its stock price of the erroneous financial reporting to calculate the recovery amounts. However, the SEC expressed concerns that excluding stock price and total shareholder return from covered incentive-based compensation would exclude an increasingly prevalent component of incentive-based compensation and could even encourage companies to avoid application of the recovery policy by further increasing their use of market-based performance measures.

Q: Which types of compensation are *not* subject to the recovery policy?
A: Amounts paid to an executive officer that are not granted, vested or earned based on the attainment of a financial measure would not be subject to recovery.

Incentive-based compensation does not include base annual salary, compensation that is awarded based purely on service to the issuer (*e.g.*, a time-vesting award, including a time-vesting stock option) or compensation that is awarded solely at the discretion of the board, nor does it include compensation that is awarded based on subjective standards, strategic measures (*e.g.*, completion of a merger) or operational measures (*e.g.*, attainment of a certain market share).

While salary increases are generally not considered incentive-based compensation for purposes of the rule, such increases may be subject to recovery if they are earned "wholly or in part based on the attainment of a financial reporting measure."

Q: How does an issuer determine the amount of compensation that should be recovered from its executive officers?
A: The amount of incentive-based compensation to be recovered by the issuer is the difference between what was paid to the executive officer and what would have been paid had the incentive-based compensation payout been based on the restated financial information.

The amount of excess compensation that is to be recovered is calculated on a pre-tax basis (*i.e.*, it does not take into account the portion of the compensation erroneously received that the executive officer paid in taxes). An issuer would recalculate the applicable financial reporting measure and the amount of incentive compensation that was based on that measure after a restatement in determining the "excess" amount, or a portion of the incentive-based compensation that was based only in part on the achievement of the financial reporting measure.

If the company uses stock price or total shareholder return to measure its incentive-based compensation, the excess amount is calculated based on the issuer's reasonable estimate of the effect of the restatement on the issuer's stock price. The issuer must maintain appropriate documentation of the process for arriving at the estimate of the effect of the restatement on the stock price and provide such information to the relevant national securities exchange or association.

The SEC acknowledges that calculating the impact of the restatement on the issuer's stock price may be difficult and may require issuers to engage in "complex analyses that require significant technical expertise and specialized knowledge," such as an event study.[2]

Q: How should an issuer calculate recoverable incentive-based compensation with respect to bonuses paid out of a pool, or that include discretionary elements?
A: Excess bonus pool payments are allocated pro rata to executive officers with recoverable bonuses from the pool, and any discretionary portion of a bonus paid is not recoverable.

If a bonus paid to an executive officer out of a bonus pool is recoverable, then the bonus pool is re-determined based on the financial restatement, and the executive officer's pro-rata portion of the excess bonus pool paid out is recoverable. If a recoverable bonus was discretionarily increased from the amount that would have been paid under the applicable performance formula, the issuer need not recover the discretionary portion of the compensation. On the other hand, if a recoverable bonus was discretionarily decreased from the amount that would have been paid under the applicable performance formula, only the amount actually paid to the executive is used in calculating the excess incentive-based compensation.

Example. Five executive officers of an issuer are paid incentive-based compensation from a bonus pool that pays out bonuses at the end of 2017 based on the attainment of financial measures during its fiscal year 2017. The bonuses were paid at target to the executives and that the pool was determined to be $100,000, thereby resulting in the executives receiving $20,000 each. The issuer undergoes a financial restatement in 2018 related to the fiscal year 2017 financials and determines that bonuses should have only been paid at 80% of target, resulting in a bonus pool of $80,000. The amount of incentive-based compensation to be recovered from the pool would be determined based on each executive officer's pro rata portion of the excess $20,000, which in this case would be $4,000 per executive officer.

Example. An executive officer's 2017 annual bonus based on the applicable performance metrics would have been $2,000, but the issuer discretionarily decreased the bonus to $1,800. Following a financial restatement, if the issuer is required to recover a portion of the bonus and determines that, in fact, the executive's 2017 bonus would only have been $1,500, the issuer must recover $300 (*i.e.*, $1,800-$1,500). On the other hand, if the issuer had discretionarily increased the 2017 bonus to $3,000, the issuer would disregard the increase and would recover $500 (*i.e.*, $2,000-$1,500).

Q: How is equity compensation recovered?
A: Recovery of equity compensation will depend on the status of the applicable award.

If equity compensation is recoverable due to being granted, vested or earned in the three years preceding a financial restatement, the issuer must recover the excess portion of the equity award that would not have been granted, vested or earned based on the restated financials, as follows:

- if the equity award is still outstanding, the executive officer would forfeit the excess portion of the award;
- if the equity award has been exercised, or has settled into shares, and the executive still holds the shares, the issuer must recover the number of shares relating to the excess portion of the award (less any exercise price paid for the shares); and

[2] An "event study" is a study performed on a particular security to determine the effect of a specific event on the price of the security during a specifically identified period of time.

- if the underlying shares have previously been sold by the executive, the issuer must recover the proceeds received from sale of the shares relating to the excess portion of the award (less any exercise price paid for the shares).

Q: How does the proposed rule work in connection with Section 304 of the Sarbanes-Oxley Act of 2002?
A: In the case of a chief executive officer or chief financial officer, it is possible that the recovery of incentive-based compensation could be required under both the proposed rule and Section 304; however, in such a case, any amounts recovered through compliance with Section 304 would be credited toward the amount recovered under the proposed rule.

Q: Is recovery of the incentive-based compensation by the issuer mandatory?
A: Yes, subject to two limited exceptions.

An issuer must promptly recover erroneously paid incentive-based compensation from its executive officers, except under two limited circumstances:

- the issuer determines that it would be impracticable to recover the excess compensation from an executive officer, meaning that the expense paid to a third party to recover the compensation would exceed the amount of the compensation to be recovered; or
- the recovery of the incentive-based compensation would violate the home country law of the issuer.

To meet the first exception, the issuer must make a reasonable attempt to recover the compensation prior to determining that it is impracticable, and the issuer must provide documentation of the attempt to the exchange or association. Certain disclosure requirements must also be met, as described below.

To meet the second exception, the issuer must provide the exchange with an acceptable opinion of home country counsel stating that such recovery would violate home country law, and the home country law prohibiting recovery must have been in effect *prior to the publication of the proposed rule in the Federal Register*. Notably, this exception is limited to issues that arise under the law of the issuer's home country, and therefore would not be available to avoid recovery in the event that recovery would violate the law of a country where an executive is located, if such country were not the home country of the issuer.

There is no exception for *de minimis* amounts.

Q: Can the issuer indemnify its executive officers against the recovery of the officers' incentive-based compensation?
A: No.

An issuer may not indemnify its executive officers, directly or indirectly through the payment of such executives' insurance premiums, for losses that such officers may incur in connection with the recovery of excess incentive-based compensation. While not explicit, this would also appear to prohibit issuers from having gross-up arrangements or otherwise making executives whole for prior recovery amounts.

Q: What are the consequences of failing to comply with the proposed rule?
A: An issuer is subject to delisting from its national securities exchange, and the issuer may not be listed on a different exchange prior to coming into compliance with the recovery policy required by Rule 10D-1.

Disclosure

Q: What will issuers be required to disclose when the proposed rule becomes effective?
A: An issuer must provide its recovery policy as an exhibit to its annual report.

A proposed amendment to Item 601 of Regulation S-K provides that an issuer must file a copy of its recovery policy as an exhibit to its annual report. In the case of a foreign private issuer, an amendment to Form 20-F provides that the issuer must file a copy of its recovery policy as an exhibit to its annual report on Form 20-F.

Q: What disclosure requirements apply if an issuer is subject to recovery of incentive-based compensation?
A: The issuer will be required to provide the date of the relevant accounting restatement and detailed information regarding the recovery of excess incentive-based compensation.

A proposed amendment to add Item 402(w) to Regulation S-K would require an issuer to disclose certain details regarding the recovery of incentive-based compensation under its recovery policy.[3] In such an event, the issuer will be required to describe the following in its next proxy statement (or, in the case of an issuer that does not file a proxy statement, in its next annual report):

- the date on which the relevant accounting restatement took place;
- the aggregate dollar amount of incentive-based compensation deemed to be in excess based on the restatement;
- if the performance metric for the incentive-based compensation was stock price or total shareholder return, the estimates used to determine the excess incentive-based compensation based on the restatement; and
- the aggregate amount of outstanding excess incentive-based compensation at the end of the last completed fiscal year.

The information can be aggregated without singling out any executive. However, if the issuer has attempted to recover excess incentive-based compensation, but the excess compensation has not been recovered and remains outstanding for 180 days or more, the issuer must disclose the name of the current or former officer and the dollar amount of outstanding compensation.

If an issuer decided against recovering excess incentive-based compensation from an individual, the issuer is required to disclose the name of the current or former officer, the amount that would have been recovered and the issuer's rationale for deciding against such recovery.

In addition, any recovered amounts must be reduced from the summary compensation table disclosure relating to the year in which the compensation relating to the recovered amounts was reported.

Information related to the collection of such excess incentive-based compensation must be provided in eXtensible Business Reporting Language (XBRL).

[3] A proposed amendment to Item 401(a)(1) provides that foreign private issuers will be deemed to comply with this requirement if they meet the requirements of amended Form 20-F, which requires such issuers to disclose substantially identical information.

Request for Comments and Action Items

Q: On what aspects of the proposed rule does the SEC request comments?
A: The SEC requested comments on 115 questions relating to all aspects of the proposed rule.

The questions seek further comment on issues, such as which issuers should be covered by the rule, how the amount of compensation to be recovered should be determined and what effects the implementation of the rule will have on existing compensation practices. Below are a few of the key questions posed that companies may consider commenting on:

- **Q1**: Should the listing standards and other requirements of the proposed rule and rule amendments apply generally to all listed issuers, as proposed?
- **Q23**: Is the proposed definition of "executive officer" too broad? Should we instead limit the recovery policy to "named executive officers," as defined in Items 402(a)(3) and 402(m)(2) of Regulation S-K, or otherwise define a more narrow set of officers subject to recovery?
- **Q44**: For incentive-based compensation based on stock price or total shareholder return, would permitting the recoverable amount to be determined based on a reasonable estimate of the effect of the accounting restatement, as proposed, facilitate administration of the rule by issuers and exchanges? Should we provide additional guidance regarding how such estimates should be calculated? If so, what particular factors should that guidance address?
- **Q51**: Is the proposed issuer discretion not to pursue recovery of incentive-based compensation consistent with the purpose of Section 10D? Is the scope of this discretion appropriate?
- **Q85**: Should we require that the disclosure required by proposed Item 402(w) be tagged in XBRL format, as proposed? Should we require a different format, such as, for example, eXtensible Markup Language (XML)? Would tagging these disclosures enhance the ability of shareholders and exchanges to assess issuers' compliance with their recovery policies? Alternatively, should tagging this disclosure be optional?

Q: What should companies be doing now?
A: Given that the SEC's rule is still at its proposal stage and that the rule will not be effective before next proxy season at the earliest for most companies, there is no immediate need to take substantive action.

Nevertheless, companies should consider taking the following actions now, as the proposed new rule will require work:

- Inform your company's board of directors or the relevant committee(s) of the proposed rule and its relationship to incentive-based compensation generally.
- Consider whether it would be appropriate to review the individuals who have been identified as Section 16 officers.
- Consider commenting on the proposed rule, especially in the areas noted in the Q/A above.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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