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To the Point

SEC – proposed rule

SEC proposes requiring 'clawback' policies and disclosures

'Executive officers should not be permitted to retain incentive-based compensation that they should not have received in the first instance.'

– SEC Chair Mary Jo White

What you need to know

- The SEC proposed a rule that would direct national securities exchanges to establish listing standards that would require companies to claw back incentive-based compensation received by current and former executive officers during the three years preceding an accounting restatement.
- Companies would be required to disclose their clawback policies and compensation subject to clawback in exhibits to annual reports and in proxy and information statements.
- The proposal will have a 60-day comment period once it is published in the Federal Register.

Overview

The Securities and Exchange Commission (SEC or Commission) voted 3 to 2 to propose a rule that would direct national securities exchanges to establish listing standards that would require issuers to establish policies to recover incentive-based compensation from current and former executives in the event of a restatement. The so-called clawback rule was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

All listed companies except for certain registered investment companies would be required to disclose their clawback policies and, after a restatement, information about compensation subject to clawback. The scope would include listed companies that are foreign private issuers, smaller reporting companies or emerging growth companies. The policies would apply regardless of whether an executive was at fault, and executive officer would be defined broadly in a manner consistent with Section 16 of the Exchange Act.

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Key considerations

Scope and details of the proposal

The proposed rule would require national securities exchanges and associations to establish listing standards that would require companies to claw back incentive-based compensation an executive or former executive received based on a material error that is corrected in an accounting restatement. A company that doesn't implement a compliant policy after a transition period would be subject to delisting.

Incentive-based compensation

The proposal defines incentive-based compensation as compensation that is "granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure." These would include accounting-related measures reported in the financial statements (e.g., revenue, net income) or derived from the financial statements (e.g., EBITDA). It would also include incentive-based compensation that is based on a company's stock price or total shareholder return (TSR).

The Commission acknowledged that it may be difficult for a company to determine how much compensation to claw back when the measure used to calculate compensation is the company's stock price or TSR. That's because it is not possible to precisely measure how the misstated financial statements affected a company's stock price or TSR. For these reasons, the Commission proposed allowing companies to use reasonable estimates to make that determination. Companies would have to disclose how they arrived at their estimates.

How we see it

Restatements can have different effects on stock prices, depending on their nature, the timing of communications about the error and the magnitude of the restatement. As a result, companies may find it difficult to determine the effects of misstatements on their stock prices or TSR, which could lead to diversity in practice resulting from judgments companies make in estimating the effects.

Clawback polices would not apply to compensation based solely on service-based criteria or satisfying one or more operational measures (e.g., opening 100 new stores).

Definition of executive officer

The proposed rule would create a broad new definition of executive officer and apply to former executives.

The definition, which is similar to the definition in Exchange Act Rule 16a-1(f)), would include a company's president, principal financial officer, principal accounting officer (or controller), those in charge of a business unit, division or function, and those in a policy-making function. This contrasts with narrower definitions in other rules that apply only to the principal executive and financial officers (Sections 302 and 304 of the Sarbanes-Oxley Act of 2002) or principal executives and officers with the highest compensation (Item 402 of Regulation S-K).

How we see it

The proposed definition of executive officers would expose a large group of employees to clawbacks even if they had no responsibility for the accounting restatement. While this may incentivize certain executives who are directly involved in financial reporting to focus more on internal controls, it may cause other executives who are not involved in financial reporting to seek to mitigate their exposure to clawbacks by requesting higher base salaries and less incentive-based compensation, for example.

Time period of clawback

Company policies would have to require clawbacks of excess incentive-based compensation received for a period of up to three fiscal years before a restatement. The look-back period would generally begin on the date a company concludes that its previously issued financial statements can no longer be relied upon rather than the date it issues a restatement. For example, if the board of directors determines (for a calendar year-end company) in May 2016 that a restatement is required, the look-back period would apply to compensation received during 2013, 2014 and 2015, even if the restated financial statements are not issued until 2017.

Other provisions

Companies would not need to determine that executive officers were at fault or directly contributed to the factors leading to a restatement in order to recover compensation from them. Boards would not be allowed to reimburse or indemnify executives for recovered amounts (including through the funding of insurance coverage). Further, boards could not choose to forgo recovery unless the cost of any recovery effort would exceed the recovery amount (i.e., it would be impracticable for the company to recover the compensation) or if recovery would violate home country laws.

The SEC estimated that 4,845 registrants, including 1,082 smaller reporting companies, would be subject to the proposed clawback rules.

The SEC proposed that boards should not use discretion (other than reasonable estimates related to compensation based on share price or TSR) when determining the amounts to be recovered from each executive officer because doing so could undermine the "no-fault" concept. However, boards would have discretion to determine how executives reimburse the company (as long as the recovery is prompt).

Proposed disclosure requirements

A company would be required to describe its clawback policy in an exhibit to its Exchange Act annual report on Form 10-K and in disclosures in proxy and information statements. If during its last completed fiscal year a company either prepared a restatement that required the recovery of excess incentive-based compensation, or had an outstanding balance of excess incentive-based compensation relating to a prior restatement, the company would have to disclose the following:

- For each restatement, the date on which the company was required to prepare an accounting restatement, the total amount of excess incentive-based compensation attributable to the restatement and the total amount of excess incentive-based compensation that remains outstanding at the end of its last completed fiscal year
- The estimates used to determine excess incentive-based compensation if that compensation was based on a stock price or TSR metric
- The name of each person from whom the company decided during the last completed fiscal year not to pursue recovery, the amount forgone for each person and a brief description of why the company decided in each case not to pursue recovery
- 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 Commission said the proposed disclosures shouldn't be included in a company's Item 402 Compensation Discussion and Analysis (CD&A) because the proposed rule would define executive officers more broadly than the named executive officers discussed in CD&A, and because certain entities are not required to include CD&A (e.g., foreign private issuers, emerging growth companies). The disclosures also would have to be tagged using XBRL to make it easier for the SEC staff and market participants to compare information about clawbacks.

Transition period

National securities exchanges and associations would need to develop and file their proposed listing standards with the SEC within 90 days of a final rule, and the listing standards would have to be effective no later than one year after publication of the final rule. Companies would be required to adopt clawback polices within 60 days of the effective date of the new listing standard.

Next steps

Companies that don't currently have clawback policies may want to review their executive compensation agreements and determine what changes, if any, would be needed to comply with the proposal.