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SEC Proposes Rules on Clawback Policies & Other Dodd-Frank Act Executive Compensation Updates

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank" or the "Act") includes a number of measures focused on governance and disclosure practices related to executive compensation. Although several of these measures were implemented relatively quickly (*e.g.*, the "Say-on-Pay" requirements), a number of other measures have been delayed as the Securities and Exchange Commission ("SEC") and other agencies continue to work through their rulemaking backlog. Recently, though, the executive compensation rulemaking process has kicked into a higher gear, with the SEC proposing several rules beginning last fall. In this Alert, we focus on three of these proposals:

- The "Clawback Policy" requirements under §954 of the Act (proposed in July 2015);
- The "Pay-for-Performance Disclosures" under §953(a) of the Act (proposed in April 2015); and
- The "CEO Pay Ratio Disclosures" under §953(b) of the Act (proposed in September 2014).

Click here for a complete update on the rulemaking status as of July 1, 2015 for the Act's executive compensation measures, including the location of proposed and final rules.

Of the three proposed rules listed above, we believe that the proposed rules regarding the adoption of a Clawback Policy will have the most potential impact on companies and their executives. If adopted as proposed, these rules would not only require companies to adopt a new (or revise an existing) clawback policy, but may also cause many companies to reconsider and adjust substantive compensation practices to avoid some of the key challenges associated with the proposed rules. In contrast, the proposed rules regarding Pay-for-Performance Disclosures and CEO Pay Ratio Disclosures, while potentially adding cost and complexity to proxy statement disclosures, are less likely in our view to result in significant changes to substantive compensation practices.

CLAWBACK POLICY

What is a Clawback?

The term "clawback" has become a commonly used, loosely defined term of art in the world of executive compensation. In general, a clawback is the right of a company to recover from an executive previously earned and paid compensation as the result of some triggering event, such as a financial restatement or the executive's breach of an employment policy or covenant. Some companies also more broadly refer to clawbacks as conditions that would allow a reduction in compensation that has not yet vested or that has been held back for a specified deferral period. The Clawback Policy requirements under the Act focus on recovering previously earned incentive compensation in the event of a financial restatement.

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What Purpose Does a Clawback Policy Serve?

There are at least three broad categories of purposes that a clawback policy could potentially serve:

- Limit the Risk of Manipulation. The risk of manipulation occurs when a compensation program encourages individuals to manipulate data used in determining compensation as a way to increase compensation. A clawback policy can mitigate this risk by triggering a right to the clawback if there has been executive misconduct in manipulating financial results. The clawback requirements under §304 of the Sarbanes-Oxley Act of 2002 (which applies to incentives paid to a company's Chief Executive Officer and Chief Financial Officer in case of a financial restatement due to misconduct) illustrate this type of clawback policy.[1]
- Penalize Bad Behaviors. As a condition to an incentive award or other payment of compensation, a company may establish a contractual right with an executive to recover previously paid compensation if the executive engages in certain detrimental conduct unrelated to a financial restatement, such as violation of company policies or breach of employment covenants.
- Prevent Windfalls. The broadest form of clawback policy permits recovery of compensation without regard to misconduct if there is a financial restatement or other change in financial results, and as a result more compensation was paid than would have otherwise been the case had the correct financial results been originally reported. The Act's Clawback Policy requirements fall into this category.

For the first two categories above, the clawback policy is designed to discourage the particular "bad" behavior that triggers the right to the clawback. The third category focuses more on preventing unjust enrichment than creating a disincentive to engage in specific bad behaviors, although this type of "no fault" clawback policy should also broadly reduce the risk of manipulation.

Statutory Requirements Under §954

§954 of the Act added Section 10D to the Securities Exchange Act of 1934, which requires issuers of securities listed on national securities exchanges to adopt a policy that:

- is triggered by a required financial restatement due to "material noncompliance" with any financial reporting requirements under the securities laws; and
- requires recovery from any current or former executive officer of any incentive-based compensation (including stock options) awarded during the three-year period preceding the date that the company is required to prepare the restatement that is in excess of what the executive would have otherwise received absent the reporting error.

Unlike §304 of the Sarbanes-Oxley Act, §954 does not require any misconduct (by the executive or any other person) to trigger the clawback. In this regard, Congress appeared to be focused on preventing a windfall in addition to mitigating the risk of manipulation. Also, unlike most clawback policies currently in effect, §954 does not appear to permit discretion by the board of directors to choose to not pursue the clawback in a particular circumstance.

[1] Although a clawback under §304 of the Sarbanes-Oxley Act requires misconduct, the SEC and certain courts have taken the position that this does not only mean misconduct by the executive, but can also include misconduct by another employee. See, e.g., SEC v. Jenkins, No. CV-09-1510-PHX-GMX, 2010 WL 2347020 (D. Ariz. June 9, 2010).

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Rather, if a triggering financial restatement occurs, it appears that §954 requires an attempt to recover any excess compensation awarded as a result of that restatement. §954 also requires companies to disclose their clawback policy in their public filings. The Act mandated that the SEC implement rules to direct the exchanges to prohibit the listing of securities of issuers that have not developed and implemented compliant clawback policies.

The SEC Proposed Rules

On July 1, 2015, the SEC proposed rules to implement the statutory requirements of §954. The proposed rules require certain specified issuers to adopt, comply with and disclose an incentive compensation recovery policy meeting certain requirements. The policy must require the issuer to seek recovery of any "excess incentive-based compensation" that was "received" by any current or former "executive officer" during the three fiscal years preceding the year in which the issuer is required to prepare an accounting restatement to correct a material error in previously issued financial statements. As with the statutory provisions, the §954 proposed rules reflect a no-fault, "no windfall" approach to the clawback with little room for company discretion. We explore the details and key concepts of the proposed rules below.

The rules, if adopted as proposed, would direct the national securities exchanges to adopt listing rules that would require the covered companies to comply with Section 10D and the newly proposed Rule 10D-1 as a condition to having most securities listed, including common and preferred equity securities and debt securities. There is a 60-day comment period following publication of the proposed rules in the Federal Register, but it is unclear how long it will take the SEC to consider those comments before finalizing its rules. For example, as of the date of this Alert, it has been nearly 10 months since the CEO Pay Ratio Disclosure rules were proposed, and the SEC has not yet finalized them. After the adoption of the final rules, each national securities exchange will then have 90 days to adopt its listing rules. The national securities exchanges may have a delayed effective date for their listing rules so long as it does not to exceed 12 months. Companies will have 60 days to adopt the written clawback policy after the applicable exchange rule becomes effective. Given these rulemaking steps, final exchange rules are likely not to be effective until 2016 at the earliest, and given the significance of the proposal and likelihood of divergent comments, the rules may not become effective until 2017 or later.

Note, however, that important aspects of the Clawback Policy rules may become effective before the final exchange rules take effect. As proposed, the Clawback Policy requirements would apply to incentive-based compensation earned for fiscal years ending on or after adoption of the SEC final rules (even if this will be before the final exchange rules become effective). For example, if the SEC finalizes its rule in 2016 but the final exchange rules do not become effective until 2017 (at which time the companies will need to formally adopt their policies), the policies adopted in 2017 would need to apply to incentive-based compensation that is received in 2016 (and later).

Covered Companies. The proposed rules broadly cover all publicly-listed U.S. companies, regardless of size or type of security that is listed, including smaller reporting companies, emerging growth companies, companies with listed debt that do not have listed equity securities, foreign private issuers and registered management investment companies that have paid incentive-based compensation. As the SEC notes in its discussion, past studies indicate that smaller reporting companies and emerging growth companies are most at risk of having financial restatements triggered by material errors and as a result may be most likely to be impacted by the Clawback Policy requirements.[2]

Covered Executives. The proposed rules require the Clawback Policy to apply to current and former "executive officers," defined as:

- the president;
- the principal financial officer;
- the principal accounting officer (or controller, if there is no principal accounting officer);
- any vice president 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; and
- any other person who performs similar policy-making functions for the company.

This definition mirrors the "officer" definition applicable under Section 16 of the Securities Exchange Act of 1934, and picks up all policy-making individuals plus the principal accounting officer (even if not otherwise a policy-making officer). For an individual who serves as an executive officer for a portion of the period covered by the Clawback Policy (for example, as the result of a promotion or demotion during the period), incentive compensation earned by the individual will be subject to the Clawback Policy if the individual served as an executive officer for any portion of the relevant performance period for that incentive award, even if the individual is no longer an executive officer at the time recovery is sought. In contrast, incentive compensation earned before an individual is promoted to an executive officer position will not be subject to the Clawback Policy.

Triggering Events. Under the proposed rules, the compensation recovery process begins when the company concludes, or reasonably should have concluded, that a financial restatement is required to correct a material error in a previously issued financial statement. The date of this triggering event is important for identifying the applicable three-year look-back period for determining any excess incentive-based compensation to be recovered and related disclosures. There are two important concepts to pull out of this proposed definition.

First, the Clawback Policy triggering event is not the restatement itself, but the determination that a restatement is required.[3] As the SEC notes, this event will generally correspond to the event giving rise to the requirement to file a Form 8-K under Item 4.02(a), although the Clawback Policy triggering event is not dependent on such an 8-K having been filed.[4] There is a twist, however. The proposed rules define the event not simply as the date the company concludes that a restatement is required, but adds that it is the date the company "reasonably should have concluded" that a restatement is required, if earlier. This opens the

[2] See discussion at Section III.B.3 of the SEC release regarding the proposed rules (at http://www.sec.gov/rules/proposed/2015/33-9861.pdf) (the "Release"), including footnote 318. Elsewhere in Section III of the Release, especially at footnotes 262 to 266 and related text, the SEC cites data regarding the number of incidences of financial restatements from 2005 to 2012 based on Form 8-K, Item 4.02(a) disclosures, noting an average of 531 restatements per year, although the numbers were falling through the period.

[3] The proposed rules would also trigger the Clawback Policy as of the date a court, regulator or legally authorized body directs the company to restate a previously issued financial restatement to correct a material error, if such action occurs before the company has concluded that a restatement is required.

[4] Item 4.02(a) of Form 8-K is triggered, and related disclosures are required, if the registrant's board of directors, a committee of the board of directors or the officer or officers of the registrant authorized to take such action if board action is not required, concludes that any previously issued financial statements, covering one or more years or interim periods for which the registrant is required to provide financial statements under Regulation S-X (17 CFR 210) should no longer be relied upon because of an error in such financial statements as addressed in FASB ASC Topic 250, Accounting Changes and Error Corrections, as may be modified, supplemented or succeeded.

door to potential derivative suits or enforcement actions alleging the existence of facts demonstrating that a company could have made an earlier restatement determination.

Second, the restatement must result from a "material error" in a prior financial statement. The proposed rules do not provide guidance on the meaning of "material" for this purpose, other than the SEC noting that materiality determinations will depend on facts and circumstances and should be informed by the existing body of case law on the topic, which the SEC describes as "extensive and comprehensive." The SEC identifies certain limited restatement events that would not be considered the result of an "error," such as the retrospective application of a change in accounting principles or retrospective revision of reportable segment information due to a change in the company's organization or internal structure. The SEC also cautioned, however, that "a series of immaterial error 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."

Covered Incentive-Based Compensation. If a triggering event occurs, the Clawback Policy must apply to any "incentive-based compensation" that a current or former executive officer "received" during any of the three fiscal years preceding the year of the applicable triggering event.

"Incentive-based compensation" includes any compensation that is granted, earned or vested based wholly or in part on attainment of a financial reporting measure, including stock price or total stockholder return (TSR). This definition takes an expansive view of the compensation covered by the Clawback Policy and potentially picks up a wide array of common executive compensation arrangements. The following summarizes common arrangements that would be included as incentive-based compensation under the proposed rules, and other arrangements that would likely not be covered:

Covered Arrangements	Arrangements Not Covered
• annual cash bonuses, to the extent based on financial measure results; • time-vesting stock options or restricted stock units, if the grant of the award was based on achievement of a financial measure -- a relatively common practice used to qualify time-vesting awards as "performance-based compensation" under Internal Revenue Code §162(m); • long-term cash incentive awards that are earned based on financial performance results over a multi-year performance period; and • performance-vesting equity awards, such as "performance restricted stock units" (PRSUs), that become earned based on financial performance results over a multi-year performance period.	• salary (although a salary increase specifically triggered by attainment of a financial result may be considered incentive-based compensation under the proposed rules); • bonuses paid "solely at the discretion" of the company (and not from a bonus pool based in whole or in part on financial performance results); • bonuses paid "solely" on achievement of subjective standards or continued employment (such as a retention bonus); • awards that vest "solely" on satisfying one or more strategic or operational measures (*i.e.*, measures that would not be based on a financial measure that would be changed as the result of a financial restatement, such as store openings or obtaining regulatory approval for a product); and • time-vesting equity awards where the grant is not based to any extent on achievement of any financial goals.

By referencing awards that are earned "in part" by attainment of a financial measure and by applying both to bonus pools as well as individual bonus determinations, the proposed rules may broadly apply to many common types of annual bonus programs. For example, a number of companies disclose an annual bonus process where the executive officer has a

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target bonus opportunity (usually expressed as a percentage of salary) and a range of possible payouts (such as 50% to 200% of target), where the final payout within the range is based on both a business performance factor and an individual performance factor. Under such a design, the portion of the award based on business performance may be at risk under the Clawback Policy. Similarly, if a company has a bonus pool that is formulaically based on financial results, but then provides for discretionary individual allocations from the pool based on subjective determinations about performance, the Clawback Policy will require that the bonus pool be re-determined in case of a triggering event, and if the re-determined pool is less than the total individual awards actually paid, the individual awards will need to be proportionately reduced.

This broad definition may also apply to so-called “umbrella plans” under Internal Revenue Code §162(m), in which a maximum bonus amount is formulaically derived from a financial performance result, with actual bonuses based on other, more subjective factors and awarded based on an exercise of “negative discretion” below the formulaic maximum. A restatement that causes the formulaic maximum to be reduced under the umbrella plan may result in the individual awards being required to be reduced depending on how much “negative discretion” was applied. It is unclear under the proposed rules, however, how the Clawback Policy must be applied if the exercise of “negative discretion” under the umbrella plan is based in part on financial performance considerations. For example, companies may have a “plan within a plan,” under which the actual annual bonus is determined based in part on a review of specified financial results, subject to subjective adjustments, with the final bonus amount required to be less than the “umbrella plan” formulaic maximum. Depending on the design of that “plan within a plan,” the determination of the individual bonus amount may itself be subject to adjustment under the Clawback Policy in case of a triggering event, even if the re-determined “umbrella plan” formulaic maximum bonus was not exceeded.

The definition of the applicable financial reporting measure upon which the incentive-based compensation is determined is potentially quite broad in several respects. The SEC states that the measures are not only financial measures determined and presented within the financial statements, but also measures <u>derived</u> wholly or <u>in part</u> from those measures, regardless of whether such derived measures are actually presented within the financial statements. As a result, the proposed rules would apply to various financial ratios, return measures and non-GAAP measures such as EBITDA. Many companies use measures that are adjusted for compensation purposes for unusual, non-recurring or un-budgeted events, and these adjusted results would also appear to be covered.

Perhaps even more troubling and expansive, the proposed rules would include stock price and TSR as categories of financial reporting measures that would need to be re-determined in case of a triggering event. It appears that the proposed rules include stock price and TSR for this purpose only if such measures are used as a basis for an award to be granted or earned, and not simply because stock price impacts the value of a time-vesting stock option of restricted stock unit. Where companies use TSR performance (typically relative to a peer group) as a component for vesting PRSUs, such awards are within scope of the Clawback Policy under the proposed rules. We discuss further in the next section some of the challenges this presents in determining the amount of excess incentive-based compensation to be recovered.

The proposed rules contemplate that incentive-based compensation is “received” when all of the relevant financial performance has occurred. For annual cash bonuses, this will usually

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be as of the end of the applicable performance year even though the award is not actually paid until the following year. This concept may prove trickier for equity awards. For example, PRSUs often have a time-vesting component requiring continued service after the performance period. For purposes of the Clawback Policy, such awards are considered "received" as of the end of the performance period, not as of the later vesting dates. For an equity award granted based on performance, the award will be considered "received" as of the end of the performance year even if the grant date is in the following year (similar to an annual cash bonus).

Calculating and Recovering Excess Incentive-Based Compensation. If a triggering event occurs, the company must re-determine any incentive-based compensation that was received by current or former executive officers during the three fiscal years preceding the year of the triggering event based on the restated financial results. This is a form of "but for" test -- that is, the re-determined incentive-based compensation is the amount that the executive officer would have received "but for" the erroneous financial results. No executive misconduct or error in judgment is required as part of this analysis, reflecting the "no fault" approach under the statutory language. This means, for example, that compensation recovery may be triggered as the result of good faith errors in judgment in applying accounting principles.[5]

For example, if a company determines in November 2020 that a financial restatement is required because of a material error in the 2019 financial statements, the company must review the incentive-based compensation received by executive officers in each of 2017, 2018 and 2019. In this example, if the financial reporting error is limited to 2019, it is unlikely that the awards received in 2017 and 2018 would be impacted. The company would need to determine whether incentive-based compensation received by executive officers in 2019 would have been less if determined based on the restated financial results.

If the individual received more incentive-based compensation than he or she would have otherwise received based on the restated results -- referred to as "excess incentive-based compensation" -- such excess amounts must be promptly recovered by the company. The proposed rules significantly limit any company discretion regarding the recovery process. The SEC permits only two reasons not to fully pursue recovery:

- if the "direct costs" of pursuing recovery would exceed the recoverable amount, or
- if recovery would violate home country law.

Determinations not to pursue recovery within these limited exceptions must be made by the independent compensation committee, and if based on home country law, must be supported by a written legal opinion of home country counsel which counsel must not be unacceptable to the applicable exchange. Before concluding that it would be impracticable to recover any amount based on recovery costs, the company would be required to make a reasonable attempt to recover incentive-based compensation in accordance with its policy. The company would need to document its recovery efforts and provide relevant documentation to the applicable exchange. All such determinations would be subject to review by the applicable exchange.

[5] The SEC observes that this no-fault feature could result in companies re-allocating resources towards their financial reporting function and as a result forgoing other value-creating projects. See discussion at Section III.B.1 of the Release.

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The re-determination process may prove challenging where the amount of incentive-based compensation is based on a combination of financial and non-financial performance. But the most difficult part of this re-determination process under the proposed rules undoubtedly belongs to awards that are granted or earned based on stock price or TSR performance. The proposed rules require companies to make a "reasonable estimate" of the restatement's impact on the stock price or TSR. The proposal suggests a number of possible methods with different levels of complexity upon which such reasonable estimates may be based. If this aspect of the proposed rules survives to the final rules, many companies may consider moving away from TSR-based incentive plans to avoid the potential costs and uncertainty that will result under the Clawback Policy if triggered.

The amount of excess incentive-based compensation to be recovered is calculated on a pre-tax basis. For example, if the excess amount to be recovered from an annual cash bonus is $10,000, the company must require the executive to repay the entire $10,000, even though the executive received only $6,000 of the $10,000 after taxes.[6] The proposed rules include details about the amount to be recovered for equity-based awards, with the amount to be recovered generally expressed as shares, but converted to a cash amount based on sale proceeds if the shares have been previously sold.

Required Disclosures. The proposed rules include several key provisions regarding public disclosures about a company's Clawback Policy.

First, the Clawback Policy itself must be attached as an exhibit to the company's annual report on Form 10-K, Form 20-F, Form 40-F or Form N-CSR, as the case may be. We expect that the written policies for many companies will likely track the language and requirements of the final rules, and therefor this aspect of the disclosure requirements is unlikely to be controversial.

Second, the proposed rules would require disclosure in annual reports and any proxy and consent solicitation materials that require executive compensation disclosure pursuant to Item 402 of Regulation S-K (per a new Item 402(w) under Regulation S-K or, in the case of registered management investment companies, an amendment to Item 22 of Schedule 14A) if, in the last fiscal year, either a triggering event occurred or any uncollected excess incentive-based compensation from a previous year triggering event remained uncollected. The disclosure must include aggregate information about the amount of excess incentive-based compensation related to each restatement, information about estimates used to determine excess incentive-based compensation related to stock price and TSR performance, and name-by-name disclosure as to any executive officers (not just the named executive officers whose compensation is otherwise disclosed in the proxy statement) from whom the company determined not to seek recovery (based on one of the limited permitted reasons to forgo recovery, including a brief description why the company chose to forgo recovery) or for whom a balance remains due that has been outstanding more than 180 days. The proposed rules would require these disclosures to be provided in interactive data format using eXtensible Business Reporting Language and block-text tagging. The company would file the interactive data as an exhibit to its annual report or proxy or information statement, as the case may be.

[6] It may be possible for the executive to claim a tax deduction for the amount repaid for the year of repayment, although this result is not clear. See, *e.g.*, *Nacchio v. United States* No. 1:12-cv-20 (Fed. Cl. Mar. 12, 2014).

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Finally, a new instruction to the Summary Compensation Table would require that any recovered amounts of excess incentive-based compensation reduce the amounts reported in the applicable columns, including the "Total" column, for the fiscal year in which the amount recovered initially was reported based on the erroneous results. The company would identify the recovered amounts by footnote to the Summary Compensation Table.

Indemnification Prohibited. The proposed rules prohibit companies from indemnifying executive officers against any required recoveries. Such prohibition includes a company reimbursing an executive officer for purchase of insurance on an individual basis providing coverage against such recoveries; however, an individual would not be prevented from purchasing such insurance (if available) on their own. In its discussion about the potential costs and benefits of the proposed rules, the SEC noted that a market may develop for such insurance, and companies may ultimately build the cost of such insurance into compensation otherwise paid to its executives, such as through increased salary levels.[7]

UPDATE ON PROPOSED RULES FOR PAY-FOR-PERFORMANCE AND CEO PAY RATIO DISCLOSURES

As of the date of this Alert, the SEC's proposed rules for the Pay-for-Performance Disclosures and CEO Pay Ratio Disclosures have yet to be finalized.

Pay-for-Performance Disclosures

Unlike other principles-based executive compensation disclosure requirements (such as for the Compensation Discussion & Analysis), the proposed rules for the Pay-for-Performance Disclosures are quite prescriptive in nature. The proposed rules would require tabular disclosure showing Summary Compensation Table total compensation, compensation "actually paid" (a new concept introduced by the rules) and company and peer group TSR results for a five-year period. Compensation would be shown separately for the CEO and the average for the other named executive officers. Narrative, and possibly graphic, disclosure would accompany the table to help explain the relationship of compensation actually paid to company performance. A key, and controversial, feature of the proposed rules is this new concept about compensation "actually paid," which for equity awards would be based on a calculated value as of vesting. For option awards, the calculated value would effectively require a vesting date Black-Scholes calculation.

The initial comment period for these proposed rules recently closed. Not surprisingly, a wide range of comments were received, generally falling into two camps. Most issuers, compensation consulting firms and industry groups that commented broadly condemned (i) the prescriptive nature of the proposed rules, (ii) the novel approach to defining compensation "actually paid" in a manner not otherwise customarily used in pay-for-performance analyses, (iii) the inherent lack of intentional connection between a vesting date snapshot value of compensation "actually paid" versus a moving cumulative TSR and (iv) use of TSR as a sole reference point for company performance. Comment letters from organized labor and public pension funds tended to support the proposed rules.

If the final rules are adopted as proposed, we expect most companies will have to spend significant time and effort in developing narrative and graphical proxy statement disclosures to accompany the required table in order to explain why the tabular data is not the most

[7] See discussion at Section III.B.5 of the Release.

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accurate picture of the company's pay-for-performance program. But we think most sophisticated investors would not place much weight on the required tabular data, and we do not expect significant changes in compensation practices. Given that the comment period has just recently closed and the proposal was not without controversy, it is unclear when the rules may be finalized.

CEO Pay Ratio Disclosures

The proposed rules for the CEO Pay Ratio Disclosures require the identification of a company's "median" employee, and a comparison of the total compensation of that employee to the CEO. Under the proposed rules, most companies will need to conduct a statistical sampling of their global workforce to identify their median employee. We think that most sophisticated investors will place little or no value in this disclosure and that it will be used primarily by organized labor, media or other groups in an attempt to "shame" companies over perceived executive compensation excesses. These proposed rules have been pending for a number of months. A recent article reported that the SEC intends to finalize these rules in August 2015,[8] but that timing has not been officially confirmed by the SEC staff.

OBSERVATIONS AND NEXT STEPS

The broad, prescriptive and inflexible nature of the proposed Clawback Policy rules will present a number of challenges if adopted as proposed:

- The requirement that stock price and TSR be considered a financial measure that must be re-determined in case of a restatement will prove very difficult to administer. Many companies will likely feel pressure to move away from using stock price or TSR as a performance measure in awards.
- More clarity will be needed whether awards that are granted based on a subjective review of performance, where the subjective review includes consideration of various financial performance results without formulaic weightings, will be considered to have been granted based "solely" on discretion or whether such awards will be considered "incentive-based compensation" that are within the scope of the Clawback Policy.
- Companies may face a "damned if we do, damned if we don't" dilemma in administering various aspects of the Clawback Policy whenever judgment is required, for example in determining whether a particular restatement is due to a "material" error, determining when the company should "reasonably have concluded" that a restatement is required, or applying "reasonable estimates" regarding stock price or TSR results. Whatever judgments are made, the company may face shareholder derivative lawsuits if the company is perceived to have acted favorably towards executives or lawsuits by the executive over the amount of compensation to be recovered if the company is perceived to have acted unfavorably towards the executive.

Companies should consider taking steps in preparation for Clawback Policy final rules, including:

[8] Michaels, D. (June 18, 2015). SEC Could Make Gabelli Pay New Front in Fight Over Income Divide. *Bloomberg Business*. Retrieved from http://www.bloomberg.com/news/articles/2015-06-18/sec-could-make-gabelli-pay-new-front-in-fight-over-income-divide.

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- Companies that already have a clawback policy should consider reviewing the policy against the requirements in the proposed rules and consider what changes would be required if the proposed rules are adopted without change. In some cases, companies may want to consider preserving certain aspects of their current policies. For example, companies that include a right to recover compensation in case an executive breaches company policies or employment covenants may want to keep those provisions in place. Nothing in the statutory provisions of §954 or the proposed rules would prohibit recovery policies that go beyond the Dodd-Frank requirements.
- Companies will need to carefully review the enforceability of the Clawback Policy in each jurisdiction where executive officers are located. The company's right to enforce the Clawback Policy should be incorporated into incentive plans, award agreements and employment agreements to enhance enforceability. These contractual provisions should also include language protecting the company against claims by the executive for any determinations made by the company under the policy. Some companies may want to consider designs for incentive awards with a forced three-year deferral period and a right to adjust deferrals in case a clawback is triggered.[9]
- Companies may want to review their approach to identifying their policy-making executive officer group and whether the policy-making group should be smaller under the company's particular facts and circumstances.
- Companies should begin to consider how their current annual and long-term incentive compensation plans would likely be categorized under the proposed rules. If any equity-based awards could potentially be "incentive-based compensation" under the proposed rules, the company may want to begin considering with its accounting team whether subjecting the awards to a clawback policy along the lines required by the proposed rules would have any adverse accounting consequences (such as mark-to-market accounting).

Companies should consider whether to comment to the SEC about the Clawback Policy proposed rules, either directly or through a trade or industry group.

In our view, given the significant and disparate comments, it is premature to spend significant time on anticipating the final Pay-for-Performance Disclosure rules. For the CEO Pay Ratio Disclosure rules, some companies have begun to consider how to identify their median employee, but most companies appear to be taking a wait-and-see approach.

We will continue to monitor and update on all of these proposed rules as they develop.

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[9] Care will need to be taken in any such design to ensure compliance with Internal Revenue Code §409A.

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