GOODWIN PROCTER ALERT

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SEC Proposes Mandatory Incentive Compensation Clawback Rules

by Daniel P. Adams, John O. Newell, Ettore A. Santucci, Marian A. Tse

Speed Read

The SEC has proposed long-awaited rules on incentive compensation clawbacks under the Dodd-Frank Act. The proposed rules would require national securities exchanges to adopt new listing standards requiring listed companies to adopt and enforce clawback policies. The proposed rules would also require listed companies to make a variety of disclosures concerning their clawback policies and any clawbacks required by these policies. The proposed rules are sweeping in their scope, in terms of the number of listed companies covered, the number of executives covered, the types of incentive compensation covered and the number of fiscal years covered. If the SEC adopts these rules as proposed, the potential impact on executive compensation could be significant.

On July 1, 2015, the Securities and Exchange Commission proposed rules, consisting of new Rule 10D -1 and related rule and form amendments, that would require clawbacks of incentive compensation received by executive officers of listed companies in the event of subsequent accounting restatements. The SEC proposed these rules to implement Section 10D of the Securities Exchange Act of 1934, which was added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The proposed rules would require national securities exchanges, including the NYSE and Nasdaq, to adopt rules that would prohibit the initial or continued listing of any security of a company that does not adopt and comply with a written policy providing that, in the event the company is required to prepare an accounting restatement as a result of material non-compliance with any financial reporting requirement under the securities laws, the company will recover (*i.e.,* "claw back") the amount of excess incentive based compensation received by the company's executive officers during the three fiscal years preceding the date on which the company is required to prepare the restatement. The proposed rules would also require each listed company to publicly file its written clawback policy and, if there is a restatement that is subject to the policy, to disclose specified information regarding the restatement and the company's application of its policy in connection with the restatement.

As described in more detail below, the new clawback policies that would be required could raise several difficult issues if the SEC adopts the proposed rules in their current form. For example:

- *Stock Price and TSR-Based Incentive Compensation*. The proposed rules would require listed company clawback policies mandated by the proposed rules to apply to compensation that had been earned based on the company's stock price or total shareholder return (TSR). In this situation, the listing standards required by the proposed rules would require that the amount of compensation to be clawed back be based on "a reasonable estimate of the effect of the accounting restatement on the stock price or total shareholder return upon which the incentive-based compensation was received." Companies would likely encounter significant difficulties and uncertainties when they attempt to determine the precise impact of the misstated financial information on the company's stock price, and would likely need to hire a third party to assist with this determination. Requiring a company to make and publicly disclose these estimates could also harm the company's ability to defend potential litigation relating to a restatement.
- *No Tax Offset*. The new clawback policies would require companies to compute clawback amounts without regard to any taxes paid. As a result, if an executive ultimately is not able to obtain a full refund or credit for the taxes paid on compensation that is clawed back, the proposed rules would not provide for a reduction in the amount required to recovered from the executive and the executive could potentially be worse off than if the executive had never received the compensation in the first place.

- *Determination of When Restatement is Required*. The proposed rules would require companies to claw back excess incentive-based compensation received by the company's executive officers during the three fiscal years preceding the date on which the company is required to prepare the restatement. The definition of the date on which the company is required to prepare the restatement includes the date on which the relevant decision maker at the company "concludes, *or reasonably should have concluded*, that the company's previously issued financial statements contain a material error" (emphasis added). As a result, in order for a company to comply with its clawback policy, it would need to determine whether it reasonably should have reached this conclusion earlier than it actually did. Because the date of this conclusion determines the fiscal years that are subject to the company's clawback policy, this would introduce uncertainty into the determination of which compensation needed to be clawed back and potentially expose companies to delisting in the event they are second-guessed as to when they reasonably should have determined that a material error existed in prior financial statements. In addition, because the proposed rules would require companies to disclose the date on which the company was required to prepare the restatement and Form 8-K already requires companies to disclose the date on which they actually reach the conclusion that prior financial statements contain a material error, a company's determination that it reasonably should have concluded that a material error existed earlier than it actually did would be completely transparent to the public. Public disclosure of the difference between these dates could further compound the potential adverse consequences of a restatement to a company.

Which Companies Would be Affected?

The clawback policies that would be required by the listing standards under the proposed rules would apply to all companies with a class of listed securities, subject to very limited exceptions. The proposed rules would not permit exceptions for smaller reporting companies, emerging growth companies or foreign private issuers, among others.

Which Executives Would be Covered?

The new clawback policies would be required to apply to any individual who served as an "executive officer" of the company at any time during the performance period for incentive-based compensation that is subject to the clawback policy. The proposed rules define "executive officer" in the same manner that the rules under Section 16 of the Securities Exchange Act define "officer."

What Compensation Would be Subject to Mandatory Clawback?

Clawback policies under the proposed rules would require companies to claw back "incentive-based compensation," as defined by the proposed rules, that was 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;
- while the company had a class of securities listed on a securities exchange; and
- by an individual who served as an executive officer at any time during the performance period for such incentive-based compensation.

The amount of incentive-based compensation that companies would be required to claw back would be the amount that exceeds the amount that otherwise would have been received if the incentive-based compensation had been determined based on the accounting restatement, computed without regard to any taxes paid.

"Incentive-Based Compensation." The proposed rules define "incentive-based compensation" as any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure. Financial reporting measures would be defined as:

- measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements;
- any measures that are derived wholly or in part from those measures (*e.g.*, EBITDA, FFO, return on assets or invested capital, financial ratios, liquidity, return and earnings measures, and sales per square foot or same store sales, among others); and
- stock price and TSR.

Financial reporting measures would not be limited to measures presented within the company's financial statements or SEC filings.

Because the definition of incentive-based compensation includes compensation earned "in part" upon achieving a financial reporting measure, these clawback policies would also apply to compensation that is not tied to these measures in a strictly formulaic manner. This would include discretionary bonuses paid from a bonus pool, where the size of the pool is determined based wholly or in part on the attainment of a financial reporting measure, or awards based on the attainment of a financial reporting measure that are subject to discretionary increase or decrease. Incentive-based compensation would also include compensation that was earned based on the company's performance with respect to a financial reporting measure (for example, stock price and TSR) relative to a peer group.

The proposed rules would not apply to the following types of compensation:

- salary;
- bonuses or equity awards paid solely on a discretionary basis, other than those paid from a bonus pool the size of which was determined wholly or in part by satisfying a financial reporting measure;
- bonuses or equity awards paid solely on satisfaction of subjective standards, completion of a specified employment period or the achievement of goals that do not constitute financial reporting measures, such as opening a specified number of stores, obtaining regulatory approvals of a product, consummating a merger or divestiture or completing a restructuring plan or financing transaction.

When Compensation is "Received." Pursuant to the proposed rules, incentive-based compensation would be deemed received in the company's 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 incentive-based compensation occurs after the end of that period. For instance, an equity award that is earned based on the company's TSR for the three-year period ending December 31, 2018 would be deemed received in 2018 even though the shares are not issued until early 2019, and even if the shares are subject to additional time-based vesting. As a result, the shares would be subject to these clawback provisions if the company was required to prepare a restatement in 2019, 2020 or 2021.

When a Company is "Required to Prepare a Restatement." Under the proposed rules, the date on which a company is required to prepare an accounting restatement would be the earlier of:

- the date the company's board of directors, a committee of the board of directors, or officer(s) of the company authorized to take that action if board action is not required, concludes, or reasonably should have concluded, that the company's previously issued financial statements contain a material error; or
- the date a court, regulator or other legally authorized body directs the company to restate previously issued financial statements to correct a material error.

The proposed rules include a note that the first date above is generally expected to coincide with the date of the triggering event under Item 4.02(a) of Form 8-K, which requires the company to file a Form 8-K if relevant company decision makers conclude that previously issued financial statements should no longer be relied upon because of an error. However, the Form 8-K triggering event and the proposed rule's definition of the date on which a company would be required to prepare an accounting restatement differ in one potentially significant way. The Form 8-K reporting requirement is only triggered when the relevant decision makers actually reach the required conclusion. In contrast, the clawback requirement would be triggered when the relevant decision makers *reasonably should have* reached the required conclusion.

This subjective standard would introduce an element of potential uncertainty into the determination of the compensation that is required to be clawed back, and potentially require companies to disclose in their SEC filings that they reasonably should have concluded that a material error existed in their financial statements earlier than they actually reached this conclusion. Accounting standards can be very complex and/or may rely upon inherently subjective judgments. In situations where accounting standards are subsequently determined to have been misapplied, it may be difficult to determine exactly when the relevant decision maker reasonably should have concluded that a material error existed in previously issued financial statements. Uncertainty or potential second-guessing of when this conclusion reasonably should have been made could expose a company to significant risks because

the consequences of failing to implement the clawback policy and make the required disclosures at the required date include delisting of the company's securities. Further, publicly disclosing that the company should have reasonably concluded that a material error existed earlier than it actually reached this conclusion could further compound the potential adverse consequences of a restatement to a company.

Excess Incentive-Based Compensation. The listing standards would require companies to claw back excess incentive-based compensation. The amount of the excess incentive-based compensation is the amount of the applicable incentive-based compensation that exceeds the amount that otherwise would have been received had it been determined based on the accounting restatement (*i.e.*, using the restated results). As noted above, companies must determine and recover the amount of excess incentive-based compensation without regard to any taxes paid.

For incentive-based compensation based on a company's stock price or TSR, where the amount of excess incentive-based compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the proposed rules would require that:

- the amount be based on a reasonable estimate of the effect of the accounting restatement on the stock price or TSR upon which the incentive-based compensation was received; and
- the company maintain documentation of the determination of that reasonable estimate and provide that documentation to the securities exchange on which it is listed.

The SEC also provided additional guidance in the proposing release describing how it intended the proposed rules to operate with respect to the determination of the amount of excess incentive-based compensation. In particular, the SEC noted the following:

- if a company originally used negative discretion to reduce formulaic incentive-based compensation, the excess incentive-based compensation would equal the formulaic amount determined using the restated results less the amount originally received (*i.e.*, recovery would be deemed to have already been received to the extent of any prior exercise of negative discretion);
- if a company originally used positive discretion to increase formulaic incentive-based compensation, the excess incentive-based compensation would equal the formulaic amount determined using the restated results less the formulaic amount originally determined (*i.e.*, the executive would be permitted to retain the full amount of the discretionary increase in compensation) provided that the company would have been permitted to make such a discretionary increase based on the restated results;
- for awards received from bonus pools, where the size of the pool is determined based wholly or in part on the attainment of a financial reporting measure, no recovery is required unless the aggregate amount of awards received exceeds the size of the pool based on the restated results and the excess amount of any executive's award will be a pro rata portion of the aggregate deficiency (*i.e.*, no discretion to pursue differential recovery among executives is permitted); and
- for exercised options or SARs where the underlying shares have been sold, the recoverable amount would be the sale proceeds received with respect to the excess number of shares reduced to reflect the applicable exercise price paid.

Neither the proposed rules nor the proposing release address the potential for offsetting increases where restated results would have decreased the amount of incentive-based compensation received in one year, but increased the amount received in another year (for example, in a situation where the aggregate amount of revenues or expenses recognized over a multi-year period does not change, but the specific periods in which the revenues or expenses are recognized does change).

Indemnification Prohibited. The proposed rules would prohibit companies from indemnifying executive officers against the loss of any excess incentive-based compensation.

Are Companies Required to Recover Excess Incentive-Based Compensation Under All Circumstances?

The stock exchange listing standards mandated by the proposed rules would require a company to recover excess incentive-based compensation in accordance with its clawback policy unless the company's compensation committee determines recovery is impractical because either (i) the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered or (ii) the recovery would violate home country law adopted prior to July 14, 2015.

Before concluding that recovery is impracticable based on the expense of enforcement, a company must first make a reasonable attempt to recover the excess incentive-based compensation, document that attempt and provide that documentation to the securities exchange on which the company's securities are listed. Before concluding that recovery is impracticable based on home country law, a company must first obtain an opinion of home country counsel, not unacceptable to the securities exchange on which the company's securities are listed, that recovery would result in a violation of applicable home country law and provide that opinion to the securities exchange. Neither the proposed rules nor the proposing release specify whether "home country law" is intended to refer to the laws of the country in which the company is domiciled or has its headquarters or whether it refers to the laws of any foreign jurisdiction that applied to an executive officer (for example, an executive officer located in a foreign office of a domestic company).

A company that does not comply with its clawback policy will be subject to delisting by the securities exchange on which it is listed. The proposing release suggested that the securities exchanges would have some discretion when determining whether and when to commence delisting proceedings. Because the proposed rules would not require that the clawback be completed within a specific period of time, the securities exchange would be required to determine whether the steps a company was taking constituted compliance by the company with its clawback policy. In the proposing release, the SEC indicated that a securities exchange, in making this assessment, would need to determine, among other things, whether the company was making a good faith effort to pursue recovery promptly. Because a company's failure to comply with its own policy could result in delisting, companies should be careful to craft their clawback policies in a manner that will minimize the potential for delisting due to noncompliance with requirements that are not strictly mandated by applicable SEC rules or securities exchange listing standards.

If a securities exchange delists a company for failing to comply with the clawback policy required by the securities exchange, the company will not be permitted to list its securities on any securities exchange thereafter until it has complied with its clawback policy.

How Quickly Must Companies Recover Excess Incentive-Based Compensation?

Although the proposed rules do not specify a minimum period of time within which clawback policies must require a company to recover excess incentive-based compensation, the SEC stated in the proposing release that a company should recover excess incentive-based compensation reasonably promptly, since undue delay would constitute non-compliance with its clawback policy. However, as noted below, the proposed rules would generally require a company to disclose any shortfalls in recovery that existed as of the end of the prior fiscal year in the company's proxy statement.

What New Disclosures Would be Required by the Proposed Rules?

Filing of Clawback Policy. The proposed rules would require each company that had a class of securities listed on a securities exchange at any time during its last completed fiscal year to file its required clawback policy as an exhibit to its annual report on Form 10 K.

Proxy Statement Clawback Disclosure After a Restatement. The proposed rules would require each company that had a class of securities listed on a securities exchange at any time during its last completed fiscal year to provide additional disclosure if at any time during the last completed fiscal year either (1) the company completed a restatement that required recovery of excess incentive-based compensation pursuant to the company's clawback policy or (2) there was an outstanding balance of excess incentive-based compensation from a prior restatement. In these cases, the company would be required to disclose the following information in its proxy or information statement that included executive compensation disclosure under Item 402 of Regulation S K and in its annual report on Form 10 K, either directly or through incorporation by reference to its proxy statement:

- *Clawback Amounts.* For each restatement, the company would be required to disclose:
  - the date on which the company was required to prepare an accounting restatement;
  - the aggregate dollar amount of excess incentive-based compensation attributable to the accounting restatement;
  - the estimates that were used in determining the excess incentive-based compensation attributable to the accounting restatement if the financial reporting measure related to a stock price or TSR metric; and

- the aggregate dollar amount of excess incentive-based compensation that the company had not recovered at the end of the last completed fiscal year.

If the company has not yet determined the amount of excess incentive-based compensation, the company must disclose that fact and explain the reasons.

- *Recoveries Not Pursued.* If during the last completed fiscal year the company decided not to pursue recovery of excess incentive-based compensation from any individual subject to its clawback policy, the company would be required to disclose, for each individual, the name and amount forgone and a brief description of the reason the company decided not to pursue recovery.
- *Unpaid Recoveries.* If, as of the end of the last completed fiscal year, any excess incentive-based compensation owed by an individual had been outstanding for 180 days or longer since the date on which the company determined the amount owed, the company would be required to disclose name of the individual and the outstanding dollar amount of excess incentive-based compensation due.

The proposed rules also provide that any amounts recovered from an executive pursuant to a company's required clawback policy would reduce the executive's compensation reported in the Summary Compensation Table for the fiscal year in which the recovered amount was initially reported as compensation, and would be identified by a footnote.

Under the proposed rules, the securities exchange listing standards would require each listed company to file all disclosures with respect to its clawback policy "in accordance with the requirements of the federal securities laws." A company that failed to comply with SEC disclosure requirements about its clawback policy would therefore be subject to delisting.

This new disclosure would not be incorporated by reference into registration statements except to the extent that the company specifically does so. Companies would also be required to file this new disclosure in XBRL format, block-text tagged, as an exhibit to each filing containing this new disclosure.

Other Proposed Amendments. The proposed rules would also amend Schedule 14A, Form N-CSR, Form 20-F and Form 40-F to include corresponding changes to the disclosure requirements in these forms for registered investment companies, registered management investment companies, foreign private issuers and filers under the multijurisdictional disclosure system.

When Will Companies be Required to Comply with the New Rules?

The proposed rules, other than those related to the new disclosure requirements, would not apply directly to companies, but would require national securities exchanges to adopt rules prohibiting the initial or continued listing of any security of a company that does not comply with the requirements of the listing standards required by the proposed rules. The proposed rules containing new SEC disclosure requirements would not become effective until the securities exchange listing standards requiring companies to adopt clawback policies become effective. As a result, a company will not be required to take any action until the SEC has adopted final rules and the securities exchange on which the company's securities are listed has adopted new listing standards and those listing standards have become effective. The proposed rules provide a detailed schedule for implementation of the new listing standards and disclosure requirements. The key dates are shown in the table below.

Event	Date
National securities exchanges must file proposed rules/amendments	Not more than 90 days after publication of final SEC rules
National securities exchanges rules/amendments must be effective	Not more than one year after publication of final SEC rules
Listed companies must adopt a clawback policy	Not more than 60 days after the effective date of the securities exchange rules/amendments
Incentive-based compensation subject to clawback policy	Compensation "received" on or after the effective date of the final rules adopted by the SEC
Companies must comply with new disclosure requirements	SEC filings required on or after the effective date of the securities exchange rules/amendments

Practical Considerations

In recent years, companies have increasingly redesigned their incentive compensation programs to pay compensation based on performance metrics that would be subject to the clawback policies mandated by the proposed rules. In particular, performance-based awards that use TSR, on a relative and/or absolute basis, have become commonplace. The final requirements and effective date of the proposed rules remain uncertain, but if the SEC adopts final rules that are consistent with the proposed rules, the impact of these rules on executive compensation policies could be wide-ranging and long-lasting. For example, these rules could create real tension between what many companies have seen as proper alignment/good governance policies, on the one hand, and effective incentives and fairness to executives on the other hand, as they relate to the risk/reward balances reflected in compensation policies and programs.

Companies may choose to defer any action until the mandated new securities exchange listing standards are finalized. However, companies – particularly those that rely on multi-year incentive programs that may pay compensation in future years after the SEC final rules and securities exchange listing standards become effective – may wish to begin considering how the stock exchange listing standards mandated by the proposed rules could affect their existing compensation structures and how they would comply with these listing standards and rules if the SEC adopts the proposed rules in their current form.

Associate Courtney Leffingwell contributed to the production of this alert.

Contacts:

Daniel P. Adams
Partner
617.570.1966
dadams@goodwinprocter.com

John O. Newell
Counsel
617.570.1475
jnewell@goodwinprocter.com

Ettore A. Santucci
Partner
617-570-1531
212-459-7413
esantucci@goodwinprocter.com

Marian A. Tse
Partner
617.570.1169
mtse@goodwinprocter.com

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