Client Alert

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SEC Proposes Rules to Direct Exchanges to Require Compensation Recovery Policies

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Nearly five years after the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") was enacted in July 2010, the SEC approved proposed rules required under Section 954 of the Act. Section 954 of the Act added Section 10D to the Securities Exchange Act of 1934 (the "Exchange Act"), which directs the SEC to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with Section 10D's requirements, which require that each issuer develop and implement a policy providing (1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and (2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement. The deadline for comments on the proposed compensation recovery rules is September 14, 2015.

OPERATION OF THE PROPOSED RULES

The proposed rules would require national securities exchanges and associations to establish listing standards that would require listed issuers to adopt and comply with a compensation recovery policy in which the recovery of incentive-based compensation would be required from both current and former executive officers who received incentive-based compensation during the three fiscal years preceding the date on which the issuer is required to prepare an accounting restatement to correct a material error. In this regard, issuers would be required to recover the amount of incentive-based compensation received by an executive officer that exceeds the amount the executive officer would have received had the incentive-based compensation been determined based on the accounting restatement. In these situations, the recovery would be required without regard to whether any misconduct occurred, or the executive officer's responsibility for the error in the financial statements. Notably, issuers would have discretion not to recover the excess incentive-based compensation received by executive officers if the direct expense of enforcing recovery would exceed the amount to be recovered. With respect to foreign private issuers, discretion is permitted in specified circumstances where recovery would violate home country law. Under the proposed rules, an issuer would be subject to delisting if it does not (1) adopt a compensation recovery policy that complies with the applicable listing standard, (2) disclose the policy in accordance with SEC rules, or (3) comply with the policy's recovery provisions.

Restatements Triggering Application of Compensation Recovery Policy

The proposed rules would require recovery policies "in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws." Specifically, under proposed Rule 10D-1 and the applicable listing standards to be adopted, issuers would need to adopt and comply with a compensation recovery policy providing that, in the event the issuer is required to prepare a restatement to correct an error that is material to previously issued financial statements, the obligation to prepare the restatement would trigger application of the recovery policy. Other than the requirement that an accounting error be "material," the SEC did not describe any particular type of error that would definitively be considered material for purposes of proposed Rule 10D-1. The SEC notes in the proposing release that a series of immaterial corrections, whether or not they resulted in filing amendments to previously filed financial statements, could be considered a material error when viewed in the aggregate.

Consistent with accounting standards, the following types of changes to an issuer's financial statements would not represent corrections in connection with error(s), and therefore would not trigger application of the issuer's compensation recovery policy:

- 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 adjustments to provisional amounts in connection with a prior business combination; or
- retrospective revision for stock splits.

Executives Subject to a Compensation Recovery Policy

The proposed rules would include a definition of an "executive officer" that is modeled on the definition of "officer" under Section 16 under the Exchange Act. The definition includes an issuer's president, principal financial officer, principal accounting officer (or, if there is no such officer, the controller), any vice-president in charge of a principal business unit, division or function, and any other person who performs policy-making functions for the issuer. Executive officers of the issuer's parents or subsidiaries could also be deemed executive officers of the issuer, if they perform policy-making functions for the issuer.

Section 10D calls for the compensation recovery policy to apply to "any current or former executive officer of the issuer who received incentive-based compensation [during the three-year look-back period]." Accordingly, the proposed rules would require recovery of excess incentive-based compensation received by an individual who served as an executive officer of the issuer at any time during the performance period for that incentive-based compensation. This would include incentive-based compensation derived from an award authorized before the

individual becomes an executive officer, as well as inducement awards granted in a new hire situation, as long as the individual served as an executive officer of the issuer at any time during the award's performance period.

Incentive-Based Compensation Subject to a Compensation Recovery Policy

Under the proposed rules, incentive-based compensation that is granted, earned or vested based wholly or in part on the attainment of any financial reporting measure would be subject to recovery.

The proposed rules do not identify each type or form of compensation to which a compensation recovery policy required under the listing standards would apply. This principles-based manner of defining incentive-based compensation is intended to enable the rule and rule amendments to operate effectively as new forms of compensation and new measures of performance, upon which compensation is based, are developed.

"Financial reporting measures," the attainment of which would be used to determine the amount of incentive-based compensation, are those based on the accounting principles used in preparing an issuer's financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return. Examples of financial reporting measures would include, but are not limited to, the following accounting-based measures: revenue, net income, operating income, profitability of one or more segments, financial ratios, net assets or net asset value per share, EBITDA, funds (and adjusted funds) from operations, liquidity measures, return measures, earnings measures, sales per square foot or same store sales, revenue per user, cost per employee, any of such financial reporting measures relative to a peer group, and tax basis income.

In addition to measures that are derived from the financial statements, the proposed definition of financial reporting measures would include performance measures based on stock price or total shareholder return. The SEC acknowledged in the proposing release that it sometimes may be difficult to establish the relationship between an accounting error and the stock price. Accordingly, the proposed rules indicate that the issuer would be permitted to use reasonable estimates when determining the impact of a restatement on stock price and total shareholder return, and would be required to disclose those estimates.

Examples of compensation that would not be "incentive-based compensation" for purposes of the proposed rules would include, but 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., 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.

When Incentive-Based Compensation is "Received"

Under the proposed rules, incentive-based compensation would be deemed received for purposes of triggering the recovery policy under Section 10D 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.

For awards subject to multiple conditions, the proposed rules note that an executive officer would have "received" the compensation for purposes of triggering the compensation recovery policy when the relevant financial reporting measure performance goal is attached, even if the executive officer has established only a contingent right to payment at that time.

Issuer Must Have a Class of Securities Listed on an Exchange or an Association

An award of incentive-based compensation granted to an executive officer before the issuer lists a class of securities would be subject to the compensation recovery policy as long as the incentive-based compensation was received by the executive officer when the issuer had a class of listed securities. Incentive-based compensation received by an executive officer before the issuer's securities become listed would not be subject to the compensation recovery policy under the proposed rules.

Under the proposed rules, an exchange would not be permitted to list an issuer that it has delisted or that has been delisted from another exchange for failing to comply with its compensation recovery policy until the issuer comes into compliance with that policy.

Time Period Covered by the Compensation Recovery Policy

Under the proposed rules, the three-year look-back period for the compensation recovery policy required by the listing standards would be the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement.

The proposed rules state that such three-year period for recovery of compensation would be triggered by the occurrence of certain issuer or third-party determinations about the need for a restatement, such as a determination from the issuer's board of directors, a committee of the board of directors, or the officer or officers of the issuer 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 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.

If an issuer has changed its fiscal year during the three-year look-back period, the proposed rules would require that the issuer recover any excess incentive-based compensation received during the "transition period" occurring during, or immediately following, that three-year period in addition to any excess incentive-based compensation

received during the three-year look-back period (*i.e.*, a total of four periods). A "transition period" refers to the period between the closing date of the issuer's previous fiscal year end and the opening date of its new fiscal year.

Determination of Excess Compensation

Section 10D requires exchanges and associations to adopt listing standards that require issuers to adopt and comply with recovery policies that apply to the amount of incentive-based compensation received "in excess of what would have been paid to the executive officer under the accounting restatement." Under the proposed rules, an issuer would first recalculate the applicable financial reporting measure and the amount of incentive-based compensation based thereon. The issuer would then determine whether, based on that financial reporting measure as calculated relying on the original financial statements and taking into account any discretion that the compensation committee had applied to reduce the amount originally received, the executive officer received a greater amount of incentive-based compensation than would have been received applying the recalculated financial reporting measure.

Where incentive-based compensation is based only in part on the achievement of a financial reporting measure performance goal, the issuer first would determine the portion of the original incentive-based compensation based on or derived from the financial reporting measure that was restated. The issuer would then need to recalculate the affected portion based on the financial reporting measure as restated, and recover the difference between the greater amount based on the original financial statements and the lesser amount that would have been received based on the restatement.

For incentive-based compensation that is based on stock price or total shareholder return, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the recoverable amount would be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. For these measures, the issuer would be required to maintain documentation of the determination of that reasonable estimate and provide such documentation to the relevant exchange or association.

Discretion Regarding Recovery of Compensation

Section 10D provides that "the issuer will recover" incentive-based compensation, and does not address whether there are circumstances in which an issuer's board of directors may exercise discretion not to recover.

In the proposing release, the SEC noted that allowing discretion whether to recover excess incentive-based compensation could undermine the purpose of Section 10D by permitting an issuer's board of directors to determine that an executive officer may retain incentive-based compensation to which he or she is not entitled. However, the SEC also acknowledged that there are circumstances in which pursuing recovery of excess incentive-based compensation may not be in the best interests of shareholders. To this end, the proposed rules would provide that an issuer must recover erroneously awarded compensation in compliance with its compensation recovery policy, except to the extent that pursuit of recovery would be impracticable because it would impose undue costs on the issuer or its shareholders (i.e., because the direct costs of enforcing recovery

would exceed the recoverable amounts) or, in the case of foreign private issuers, would violate home country law and certain conditions are met.

Any determination that recovery would be impracticable would need to be made by the issuer's committee of independent directors that is responsible for executive compensation decisions, or, in the absence therefore, the determination would need to be made by a majority of the independent directors serving on the board. Such a determination would be subject to review by the listing exchange.

Compliance with Compensation Recovery Policy

Under the proposed rules, an issuer would be subject to delisting if it does not adopt and comply with its compensation recovery policy. The proposed rules do not specify the time by which the issuer must complete the recovery of excess incentive-based compensation; rather, the exchange would determine whether the steps an issuer is taking constitute compliance with its compensation recovery policy.

Disclosure of Issuer Policy on Incentive-Based Compensation

The proposed rules would amend Item 601(b) of Regulation S-K to require that an issuer with a class of securities listed on an exchange must file its compensation recovery policy as an exhibit to its annual report on Form 10-K. Item 402 of Regulation S-K would also be amended to require that if at any time during its last completed fiscal year either a restatement that required recovery of excess incentive-based compensation pursuant to the issuer's compensation recovery policy was completed, or there was an outstanding balance of excess incentive-based compensation from the application of that policy to a prior restatement, the issuer would be required to provide the following information—as set forth in proposed Item 402(w)—in its Item 402 disclosure to show the issuer's activity to recover excess incentive-based compensation during its last completed fiscal year:

- For each restatement, the date on which the issuer 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 issuer 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.

The proposed disclosure would apply to any current or former executive officer to recovery, rather than only the "named executive officers" whose compensation is subject to discussion in the Compensation Discussion and Analysis (the "CD&A") mandated by Item 402 of Regulation S-K. The SEC notes that if the listed issuer is required to provide CD&A under Item 402 of Regulation S-K, however, the listed issuer could choose to include the disclosure required by proposed Item 402(w) in its CD&A discussion of its recovery policies and decisions pursuant to Item 402(b)(2)(viii) of Regulation S-K.

The proposed rules would provide a new instruction to the Summary Compensation Table to require that any amounts recovered pursuant to a listed issuer'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. The Summary Compensation Table "total" column would be revised in the same manner.

In addition to providing the exhibit and, if necessary, narrative disclosure contemplated by the proposed rules, issuers would also be required to tag the disclosure in an interactive data format using eXtensible Business Reporting Language, or XBRL. This requirement generally would apply to all issuers, with no phase-in period for smaller reporting companies.

Foreign private issuers would be required to provide the same information called for by proposed Item 402(w) in, and to file their compensation recovery policies as an exhibit to, the annual reports they file with the SEC on Form 20-F, Form 10-K and Form 40-F, as applicable.

Effect of Indemnification and Insurance

State indemnification statutes, indemnification provisions in an issuer's charter, bylaws, or general corporate policy and coverage under D&O liability insurance provisions may protect executive officers from personal liability for costs incurred in a successful defense against a claim or lawsuit resulting from the executive officer's service to the issuer. In the proposing release, the SEC made clear that indemnification arrangements may not be used to avoid or nullify the recovery required by Section 10D.

Covered Issuers

The proposed rules would apply to all listed issuers except for certain registered investment companies. The SEC also proposed to exempt security futures products and standardized options from the proposed listing standards.

Transition Period

The proposed rules would require that the exchanges file their proposed listing rules no later than 90 days following the publication of the adopted version of Rule 10D-1 in the *Federal Register*. The proposal also requires the listing rules to become effective no later than one year following the publication date.

Each issuer would be required to adopt its compensation recovery policy no later than 60 days following the date on which the listing exchange's listing rule becomes effective. The SEC also proposes that each listed issuer be required to recover all erroneously awarded incentive-based compensation received by executive officers and

former executive officers as a result of attainment of a financial reporting measure based on or derived from financial information for any fiscal period ending on or after the effective date of Rule 10D-1 and that is granted, earned or vested on or after the effective date of Rule 10D-1 pursuant to the issuer's compensation recovery policy.

Issuers would be required to provide the new disclosures in proxy or information statements and Exchange Act annual reports filed on or after the effective date of the applicable listing exchange's rule.

DISSENTING VIEWS

At the open meeting at which the proposed rules were considered, Commissioners Gallagher and Piwowar each issued dissenting statements indicating that they did not support—and would not vote in favor of—the proposed rules. Among their concerns with the proposal were: (1) the broad scope of the executive officers subject to the compensation recovery policies contemplated by the proposed rules, including not just the top executives, but "any other officer who performs a policy-making function" and "any other person who performs similar policy-making functions for the issuer;" (2) the strict liability nature of the recovery, which would be required without regard to whether any misconduct occurred or an executive officer's responsibility for the erroneous financial statements; (3) the scope of the required compensation to be clawed back includes compensation based on financial reporting metrics as well as compensation based on share price metrics like total shareholder return; (4) smaller reporting companies are not excluded from the requirements of the proposed rules; and (5) the rulemaking was inappropriately prioritized over other important Dodd-Frank Act rulemakings.

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