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SEC Reopens Comment Period for Compensation Clawback Proposal

The SEC has reopened the comment period for its 2015 proposal to implement Section 954 of the Dodd-Frank Act (available here). Interested parties are called upon to provide input on the SEC's initial proposal (available here). The proposal would create new Rule 10D-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and mandate that national securities exchanges and associations establish listing standards requiring all listed companies to adopt and comply with compensation recovery (or "clawback") policies for erroneously awarded compensation, and disclose them in accordance with SEC rules. The proposed rules would apply to all companies listed in the United States except for certain registered investment companies. As currently proposed, emerging growth companies, smaller reporting companies, controlled companies and foreign private issuers (including MJDS issuers) would be subject to the rules.

Proposed Clawback Requirement

What is the clawback requirement?

If a company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, the company would be required to recover, pursuant to its policy, incentive-based compensation awarded to current and former executive officers during the three fiscal years preceding the date on which the company is required to prepare the accounting restatement. The recovery would be required on a "no fault" basis, without regard to whether any misconduct occurred or to an executive officer's responsibility for the erroneous financial statements.

Who is subject to the clawback requirement?

Proposed Rule 10D-1 would apply to current and former executive officers of listed companies. The definition of "executive officer" is based on the definition of "officer" under Section 16 of the Exchange Act and 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. Notably, this definition is significantly broader than that in the clawback provisions of Section 304 of the Sarbanes-Oxley Act, which only applies to the CEO and CFO. The proposed rules would prohibit a company from indemnifying an executive officer for the loss of compensation that the officer is required to pay back under the clawback policy, whether directly or indirectly, without regard to fault.

How much would be required to be clawed back?

Under the proposed rules, companies would be required to recover the amount of incentive-based compensation that exceeds the amount the executive officer would have received during the applicable period had the incentive-based compensation been determined based on the restated financial statements. The recoverable amount would be calculated on a pre-tax basis.

What would constitute "an accounting restatement due to the material noncompliance of the company with any financial reporting requirement"?

In its initial proposal, the SEC proposed interpreting this to mean restatements to correct a material error. In the release reopening the comment period, the SEC noted that it considers it appropriate to expand its interpretation to include all required restatements made to correct an error in previously issued financial statements, to ensure that the clawback covers both restatements that correct errors that are material to previously issued financial statements, and also restatements required to

correct errors that were not material to those previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period. Further, while the SEC had initially proposed definitions of "accounting restatement" and "material noncompliance" it is now considering whether to rely instead on existing guidance, literature and definitions concerning accounting errors.

Despite the proposed expansion, the focus remains on errors due to "material noncompliance." Certain restatements, including those due to changes in accounting principles, certain internal restructurings, certain adjustments in connection with business combinations and revisions due to stock splits, would not be considered corrections triggering clawbacks.

Would the company be required to recover all such erroneously awarded incentive compensation?
The SEC noted in the initial proposal that the unqualified "no-fault" recovery mandate of the clawback provisions means that companies would be required to pursue recovery in most instances, except where "impracticable." For example, companies would have limited discretion not to recover the excess incentive-based compensation if the direct expense of enforcing recovery would exceed the amount to be recovered or, for foreign private issuers, in specified circumstances where recovery would violate home country law.

Incentive-Based Compensation

What would be included in "incentive-based compensation"?
"Incentive-based compensation" is defined as "any compensation that is granted, earned or vested 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 company's financial statements, any measures derived wholly or in part from such financial information and stock price and total shareholder return. Certain compensation, such as bonuses paid solely upon satisfying one or more subjective standards, non-equity incentive plan awards earned solely upon satisfying one or more strategic measures and awards that are granted, earned or vest solely upon the occurrence of non-financial events would not be considered incentive-based compensation.

When would incentive-based compensation be deemed to be "received" for the purposes of the clawbacks?
Under the initial proposal, incentive-based compensation would be deemed received in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs after the end of that period. Under this standard, the date of receipt would depend on the terms of the award. If the grant of an award is based, either wholly or in part, on satisfaction of a financial reporting measure, the award would be deemed received in the fiscal period when that measure was satisfied. If an equity award vests upon satisfaction of a financial reporting measure, the award would be deemed received in the fiscal period when it vests.

How would the amount to be clawed back in respect of incentive-based compensation based on stock price or total shareholder returns be calculated?
For incentive-based compensation based on stock price or total shareholder return, companies could use a reasonable estimate of the effect of the restatement on the applicable measure to determine the amount to be recovered. While the initial proposal did not explicitly require disclosure of how companies calculated the recoverable amount, the SEC has now requested comment on whether companies should disclose their calculations.

Disclosure Requirements

Where would companies disclose their clawback policies?
Each listed company would be required to file its compensation recovery policy as an exhibit to its Exchange Act annual report.

What do companies need to disclose regarding clawed back compensation?
If, during its last completed fiscal year the company either prepared a restatement that required recovery of excess incentive-based compensation, or there were an outstanding balance of excess incentive-based compensation relating to a prior restatement, 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;
- the aggregate dollar amount that remained outstanding at the end of its last completed fiscal year;
- the name of each person subject to recovery from whom the company decided not to pursue recovery;
- the amounts due from each such person;
- 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.

The proposed disclosure would be included along with the listed company's other executive compensation disclosure in annual reports on Forms 10-K, 20-F and 40-F and any proxy or information statements in which executive compensation disclosure is required. Listed companies would also be required to block tag the disclosure in an interactive data format using eXtensible Business Reporting Language (XBRL).

The Commission also proposed amendments to the Summary Compensation Table disclosure requirements. A new instruction to the Summary Compensation Table would require that any amounts recovered pursuant to a listed company's erroneously awarded compensation recovery policy reduce the amount reported in the applicable column for the fiscal year in which the amount recovered initially was reported, and be identified by footnote.

How would companies disclose restatements that are not correcting a material error to previously issued financial statements?
Because a Form 8-K is not typically filed for an error that is not material to the previously issued financial statements, the SEC is considering whether to add check boxes to the cover page of the Form 10-K to indicate separately (a) whether the previously issued financial statements included in the filing include an error correction, and (b) whether any such corrections are restatements that triggered a clawback analysis during the fiscal year, or whether restatements resulting in clawbacks would require a Form 8-K filing.

Next Steps

How long will the reopened comment period be open?
The comment period will be open for 30 days following publication of the SEC's Reopening Notice in the Federal Register.

When could companies be required to comply with the rules?
The initial proposal required that the exchanges file their proposed listing rules no later than 90 days, and that such rules become effective no later than one year, after publication of the final version of Rule 10D-1 in the Federal Register. Listed companies would then be required to adopt clawback policies no later than 60 days after such effectiveness and 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 listing exchange's rule. Based on this, it is unlikely that companies would be required to adopt new clawback policies (if their existing policies do not comply with the new listing standards) before 2023 at the earliest.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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