SEC Issues Proposed Rule on Mandatory Clawback

Introductory Comments from Matt Isakson, Lead Consultant

As discussed last week in Seattle, the Compensation Committee's review of management's proposed goals is now a primary focus for directors. There are many tools available to the Compensation Committee to help assess the goals from an objective perspective.

On a related note, the SEC's proposed no fault mandatory clawback policy will also introduce a level of exposure to the company's performance against goals, specifically as it relates to incentive plan payouts in the event of a financial restatement. The SEC's proposed clawback policy requires a level of compliance and complexity unseen in executive compensation policies. We will continue to monitor the SEC developments and how it impacts the Compensation Committee.

In our Client Update of July 1, 2015, we reported on testimony provided at a hearing of the Securities and Exchange Commission (SEC) during which it approved a proposed rule that would require public companies to adopt a mandatory clawback policy. This Client Update summarizes the release of the proposed rule ("Proposed Rule") that was published following the SEC hearing.

Background

Under Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the SEC is mandated to direct the national securities exchanges and national securities associations ("Securities Exchanges") to establish listing standards that would require each listed company to develop a mandatory clawback policy compliant with Section 954 and SEC rules and to disclose the clawback policy. The Proposed Rule reflects this mandate. ***Listed companies would be required to implement a compliant clawback policy within 60 days after the effective date of the new listing standard.***

Highlights of the Proposed Rule

Summarized below are highlights of the Proposed Rule:

- Mandatory clawback policy would cover Section 16 officers ("Executive Officers").
- Clawback would be triggered upon a financial restatement due to a material error in previously issued financial statements, with no requirement of employee misconduct.
- "Excess" incentive compensation received by an Executive Officer during three-year look-back period would be subject to clawback (i.e., the *three completed fiscal years* immediately preceding the date on which a company knew or should have known that previously issued financial statements contain a material error).
- "Incentive-based compensation" would be defined as any compensation that is ***granted, earned or vested*** based wholly, or in part, upon the attainment of any "**financial reporting measure**" (i.e., GAAP measures and measures related to total shareholder return and stock price).

- Incentive based compensation would ***not*** include time-vested equity awards, including time-vested stock options or stock appreciation rights and time-vested restricted stock or RSU grants.
- Clawback of excess incentive compensation would be mandatory, ***except*** if recovery costs exceed recoverable amount or recovery would violate home country law of a foreign private issuer.
- Means of recovering excess incentive compensation would be at the discretion of the company (e.g., offsetting amounts recoverable against other compensation due an Executive Officer would be allowed).
- Disclosure of mandatory clawback policy would be made as an exhibit to Form 10-K and disclosure of aggregate excess incentive-based compensation attributable to a financial restatement, and certain other related items, would be made in a company's proxy.

Details of the Proposed Rule

The following describes the key elements of the Proposed Rule.

Covered Executive Officers

The definition of "Executive Officer" under the Proposed Rule would be patterned after the definition of "officer" under Rule 16a-1(f). Specifically, the Proposed Rule would cover the following positions:

- President,
- Principal financial officer,
- Principal accounting officer (or if there is no such accounting officer, the controller),
- Any vice-president of the issuer in charge of a principal business unit, division or function (such as sales administration or finance),
- Any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer,
- Executive officers of the company's parent or subsidiaries would be deemed executive officers of the company if they perform policy-making functions for the company.

The proposed clawback policy would apply to both **current and former executive officers** who received incentive-based compensation during the three-year "look-back period" (see discussion below for definition of look-back period).

Covered Entities

Subject to narrow exceptions, all listed companies would be subject to the Proposed Rule, including foreign private issuers, smaller reporting companies, emerging growth companies under the Jumpstart Our Business Startups Act, controlled companies and registered investment advisers (only in the case where the investment adviser pays Executive Officers incentive-based compensation). In addition, the Proposed Rule would apply to a company with listed debt securities or preferred securities even if the company does not have listed equity securities. The Securities Exchanges would be allowed to permit foreign private issuers to forego recovery of excessive incentive compensation if it would violate home country laws. However, the Securities Exchanges would not be given the discretion to decide whether certain categories of securities could be exempted from the proposed listing standards.

Trigger Event.

Under the Proposed Rule, a public company would be required to claw back "excess" incentive compensation earned by an Executive Officer during a "look-back period" in the event of a financial restatement due to the ***material noncompliance*** of the company with any financial reporting requirement under the securities laws ("Trigger Event"). Material noncompliance would be defined as an error that is material to previously issued financial statements. Materiality would be determined on a facts and circumstances basis. The SEC chose not to describe any type or characteristic of an error that would be considered material for this purpose. However, the Proposed Rule identified the following types of revisions to a company's financial statements that would not represent the correction of an error and therefore, ***would not*** trigger the potential recoupment of incentive-based compensation paid to an Executive Officer:

- Retrospective application of a change in accounting principle,
- 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.

Unlike the Sarbanes-Oxley clawback requirement, the clawback trigger under the Proposed Rule would not require misconduct on the part of an Executive Officer or any other employee.

Look-Back Period.

Upon a Trigger Event, the Proposed Rule would require a public company to recover excess incentive compensation received by an Executive Officer during the ***three completed fiscal years immediately preceding*** the date on which the company is required to prepare an accounting restatement (i.e., look-back period). This date would be the earliest of:

- The date the company's board of directors, a committee of the board of directors, or the officer or officers of the company authorized to take such 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 its previously issued financial statements to correct a material error.

Definition of Incentive-based Compensation

The Proposed Rule would define "incentive-based compensation" as any compensation that is ***granted, earned or vested*** based wholly, or in part, upon the attainment of any "financial reporting measure."

- **Definition of financial reporting measure.** Financial reporting measures would be limited to measures:

  — Determined and presented in accordance with the accounting principles used in preparing the company's financial statements,

  — Derived wholly or in part from financial statements,

— Related to company stock price, and

— Related to total shareholder return on company stock.

An incentive plan award that is granted, earned or vested based solely upon the occurrence of non-financial events would not be considered incentive-based compensation and therefore, would not be subject to the proposed clawback policy.

- **Examples of incentive-based compensation**. Compensation that **would be subject to** the proposed clawback policy would include, but would not be limited to:

— Non-equity incentive plan awards that are earned based wholly or in part on satisfying a financial reporting measure performance goal,

— Bonuses paid from a "bonus pool," the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal,

— Performance share or unit plans,

— Restricted stock, restricted stock units, stock options, and stock appreciation rights ("SARs") that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal, and

— 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 reporting measure performance goal.

Based on the foregoing definition of "incentive-based compensation" and illustrative examples, the Proposed Rule would not apply to time-based stock options, SARs, restricted stock or RSUs.

- **Examples of compensation not treated as incentive-based compensation**. Compensation that **would not be subject to** the Proposed Rule would include, but would not be limited to:

— Salaries,

— Bonuses paid solely at the discretion of the compensation committee or board 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,

— Bonuses paid solely upon satisfying one or more subjective standards (e.g., demonstrated leadership) and/or completion of a specified employment period,

— Non-equity incentive plan awards earned solely upon satisfying one or more strategic measures (e.g., consummating a merger or divestiture), or operational measures (e.g., opening a specified number of stores, completion of a project, increase in market share), and

— Equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more non-financial reporting measures. Most stock option grants and restricted stock and RSU awards fall under this category.

Determination of When Incentive Compensation is Received by an Executive Officer

Under the Proposed Rule, 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. This would be the case regardless of whether the payment or grant occurs after the end of that period (e.g., the payment of the compensation is subject to a multiyear deferral period) or whether the payment remains subject to a substantial risk of forfeiture.

The following are illustrative examples of when compensation would be considered received by an Executive Officer:

- 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.
- A cash award earned upon satisfaction of a financial reporting measure would be deemed received in the fiscal period when that measure is satisfied.

Ministerial acts or other conditions necessary to effect issuance or payment, such as calculating the amount earned or obtaining the board of directors' approval of payment, would not affect the determination of the date received. Thus, for example, most annual bonus and performance share/unit plan payouts would be deemed "received" as of the last day of the fiscal year, even if final determination and payout occurs in the first 90 days of the following year.

Calculation of Excess Incentive-Based Compensation.

Under the Proposed Rule, excess incentive-based compensation would be equal to:

- The amount by which incentive-based compensation received by an Executive Officer during a Look-Back Period exceeds
- The amount of incentive-based compensation that otherwise would have been received by the Executive Officer had it been determined based on the restated financial statements.

The recoverable amount would be calculated on a pre-tax basis.

- **Examples of the Determination of Excess Incentive-Based Compensation**. The following are illustrative examples showing the determination of excess incentive-based compensation:

  — <u>For incentive-based compensation that is based only in part on the achievement of a financial reporting measure performance goal</u>. A company first would determine the portion of the original incentive-based compensation based on or derived from the financial reporting measure that was restated. The company would then need to recalculate the affected portion based on the financial reporting measure as restated, and recover the excess of the amount paid over the amount that would have been received based on the restatement.

  — <u>For incentive-based compensation that is based on stock price or total shareholder return</u>. The recoverable amount may be determined based on a ***reasonable estimate of the effect of the accounting restatement on the applicable measure (e.g., share price)***. A company would be required to maintain documentation of the determination of that reasonable estimate and provide such documentation to the relevant exchange or association.

  — <u>For cash awards paid from bonus pools</u>. If the size of the aggregate bonus pool from which individual bonuses are paid would be reduced based on applying the restated financial reporting measure, then

        - where the reduced bonus pool is less than the aggregate amount of individual bonuses received from it, the excess amount of an individual bonus would be the pro rata portion of the deficiency.

        - Where the aggregate reduced bonus pool would have been sufficient to cover the individual bonuses received from it, then no recovery would be required.

    — For equity awards with performance-based vesting conditions where shares are still held at the time of recovery. The recoverable amount would be the number of shares received in excess of the number of shares that should have been received applying the restated financial reporting measure.

    — For options or SARs with performance-based vesting conditions that have been exercised, but the underlying shares have not been sold. The recoverable amount would be the number of shares underlying the excess options or SARs applying the restated financial measure.

    — For options or SARs with performance-based vesting conditions that have been exercised and 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.

- **Coordination with Sarbanes-Oxley Clawback**. In the release of the Proposed Rule, the SEC notes that there may be circumstances in which both proposed recovery rule and Sarbanes-Oxley could provide for recovery of the same incentive-based compensation. To avoid this result, the Proposed Rule provides that if an Executive Officer returns compensation to a company pursuant to Sarbanes-Oxley, such compensation would not also be recoverable under the Proposed Rule.

Mandatory (no-fault) Clawback

The Proposed Rule would ***require*** a public company to claw back excess incentive compensation from an Executive Officer upon a trigger event, ***except*** if the company's compensation committee determined that such recovery would be "impractical." No misconduct on the part of an Executive Officer or any other employee would be required under the Proposed Rule.

Recovery would be considered impractical under the following two circumstances:

- **Recovery costs exceed recoverable amount.** If the "direct costs" of recovery would exceed the recoverable amounts, recovery would be considered impractical. Before concluding that it would be impracticable to recover excess incentive-based compensation due to enforcement costs, a company would first need to make a reasonable attempt to recover such compensation. In addition, the company would be required to document its attempts to recover, and provide that documentation to the applicable securities exchange on which its securities are listed.

- **Recovery would violate home country law of foreign private issuer.** If recovery of excess incentive compensation would violate home country law of a foreign private issuer (provided that such home country law was adopted prior to the date of publication in the Federal Register of the Proposed Rule), recovery would be considered impractical. Before concluding that recovery would violate home country law, a foreign private issuer first would need to obtain an opinion of home country counsel, acceptable to the applicable national securities exchange or association, that recovery would result in such a violation.

A compensation committee's determination that recovery of excess incentive-based compensation would be impracticable would be subject to review by the applicable securities exchange.

Means of Recovery of Excess Incentive Compensation.

Under the Proposed Rule, a public company would have the discretion with regard to the means of recovering excess incentive compensation from an Executive Officer. For example, it appears that a company would be able to recover excess incentive compensation through the cancellation or forfeiture of amount otherwise payable to the affected Executive Officer. Regardless of the means of recovery, the Proposed Rule would require companies to recover excess incentive compensation "reasonably promptly." Whether a company has made a reasonable recovery effort would be the responsibility of the applicable securities exchange. In making this assessment, the securities exchange would need to determine whether a listed company was making a good faith effort to promptly pursue recovery.

Disclosure Requirements.

Under the Proposed Rule, a public company would be required to make the following disclosures:

- **Disclosure of Clawback Policy**. A company's clawback policy would be filed as an exhibit to its annual report on Form 10-K.

- **Disclosure of Excess Incentive-Based Compensation and Recovery Efforts**. If at any time during its last completed fiscal year either the company recovered excess incentive compensation from an Executive Officer or there was an outstanding balance of excess incentive-based compensation due from an Executive Officer, the company would be required to make the following proxy disclosures:

  — For each restatement, the date on which the listed company was required to prepare an accounting restatement, the aggregate dollar amount of excess incentive-based compensation attributable to such accounting restatement and the aggregate dollar amount of excess incentive-based compensation that remains outstanding at the end of its last completed fiscal year;

  — The estimates used to determine the excess incentive-based compensation attributable to such accounting restatement, if the financial reporting measure related to a stock price or total shareholder return metric;

  — The name of each person subject to recovery of excess incentive-based compensation attributable to an accounting restatement, if any, from whom the listed company decided during the last completed fiscal year not to pursue recovery, the amount forgone for each such person, and a brief description of the reason the listed issuer decided in each case not to pursue recovery; and

  — The name of, and amount due from, each person from whom, at the end of its last completed fiscal year, excess incentive-based compensation had been outstanding for 180 days or longer since the date the issuer determined the amount the person owed.

  A company would have the discretion to include the foregoing disclosures as a free-standing section in its proxy or to include the disclosures in its Compensation Discussion and Analysis.

- **Modification of Summary Compensation Table Disclosure**. If a company recovers excess incentive compensation from an Executive Officer, the company would be required to reduce the amount reported in the applicable column of it Summary Compensation Table for the fiscal year in which the amount recovered initially was reported, and be identified by footnote. In addition, if a company recovers excess incentive compensation from an Executive Officer, presumably, the company would also reduce the amount reported pursuant to the pay-versus-performance disclosure, as contemplated by the SEC's proposed rule dated April 29, 2015.

Executive Officer May Not Be Indemnified.

The Proposed Rule would prohibit a company from indemnifying any Executive Officer or former Executive Officer against the loss of erroneously awarded compensation. In addition, the Proposed Rule would prohibit an issuer from paying or reimbursing an Executive Officer for premiums paid by the Executive Officer for coverage under a third-party insurance policy to fund potential recovery obligations.

Comment Period and Effective Date.

Set forth below are key dates with regard to the Proposed Rule's comment period through the effective date of the final rule on the mandatory clawback policy:

Date	Action
60 days after the date the Proposed Rule is published in the Federal Register	End of comment period
2015/2016	SEC adopts final rule and establishes Effective Date
90 days after final rules are published in the Federal Register	Latest date by which Securities Exchanges must file proposed changes to their listing standards with the SEC
Uncertain	SEC approves proposed changes to listing standards
1 year after final rules are published in the Federal Register	Latest date by which changes to the listing standards may be effective
60 days after the effective date of the listing standards	Latest date by which listed companies must adopt mandatory recoupment policy
Date on which a listed company files its first Form 10-K on or after the effective date of listing standard	Disclosure of mandatory recoupment policy as exhibit to Form 10-K

Application of Proposed Rule on or after the Effective Date.

The Proposed Rule would apply to incentive-based compensation when both of the following conditions are present:

- The incentive-based compensation was paid due to the attainment of a financial reporting measure based on or derived from financial information for any fiscal period ending on or after the Effective Date and
- The incentive-based compensation was granted, earned or vested on or after the Effective Date.

This application of the Proposed Rule could result in the clawback of excess incentive-based compensation that relates to a multiyear award granted prior to the Effective Date but that is earned and vested after the Effective Date. For example, if the Effective Date is December 1, 2016, the Proposed Rule would apply to a performance share award granted on January 1, 2014 that is earned based on the achievement of a three-year financial metric through December 31, 2016 (i.e., compounded average revenue growth rate).

Securities Exchanges Directed to Adopt New Listing Standards.

Once a final rule has been issued by the SEC, the Commission will direct the Securities Exchanges to adopt new listing standards that would require each listed company to establish and implement a mandatory clawback policy compliant with Dodd-Frank and the SEC rule and to comply with the applicable disclosure requirements. A listed company that fails to do so would be subject to delisting.

Meridian comment. The Proposed Rule presents a mixed bag. On the plus side, time-vested stock options and time-vested restricted shares and RSUs would not be covered under the Proposed Rule. On the more questionable side is the SEC's surprise definition of "financial performance measures" to include a company's stock price and total shareholder return (TSR).

Dodd-Frank defines excess incentive-based compensation as "the amount by which incentive compensation previously paid to the Executive Officer exceeds what would have been paid to the Executive Officer under the restated financial statements." This statutory provision appears to limit the scope of the mandatory clawback policy to incentive-based compensation that is linked to the achievement of specific financial metrics. Nothing in the legislative history of Dodd-Frank suggests a different interpretation of this provision. Nonetheless, the SEC has broadly interpreted the provision to also mean incentive compensation linked to the achievement of company stock price or TSR. We believe that this is an overly expansive interpretation by the SEC and will likely be subject to significant comments and challenges.

As consequence of the SEC's broad interpretation of incentive-based compensation, the determination of excess incentive-based compensation for awards subject to company stock price or TSR would be a very challenging exercise, resulting in multiple estimation techniques being developed. The Proposed Rule would require a company to "estimate" the impact of an accounting restatement on its share price. No universally recognized method exists for making such a determination. Nonetheless, the SEC would require companies to claw back excess incentive-based compensation based on this purely hypothetical estimate of share price. One thing is certain, clawbacks based on an estimated share price will give rise to lawsuits claiming that the methodology used to determine share price either overstated or understated the impact of the restatement.

Finally, the potential retroactive application the Proposed Rule to already granted compensatory awards could result in the recoupment of compensation in violation of the terms of such award under an existing award agreement or employment contract. The SEC dismisses this potential issue by asserting that a company may unilaterally amend existing awards without an award holder's consent "to accommodate recovery." Despite this assertion, the potential retroactive application of the Proposed Rule to existing awards could result in an Executive Officer (particularly a former Executive Officer) challenging a company's recovery attempt in court.

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