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Putting Executive Pay at Risk: SEC Proposes Rules on Mandatory Clawback Policies

On July 1, 2015, the Securities and Exchange Commission proposed rules to require issuers of securities listed on U.S. stock exchanges to adopt and enforce clawback policies applicable to incentive-based compensation received by current and former executives in the three-year period preceding the date the issuer is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements. The proposed rules would implement the "no fault" clawback rule requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Section 10D of the Securities Exchange Act of 1934, as amended).

Which issuers are covered by the proposed rules?

The new rules would apply to all listed issuers (including emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies and issuers of listed debt), with limited exceptions for issuers of securities futures products or standardized options, unit investment trusts, and registered management investment companies that have not awarded incentive-based compensation to any executive officer in the last three fiscal years (or, if shorter, since initial listing).

Which restatements trigger application of a clawback under the required policy?

A clawback would be triggered when an issuer is required to prepare a restatement to correct an error that is material to previously issued financial statements. Materiality must be analyzed in the context of particular facts and circumstances. Changes to an issuer's financial statements that do not represent the correction of an error would not trigger application of the clawback policy. Among other exceptions, restatements due to changes to accounting principles, certain internal restructurings, certain adjustments in connection with business combinations and revisions due to stock splits would not be considered "errors" triggering clawbacks.

When is an issuer "required to prepare an accounting restatement"?

An issuer would be deemed to be "required" to prepare an accounting restatement upon the earlier to occur of:

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

Which persons are subject to the clawback policy?

The clawback policy would have to apply to current and former "executive officers," defined in the same way as the "officer" definition for Section 16 purposes. Former executive officers would include any individual who served as an executive officer at any time during the performance period for the affected incentive-based compensation.

What compensation is "incentive-based"?

The proposed rules define "incentive-based" compensation as any compensation that is granted, earned or vests based wholly or in part upon the attainment of any financial reporting measure. Financial reporting measures are measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from those measures, and stock price and total shareholder return ("TSR").

The table below provides illustrative examples of covered and not-covered items of compensation:

Covered "Incentive-Based" Compensation	Compensation Not Covered
Bonuses earned wholly or in part based on satisfying a financial reporting measure performance goal	Salaries
Bonuses paid from a bonus pool, if the pool size is based wholly or in part on satisfying a financial reporting measure performance goal	Bonuses paid solely at the discretion of the compensation committee that are not paid from a bonus pool, the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal
Equity awards granted or vesting based wholly or in part on satisfying a performance goal based on a financial reporting measure, TSR or achieving a certain stock price	Bonuses paid solely on satisfying one or more subjective standards and/or continued employment
Proceeds received upon the sale of shares acquired under an equity award that was granted or that vested wholly or in part on satisfying a financial reporting measure performance goal	Bonuses earned solely based on achieving one or more strategic or operational measures (e.g., obtaining regulatory approvals)
	Time-based equity awards or equity awards earned based on attaining one or more non-financial reporting measures

How long would incentive-based compensation be at risk under the clawback policy?

The policy must apply for the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement, with a special rule for issuers changing fiscal years. Any incentive-based compensation "received" (as described below) during this period would be subject to recovery.

When is incentive-based compensation "received"?

Incentive-based compensation would be deemed received in the fiscal year during which the financial reporting measure specified is attained (regardless of when granted or paid), even if not all conditions to payment have been satisfied (such as additional service conditions or board certification of performance criteria).

What is the recoverable amount under the clawback policy?

The amount recoverable by the issuer is the amount of incentive-based compensation received by the covered individual that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement. Where the amount of erroneously award compensation is not subject to mathematical recalculation directly from the information in the accounting restatement (such as where incentive compensation is based on stock price or TSR), the recoverable amount may be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. In that situation, an issuer would be required to maintain documentation of how it determined its reasonable estimate and provide such documentation to the relevant stock exchange. The recoverable amount would be determined on a pre-tax basis.

For equity awards, the recoverable amount will depend in part on whether underlying shares have been sold. If the award is still held at the time of recovery, the recoverable amount would be the number of shares or awards received in excess of the number that should have been received applying the restated financial reporting measure. If the award has been exercised, but the underlying shares have not been sold, the recoverable amount would be the number of shares underlying the excess portion of the award applying the restated financial measure. If the underlying shares have been sold, the recoverable amount would be the sale proceeds received by the executive officer with respect to the excess number of shares (net of any exercise price paid by the executive officer to acquire the shares).

Would the issuer be required to pursue recovery and what discretion may be applied?

The issuer must pursue recovery unless it would be impracticable because it would impose undue costs on the issuer or its shareholders or would violate non-U.S. home country law. Any decision on impracticability would need to be made by the issuer's committee of independent directors that is responsible for executive compensation decisions. Before concluding that it would be impracticable to recover amounts the issuer would first need to make a reasonable attempt to recover such compensation and would be required to document its attempt to recover and provide such documentation to the relevant stock exchange. Generally, the issuer cannot settle for less than full recovery but issuers may exercise discretion with respect to how to accomplish recovery, as long as it is done reasonably promptly.

What disclosure would be required regarding use of the clawback policy?

The proposed rules would require disclosure of whether a triggering restatement had occurred within the last year, the aggregate dollar amount of excess incentive-based compensation attributable to such restatement and the aggregate dollar amount of such compensation that remains outstanding at the end of the last fiscal year. If the clawback policy is triggered, certain disclosure about the affected persons and amounts to be clawed back would also be required. If an issuer did not pursue a recovery, the issuer would have to disclose the reasons for failing to do so, the individuals affected and the amounts involved. A U.S. issuer would be required to file its clawback policy as an exhibit to its Annual Report on Form 10-K.

When are public comments due and when would the new rules go into effect?

Public comments are due within 60 days following the publication of the proposed rule in the Federal Register.

The SEC has proposed that stock exchanges file proposed listing rules to implement this clawback rule no later than 90 days after publication of the final rule, and that those rules be effective no later than one year after that publication date. Listed issuers would then be required to adopt a clawback policy no later than 60 days following the date on which the exchanges' rules become effective. The clawback policies would apply to all incentive-based compensation received by covered individuals based on or derived from financial information for any fiscal period ending on or after the effective date of Rule 10D-1.

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