Client Update

No Fault, No Relief: SEC Proposes New "No-Fault" Clawback Rules

NEW YORK
Lawrence K. Cagney
lkcagney@debevoise.com

Meir D. Katz
mdkatz@debevoise.com

Jonathan F. Lewis
jflewis@debevoise.com

Elizabeth Pagel Serebransky
epagelse@debevoise.com

Charles E. Wachsstock
cewachss@debevoise.com

Tomer S. Dorfan
tsdorfan@debevoise.com

Ending the long wait, the Securities and Exchange Commission has finally proposed rules on clawbacks of executive officer compensation required under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The proposed clawback rule would require issuers of public securities, as a condition to listing or continued listing, to adopt and comply with policies to recover excess incentive compensation paid to the issuer's executive officers based on restated financial statements, regardless of fault, and to provide disclosure regarding those policies and amounts recovered.

COVERED ISSUERS CLAWBACK RULE

Generally, the proposed clawback rule would apply to all issuers with listed securities, including foreign private issuers, controlled companies, emerging growth companies, smaller reporting companies and companies with any listed debt securities. However, issuers of security futures products and standardized options, as well as registered investment companies that do not pay their executive officers incentive-based compensation, would not be subject to the proposed clawback rule. Voluntary filers and public companies with no U.S. exchange-listed securities would not be subject to the rule either.

"EXECUTIVE OFFICERS" DEFINED UNDER SECTION 16 RULES

The proposed clawback rule would apply to "any current or former executive officer of the issuer," modeling the definition of executive officer on the definition of "officer" used for Section 16 purposes. [1] For this purpose, an

[1] The key distinction between the Section 16 coverage and the definition outside of Section 16 is that the chief accounting officer is covered, which the SEC viewed as appropriate in light of the clawback rule's focus on financial statements. Because the definition of "executive officer" is modeled on the Rule 16a-1(f) definition of "officer," listed issuers will not need to make a special determination of who qualifies as an "executive officer."

individual is considered an "executive officer" if he or she served in such capacity at any point during the applicable incentive-based award's performance period.

PRINCIPLES-BASED DEFINITION OF "INCENTIVE-BASED COMPENSATION"

The SEC has proposed a principles-based approach to defining "incentive-based compensation." 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*." Financial reporting measures are measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from that information and measures based on stock price and total shareholder return ("TSR"). Thus, the rule would apply both to GAAP measures and to measures derived from GAAP measures, such as EBITDA.

Incentive-based compensation would be deemed "received" in the fiscal period during which the specified performance goals are attained, even if the payment or grant of such award (or the determination that an award is payable) occurs after the end of that period or if there are outstanding conditions to be satisfied (e.g., service-based vesting).

The proposed clawback rule does not apply to all forms of executive compensation and would exclude, among other items, salaries, discretionary bonuses and awards, and awards based solely on length of service or the passage of time (e.g., time-vesting stock options). Because the rule is focused on financial reporting measures, operational performance measures are also not covered by the rule.

THREE-YEAR LOOKBACK

Issuers are required to recover excess incentive-based compensation "received" (as discussed above) by an executive officer during the three completed fiscal years preceding the year in which the issuer is required to prepare a covered accounting restatement.

The date on which an issuer is required to prepare an accounting restatement (triggering the three-year lookback) is the earlier of (*x*) the date the issuer concludes, or reasonably should have concluded, that the previously issued financial statements contain a material error and (*y*) 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. Although these triggers may also result in Form 8-K reporting, the filing of a Form 8-K (or not) does not, by itself, trigger the clawback rule.

Only restatements correcting "material errors" would trigger the recovery rules. Other restatements, such as those necessitated by changes in accounting rules or discontinued operations, would not trigger the clawback requirements. The proposed clawback rule does not define the type of errors considered "material" because the SEC recognizes that materiality is a determination that must be analyzed in the context of particular facts and circumstances. Nevertheless, the SEC has indicated that a series of immaterial error corrections, whether or not they resulted in amendments to previously filed financial statements, could be considered a material error when viewed in the aggregate.[2]

RECOVERY

Once the clawback obligation is triggered, the issuer would be required to recover compensation to the extent that the amount of incentive-based compensation actually received exceeds the amount that would have been received if the compensation had been determined based on the restated financial statements.

Limited Discretion

If an accounting misstatement is material, an issuer can forego recovery of erroneously awarded compensation only if recovery would be "impracticable," which is a standard that will be harder to meet than it sounds. Recovery is impracticable only if the direct costs of enforcing recovery would exceed the recoverable amounts or, for foreign issuers, recovery would violate home-country law. Before determining that recovery is impracticable, the board must make a reasonable attempt to recover the incentive-based compensation in a cost-effective manner or obtain an opinion from home-country counsel that pursuing recovery would violate home-country law, as the case may be. In either case, a board that resolves to forego recovery must disclose its reason for doing so, as discussed below.

Recoverable Compensation

Following a covered restatement, an issuer would be required to recalculate the amount of incentive compensation that would have been paid based on the

---

[2] The proposed clawback rule does not provide definitive guidance on whether recovery can be triggered in the absence of an accounting restatement, although the preamble to the proposed clawback rule leaves the possibility open.

restated financial statements, and then recover the excess of the amount paid over the recalculated amount. All recoveries are to be calculated (and clawed back) on a pre-tax basis. (Whether, when and how the executive officer is able to correct his or her tax position for the clawback is not a relevant consideration under the rules; the application of the rule on a *pre-tax* basis also means that the recovery amount could exceed the amount that the executive officer was paid on an after-tax basis.) Where the recoverable amount is not subject to mathematical recalculation based on information in an accounting restatement (e.g., when the amount of incentive-based compensation is based on the achievement of a pre-determined TSR or stock price), the recoverable amount may be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure.

While the recovery of cash awards received upon satisfaction of a performance goal should be relatively straightforward under the proposed clawback rule, equity awards involve additional considerations. If the equity-based award is still held by the officer (or if the underlying shares have not been sold) at the time of recovery, the executive officer would forfeit the excess equity-based awards or underlying shares. If shares have been sold, the recoverable amount would be the pre-tax proceeds received by the executive officer from the sale of the excess number of shares. Thus, clawbacks of equity compensation (especially stock options) may impact executive officers who received the same awards in very different ways.

No Indemnification

While an executive officer may be able to purchase third-party insurance to fund potential recovery obligations, a listed issuer would be prohibited from indemnifying an executive officer against the loss of erroneously awarded compensation and from paying or reimbursing the executive officer for the cost of third-party insurance. This limitation on indemnification applies even if an issuer had an indemnification agreement in effect pre-existing the proposed clawback rule's adoption.

RECOVERY POLICY DISCLOSURE

The proposed clawback rule requires each listed issuer to publicly disclose, among other things, the substance of its recovery policy, the details of its implementation and the amounts recovered (or foregone) as a result of each material accounting restatement during the applicable year. The disclosures must be made on an issuer's Form 10-K, proxy statement or other required annual report (e.g., Form 20-F for certain foreign issuers) for the applicable year.

These disclosures are a separate item in an annual proxy, although an issuer that prepares a CD&A may make the disclosure in its CD&A instead.

The SEC has asked for comments on all aspects of the proposal. The comment period for the proposed rule is 60 days beginning on the date on which it is published in the Federal Register. After a final clawback rule is adopted, each exchange has 90 days to file its proposed listing rules implementing the clawback requirements. The proposed listing rules must then become effective within one year of publication and listed issuers must adopt a recovery policy no later than 60 days after the listing rules become effective. So, the good news is that we do not expect the rules to be effective for the 2016 proxy season. The bad news is that, as proposed, there are essentially no grandfathering provisions to the rule, and all issuers with listed securities of any kind should begin to consider how the rules will impact their incentive compensation arrangements in the future.

* * *

Please do not hesitate to contact us with any questions.