BURNS & LEVINSON LLP

SECURITIES LAW

UPDATE

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SEC PROPOSES "CLAWBACK" RULES FOR INCENTIVE-BASED EXECUTIVE COMPENSATION

On July 1, the Securities and Exchange Commission ("SEC") proposed new rules that would direct securities exchanges to establish listing standards requiring listed issuers to adopt so-called "clawback" policies relating to incentive-based payments to executives.

Under proposed Rule 10D-1, listed issuers would be required to claw back from current and former executive officers any incentive-based compensation tied to accounting-related metrics, stock price or shareholder return they earned based on erroneous financial statements that later required restatement and correction. The look-back period would be three fiscal years.

New listing standards for national exchanges would compel delisting of issuers that do not:

- Adopt compensation recovery policies that comply with listing standards.
- Disclose their policies and enforcement actions in accord with SEC rules.
- Comply with their adopted recovery policies.

SEC Chair Mary Jo White stated that "the proposed rules would result in increased accountability and greater focus on the quality of financial reporting."

The SEC issued the proposed rules for public comment as required by the Dodd-Frank Act which we previously summarized in our July 2010 Securities Law Update: **"Summary of Corporate Governance Changes in the Dodd-Frank U.S. Financial Regulatory Reform Act."**

This update provides an overview of the proposed changes and some of the supporting rationale. For a more detailed examination of the rule proposals, see the 198-page **SEC Release no. 33-9861; 34-75342**. Comments on the SEC proposals must be received on or before September 14, 2015.

ISSUERS AND SECURITIES WHO ARE SUBJECT TO THE NEW RULES

The new rules would require national securities exchanges and associations to adopt clawback disclosure and recovery policy requirements for all listed issuers with few limited exceptions (for example, registered management investment companies that do not pay incentive compensation to executives).

However, emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies, which are often exempt from (or benefit

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from delayed implementation of) new SEC rulemaking, would not be exempt from clawback compliance.

FINANCIAL RESTATEMENTS THAT TRIGGER RECOVERY REQUIREMENTS

New listing standards would mandate clawbacks in the event that an issuer "is required to prepare an accounting restatement due to the material non-compliance of the issuer with any financial reporting requirement under the securities laws."

The following changes to an issuer's financial statements are examples of material error corrections that would trigger clawbacks:

- Retrospective application of a change in an accounting principle.
- Retrospective revisions to segment data due to changes in the issuer's structure.
- Retrospective reclassification due to discontinued operation.
- Retrospective application of a change in reporting entity;
- Retrospective changes to provisional data related to prior business combinations.
- Retrospective revision for stock splits.

The SEC cautioned that other clawback triggers may exist based on each case. In addition, issuers should consider whether a series of immaterial errors might be material in the aggregate, thus triggering restatement requirements.

REQUIRED DATES FOR RESTATEMENTS

The date on which an issuer would be required to prepare an accounting restatement is the earlier of:

- The date the issuer's board, applicable committee or authorized officers concludes or reasonably should have concluded that the previously issued financial statements contain a material error or errors.
- The date a court, regulator or other legally authorized body directs the issuer to restate its previously issued financial statements to correct an error or errors.

EXECUTIVES SUBJECT TO RECOVERY POLICIES

Section 10D of the Securities Exchange Act of 1934 ("Exchange Act"), does not define "executive officers." The SEC concluded that the law's recovery policy was intended to apply to all executive officers of an issuer. The SEC therefore chose to use the broad definition of "executive officer" under Section 16 of the Exchange Act, which includes an issuer's: president, principal financial officer, principal accounting officer, any vice-president of the issuer in charge of a principal business unit, division or function, any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the issuer.

CLAWBACKS OF INCENTIVE-BASED COMPENSATION

The SEC chose to define "incentive-based compensation" in a principles-based manner as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure." In doing so, the SEC did not want to limit the types of compensation that would be covered, including "new forms of compensation and new measures of performance upon which compensation is based are developed."

Examples of financial reporting measures would include, but not be limited to:

- Revenues, sales per square foot, same store sales and other sales measures.
- Net income or operating income.
- Financial ratios.
- Net assets or net asset value per share.
- Earnings before interest, taxes, depreciation and amortization.
- Liquidity, earnings and returns measures.
- Any financial reporting measures relative to a peer group.
- Stock price and total shareholder return, to the extent that they are influenced by erroneous financial statements.

Forms of compensation that would be subject to applicable recovery policies include:

- Non-equity incentive plan awards based on financial reporting measures.
- Bonuses paid from a bonus pool related to financial reporting measures.
- Restricted stock, stock options, and stock appreciation rights that are granted or become vested at least in part based on financial reporting measures.
- Proceeds from the sale of shares acquired through an incentive plan that was based in whole or in part on satisfaction of certain financial reporting measures.

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Compensation that would not be incentive-based compensation would include:

- Salaries.
- Bonuses paid solely at the discretion of the board or compensation committee, which are not paid from a pool dependent upon attainment of financial reporting goals.
- Bonuses paid solely upon subjective standards such as demonstrated leadership.
- Non-equity incentive awards earned solely upon satisfying strategic or operational measures such as store openings or project completions.

Since compensation decisions and awards are generally made on a fiscal year basis, the three-year look-back period for an applicable recovery policy would consist of the three completed fiscal years immediately preceding the date an issuer is required to prepare an accounting restatement.

RECOVERY PROCESS AND RECOVERABLE AMOUNTS

The proposed rules define the recoverable amount of executive compensation in the event of a restatement as "the amount of incentive-based compensation received by the executive officer or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement."

For incentive-based compensation based on stock price or total shareholder return, the recoverable amount may be determined based on "a reasonable estimate of the effect of the accounting restatement on the applicable measure." An affected issuer would need to determine what the stock price would have been on the relevant date "but for" the release of erroneous financial information.

The recoverable amount for equity awards would be the amount received in excess of the number that should have been received based on the restated financial reporting measure.

There are circumstances in which pursuit of excess incentive-based compensation may not be in the interest of shareholders. Proposed Rule 10D-1 would provide that an issuer must recover erroneously awarded compensation "except to the extent that pursuit of recovery would be impracticable because it would impose undue costs on the issuer or its shareholders or would violate home country law," provided that the home country law was adopted prior to the date of publication.

The extent to which an executive officer was not responsible for the financial statement errors, however, is not a legitimate factor for the issuer to consider in determining not to pursue recovery.

To prevent potential conflicts of interest, only the issuer's committee of independent directors responsible for compensation decisions should make any determination that recovery is impracticable. In the absence of such a committee, a majority of independent directors should make the decision.

Issuers would be able to exercise some discretion in how to accomplish recovery, provided that recovery is reasonably prompt. This will provide flexibility in dealing with deferred compensation or compensation already granted, but difficult to pay back all at once. Thus, a reasonable recovery from future pay or from forfeiture of current rights to unvested equity might be permitted under the right conditions.

RECOVERY POLICY COMPLIANCE

An issuer would be subject to delisting if it does not adopt and comply with its own compensation recovery policy. According to the SEC, failure to make good faith efforts at prompt recovery could constitute non-compliance.

REQUIRED DISCLOSURES FOR RECOVERY POLICIES

Listed issuers would need to disclose their recovery policies, and append them as exhibits to annual reports on Form 10-K.

Issuers would also be required to provide, among other things, the following information in Item 402 disclosure:

- For each restatement, the date the issuer was required to prepare the restatement, the aggregate dollar amount of excess incentive-based compensation attributable to the restatement and the dollar amount of excess compensation that remains outstanding at the close of the last fiscal year.
- The estimates used to determine excess compensation attributable to the accounting restatement if stock price or shareholder return metrics were tied to compensation.
- The name of each executive subject to recovery from whom the issuer decided not to pursue recovery, the amount foregone for each person and a brief rationale for each decision.
- A list of activities to recover excess compensation during the last fiscal year.

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A new instruction to the Summary Compensation Table would also require that any amounts recovered pursuant to an issuer's recovery policy would reduce the amount reported in the applicable column for the relevant fiscal year with appropriate footnote identification.

INDEMNIFICATION AND INSURANCE

Rule 10D-1, as proposed, would prohibit a listed issuer from indemnifying any executive officer or former officer against the loss of erroneously awarded compensation, or an issuer from paying for an insurance policy purchased by an executive.

TRANSITION AND TIMING ISSUES

The listing rules applicable to exchanges would have to be filed with the SEC no later than 90 days following publication of the final adopted version of the rule changes. The listing rules would have to go into effect no later than one year following that publication date.

Each listed issuer would also have to adopt the applicable required compensation recovery policies not later than 60 days following the date on which the rules become effective.

EXPLANATORY NOTES:

This update is intended to call your attention to various statements by the SEC of possible interest and relevance to you, but it is not intended to constitute a legal opinion or definitive summary of all interpretations and legal information that could be material to you. Please contact a member of the Securities Law Group at Burns & Levinson if you have any questions about these interpretive statements or if you want to learn more about our expertise in this area.

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