July 24, 2015

On July 1, 2015, the SEC issued a **proposal** to implement the last of the compensation-related provisions of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act that remained untouched on the SEC's plate—Section 954, the so-called "clawback" provision. The concept underlying the Dodd-Frank clawback provision is that a company will recover compensation to which its executives were never really entitled in the first place. As Commissioner Luis Aguilar explained, the rules are intended to promote the creation of a "culture of compliance that results in accurate reporting of financial performance." However, as SEC Chair Mary Jo White observed, the idea of clawbacks is simple, but actual implementation of the statute is surprisingly complex.

Proposed new Rule 10D-1 requires exchange-listed companies to recover from current and former executive officers the amount of erroneously awarded "incentive-based compensation" received during the three years preceding the date of an accounting restatement that results from the company's material noncompliance with any financial reporting requirement under the securities laws. The proposal directs national securities exchanges and associations to establish listing standards requiring companies to adopt, disclose and enforce clawback policies that comply with requirements of the proposed rule.

During the nearly five-year wait for the SEC's proposal, some companies—approximately 23% as estimated by the SEC—have adopted interim clawback policies, with the understanding that the policies would be updated upon the release of final rules. Other companies have waited for official SEC guidance, limiting their clawback enforcement to the much narrower mandate of the Sarbanes-Oxley Act of 2002 (SOX). The proposal, which is both broader and more stringent than most corporate policies currently in place, is discussed below.

Summary of proposed rule

Under the SEC's proposal, listed companies must adopt and implement clawback policies applicable to current and former executive officers. The policy must provide that, if the company is required to prepare an accounting restatement to correct an error that is material to previously issued financial statements, then the company will recover from the executive the amount of incentive-based compensation received during the three fiscal years preceding the date the restatement was required that exceeds the amount the executive would have received had the compensation instead been determined based on the restated amount.

These requirements are further reaching than the clawback requirements included in SOX in that they cover any current or former executive (while the SOX requirements cover only the CEO and CFO) and no culpability on the part of the company or the executive is necessary to trigger a clawback (while SOX requires that the company's material noncompliance be the result of its misconduct, although not necessarily misconduct of the executive subject to the forfeiture). However, SOX does not limit the clawback to amounts paid in excess, although it covers only a 12-month period (compared to the three-year period of the proposed rules).

Individuals covered

The proposed rule applies to a person who was an "executive officer" at any time during the performance period for the incentive-based compensation subject to recovery. Under the proposal, the definition of executive officer is the same as the definition of "officer" for Section 16 purposes and includes the company's president, principal financial officer, 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 or finance) and any other officer or other person who performs a significant policy-making function for the company.

Observations and Commentary

- Because this definition is based on the definition of "officer" for Section 16 purposes, companies will have already considered who belongs in this category. However, given the three-year look back, it will now be necessary to keep careful records on a rolling basis regarding the individuals whose compensation is still subject to potential clawback, and the relevant types and amounts of such compensation for each of those individuals.
- Many boards make a determination annually as to the officers who should be considered "Section 16 officers," and that determination creates a presumption for purposes of those rules. The proposal provides for a similar presumption with regard to persons identified as executive officers in the company's Form 10-K or proxy statement.

Companies covered

The proposed rule generally applies to all exchange-listed companies, including foreign private issuers, emerging growth companies and smaller reporting companies, categories of companies that have enjoyed exemptions from certain disclosure and say-on-pay requirements.

Observations and Commentary

- The SEC's decision to make the proposed rule applicable to emerging growth companies and smaller reporting companies was not without controversy. The two dissenting SEC Commissioners, Daniel Gallagher and Michael Piwowar, both objected to the inclusion of any but the biggest companies under the rule's ambit. Commissioner Gallagher preferred to limit application of the provision to larger companies that could more easily bear the costs and then, if the rule worked effectively and efficiently, ease in smaller reporting companies and emerging growth companies. Commissioner Piwowar preferred to make compliance voluntary for these smaller companies.
- While the Dodd-Frank provision applies on its face to all listed companies, the SEC has the power to exclude specific categories of companies to the extent that doing so would be necessary or appropriate in the public interest and consistent with the protection of investors. However, in this case, the SEC took into account the provision's legislative history, which indicated that it was designed "so that shareholders do not have to embark on costly legal expenses to recoup their losses or so that executives must return monies that should belong to the shareholders." Consequently, the SEC declined to exempt emerging growth companies, smaller reporting companies, foreign private issuers or controlled companies, arguing that "the objective of recovering excess incentive-based compensation is as relevant for these categories of listed issuers as for any other listed issuer." We expect that the broad application of the rule to these categories of companies, especially emerging growth and smaller reporting companies, will draw significant public comment.

Compensation subject to clawback

The proposal applies to "incentive-based compensation," defined as any compensation that is granted, earned or vested based in whole or in part on the attainment of a financial reporting measure. Cash examples include bonuses earned by achieving, in whole or in part, a target based on a financial reporting measure and cash bonuses from a "bonus pool" the size of which is determined based on attainment of a goal that is a financial reporting measure (even if the size of particular awards is discretionary). Equity examples include stock options, restricted stock, restricted stock units and stock appreciation rights (including the proceeds of sale of the shares underlying any of these awards), provided the awards are earned, granted or vested by attainment, in whole or in part, of goals based on financial reporting measures.

The SEC's proposal defines "financial reporting measures" as those measures based on accounting principles used in preparing the company's financial statements, any measures derived in whole or in part from that information (including reportable segments

of the company's business and non-GAAP financial measures, such as EBITDA or same-store sales), stock price and total shareholder return (TSR). These measures may appear outside the financial statements, such as in MD&A or the performance graph.

With respect to stock price and TSR, the proposed rule permits companies to calculate the amount to be recovered by using a reasonable estimate of the effect of the restatement. The company is required to create and maintain documentation regarding the calculation of the reasonable estimate and to provide that documentation to the exchange on which it is listed. To the extent a bonus pool is recalculated, all relevant bonuses paid pursuant to the pool are subject to pro rata reduction.

"Incentive-based compensation" does not include compensation that is discretionary (such as salary), based on subjective goals or strategic or operational metrics (such as completion of a merger or opening a specified number of new stores) as opposed to financial reporting measures or equity compensation (including stock options) that is subject only to time-based vesting.

All calculations must be performed on a pre-tax basis "to ensure that the company recovers the full amount of incentive-based compensation that was erroneously awarded." The SEC also commented that recovery on a pre-tax basis would permit the company to avoid the burden and administrative costs associated with calculating recoverable amounts based on the particular tax circumstances of individual executive officers.

Observations and Commentary

- Some commentators have observed that the focus of this clawback provision on incentive-based compensation tied to financial performance metrics may have the unintended consequence of driving companies to return to the use of more discretionary compensation. However, there is strong competing pressure from proxy advisory firms and institutional stockholders to base a greater percentage of executive compensation on objective performance criteria, and moving in the other direction may negatively affect recommendations and votes for say-on-pay proposals. Additionally, while the proposed rules may particularly discourage companies from using TSR-based metrics, avoiding TSR-based metrics may be at odds with the recently proposed **pay-versus-performance** rules, which require companies to disclose the relationship between compensation actually paid and company financial performance, which is defined as TSR. Further, moving to discretionary performance metrics could cause companies to lose the ability to deduct a portion of that compensation under Section 162(m) of the Internal Revenue Code. Where appropriate, some companies may instead turn to operational or strategic metrics, which may still be objective, performance-based metrics, but, under the proposed rule, would not be subject to the clawback provision.
- The inclusion of stock price and TSR-based metrics as financial reporting measures may well be the most controversial aspect of the proposal and will certainly attract much public comment. When these metrics are used, the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement. As a result, it could be extremely challenging to estimate how much any change in the stock price or TSR is attributable to a restatement. That complexity is compounded when, in addition to the restatement, other events occur or are announced that could affect the stock price. As many have argued, the reasons underlying movements in stock price and TSR are speculative and may have more to do with events in Greece or pronouncements at the Fed than with developments at the company, including restatements.
- At the SEC's open meeting to consider the proposal, Commissioner Gallagher echoed this concern regarding these types of metrics, particularly as the calculation of the "but for" price (the stock price or TSR that would have prevailed in the absence of the inaccurate financial statements) would require event studies and similar analyses. As Commissioner Gallagher contended, these types of analyses involve a number of judgments and assumptions that typically produce a range of outcomes. As a result, he viewed the use of these measures as an open invitation for plaintiffs to second guess the board. However, he acknowledged that exclusion of these metrics would only encourage a shift of compensation to the use of TSR, which he viewed as contributing to short-termism. Ultimately, he had no solution for this conundrum.
- As the incentive-based compensation must be paid back to the company on a pre-tax basis and the executive officer may have already paid income and employment taxes on the amount being recovered, in that scenario, the individual

would need to independently seek recoupment from the applicable taxing authority. Generally, if the excess incentive-based compensation were returned to the company in the same year as the original payment, the amount reported on the executive officer's Form W-2 could be adjusted to reflect that the incentive-based compensation was not paid. If returned in a subsequent year, however, the executive officer would have to claim a deduction or credit on his or her tax return (subject to any applicable limits) for the year during which the amount is repaid. The executive officer may not amend a prior year's tax return to file for a refund of the taxes previously paid.

- Companies should determine which of their compensation plans and programs, if any, would be deemed to involve "incentive-based compensation" and the effect the clawback of that compensation would have under any other plans maintained by the company. If incentive-based compensation is treated as compensation for purposes of determining accrued benefits under other company plans, such as a nonqualified excess benefit plan, the clawback of the compensation could require an adjustment to the accrued benefit under the other plans.

Look-back period

Under the proposed rule, there is a three-year look-back period for recovery of incentive-based compensation. Compensation would be subject to recovery if it was "received" during the three *completed* fiscal years immediately preceding the date that a restatement is "required" to correct a material error.

The date that the company is required to prepare an accounting restatement for purposes of the proposed rule is the earlier of (1) the date that the board of directors (or committee or group of officers, as applicable) concludes, or reasonably should have concluded, that the company's previously issued financial statements contain a material error; or (2) the date a court, regulator or other legally authorized body directs the company to restate its previously issued financial statements to correct a material error.

The date on which the compensation is considered to be "received" for purposes of the proposed rule is the date on which the target financial reporting measure is attained, even if, for example, the shares underlying an award have not yet been issued or the executive must still work for an additional period of time in order to receive payment.

Observations and Commentary

- Restatements are required when previously issued financial statements are materially misstated. However, if the error is not material to the previously issued financial statements, the company may be able to correct the error as an "out-of-period" adjustment or by revising the previously issued financial statements the next time they are filed (as comparative numbers). Determinations of materiality typically involve a complex analysis of all relevant qualitative and quantitative factors, as well as significant professional judgment. However, some commentators have speculated that companies may treat these concepts as unduly malleable and try to evade the clawback rules by characterizing restatements as "revisions." Notably, however, the SEC advises that companies "should consider whether 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." In any event, the prospect of a clawback will certainly make the decision regarding the materiality of an accounting error even more fraught than in the past, and whether the use of "revisions" in lieu of restatements accelerates as a result of implementation of the proposal remains to be seen.
- Some accounting firms have expressed a view that the inclusion of too much discretion in a clawback policy—with respect to determining the amount to be recovered or when or if a clawback has been triggered—could subject certain equity incentive compensation awards to variable accounting treatment. This is an evolving area, and different firms have taken varying positions. As a result, we recommend that any company adopting a clawback policy consult first with its accountants.

No-fault rule; no reimbursement or indemnification

Companies are required under the proposal to recover the "excess" compensation even in the absence of fault or misconduct on

the part of company and even when the executive officer had no responsibility for the erroneous financial statements. In addition, companies may not reimburse executive officers for any recovered amount either directly or via indemnification or payments for insurance premiums.

Observations and Commentary

- Commissioner Gallagher contended that the language of Dodd-Frank did not mandate that the rules adopt a "no fault" position. In particular, he expressed concern that the resulting strict liability could create an injustice, especially for lower level executives who may have had limited ability to influence events.
- Commissioner Piwowar noted that the introduction of this new risk of loss of compensation may have the same type of unintended consequence that resulted from the adoption of Section 162(m) of the Internal Revenue Code: the uncertainty that would be inherent in the compensation paid could cause executives to demand substantial increases in their compensation to cover the risk.

Recovery and permissible discretion

Under the proposed rule, companies have the discretion to forego recovery of compensation only in two narrowly prescribed circumstances.

First, companies may exercise discretion not to recover compensation where it would be impracticable to do so because the cost of recovery would be in excess of the amount to be recovered. The SEC notes that "[o]nly direct costs involving financial expenditures, such as reasonable legal expenses, would be considered for this purpose. Indirect costs relating to concerns such as reputation or the effect on hiring new executive officers would not be taken into account." To justify its conclusion that recovery is impracticable, the company would first need to make a reasonable attempt to recover the compensation, document its attempts and provide that documentation to the exchange on which it is listed. As discussed below, the company will also need to disclose the reason for its determination.

Second, the company may determine that recovery is impracticable because it would violate home country laws, provided that the laws predate the clawback proposal. In that instance, the company would first need to obtain from home country counsel an opinion that recovery would be unlawful, which opinion must be "not unacceptable" to the exchange.

In either case, the determination that recovery is impracticable must be made by the compensation committee (or the majority of independent directors, if there is no compensation committee).

Observations and Commentary

- The limited nature of discretion available under the proposal may be especially problematic where recovery could create personal hardships for particular executives, or where the funds to be recovered are no longer available to the executive. One possibility, if not otherwise prohibited, is that the company withhold the amount to be recovered from other compensation payable to the officer in the year during which recovery is required. The company could not, however, enter into a promissory note allowing a current executive to repay the amount over a period of time because doing so could be deemed to violate the SOX prohibition on loans to executives. Similarly, the company could generally not offset any future payments that could be made under a nonqualified deferred compensation plan because doing so might violate Section 409A if the Internal Revenue Code. Commissioner Gallagher reported that, in the rulemaking process, he had advocated a broader relief valve that would have given the board broad discretion to decide not to pursue a recovery or to settle or otherwise pursue lower or alternative recoveries. The proposal's "baked-in" disclosure requirements (discussed below) would have acted, he argued, as a disciplining mechanism for the board. However, his alternative was not accepted as part of the proposal, although public comment may ultimately sway the SEC to allow boards more latitude.
- One open question regarding the clawback provision is whether it may be enforced by private plaintiffs or only by the

SEC or the company itself. If courts were to find a private right of action, companies could see litigation from private plaintiffs challenging, for example, boards' decisions that recovery is "impracticable" or boards' calculations of the amounts to be recovered. The courts have found that there is no private right of action to enforce the SOX forfeiture provisions, and it is unclear whether the same line of reasoning would necessarily prevail with regard to the clawback provisions in Dodd-Frank. In contrast to SOX, Dodd-Frank provides that "the issuer" will recover the excess incentive-based compensation, which could suggest that derivative litigation was contemplated. However, views are mixed as to whether the courts will infer a private right of action in this instance.

- The proposal indicates that recovery is not required if prohibited by "home country" law, but it does not address state law prohibitions or the question of federal preemption of state law. For example, in California, the labor laws generally prohibit the reduction of any wage once it has become earned and vested, and courts have been reluctant to enforce one-sided conditions on an employee's right to earn compensation where the conditions are beyond the employee's control. We recommend that companies put a provision in new arrangements providing for incentive-based compensation to put executives on notice that the compensation may be subject to a clawback and help establish the enforceability of the company's claim should the policy ever be applied. The provision would generally provide that the compensation is subject to recovery in accordance with any clawback policy that the company is required to adopt pursuant to the listing standards of any national securities exchange or association on which the company's securities are listed or as is otherwise required by Dodd-Frank, SOX or other applicable law. The provision should also provide that the clawback of the compensation will not give rise to a "good reason" or other constructive termination. With respect to existing contractual arrangements that conflict with the proposed rules, the SEC noted that it does not view this inconsistency, "in itself, as a basis for finding recovery to be impracticable, because issuers can amend those contracts to accommodate recovery." However, agreements generally cannot be amended in a way that adversely affects a party without his or her consent, and executive officers may not be willing to consent to application of the clawback policy without receiving additional benefits in exchange. These issues concern an evolving area of the law, and there is inherent uncertainty in any implementation plan until caselaw develops or regulations are issued.

Disclosure requirements

The proposal requires each listed company to file its clawback policy as an exhibit to its annual report on Form 10-K. Additionally, in amendments proposed to Regulation S-K, if during the last completed fiscal year, either the company completed a restatement that required recovery of incentive-based compensation, or there was an outstanding balance of excess incentive-based compensation as a result of application of the clawback policy to a prior restatement, the company must disclose, in any annual report, proxy or information statement in which executive compensation disclosure is required:

- the date on which the company was required to prepare each restatement, the aggregate dollar value of excess incentive-based compensation attributable to the restatement and the aggregate amount of such compensation that remained outstanding at the end of the company's last completed fiscal year;
- where the financial reporting measure related to stock price or TSR, the estimates used to determine the excess incentive-based compensation attributable to the restatement;
- the name of each person subject to recovery from whom the company determined to not pursue recovery, the amount at issue, and a description of the reason the company made the decision to not pursue recovery; and
- the name of, and amount due from, each individual from whom, at the end of the last fiscal year, excess incentive-based compensation was outstanding for 180 days or longer following the date the company determined the amount that the person owed.

In the event that a listed company recovers any amounts under its clawback policy, the company would need to reflect that recovery in its Summary Compensation Table in future filings by reducing the compensation reported in the applicable column, as well as the "total" column for the year in question, and identify the reduction in footnotes to the table. The disclosure must also be provided in interactive data format using eXtensible Business Reporting Language (XBRL) using block-text tagging so that it can be searched electronically. The interactive data must be filed as an exhibit to the definitive proxy statement and the 10-K.

Observations and Commentary

- Listed companies should modify their internal procedures to ensure that the appropriate individuals at the company who work on the annual proxy statement are provided with thorough information about any actions taken (or not taken, as the case may be) under the company's clawback policy for purposes of complying with these disclosure requirements.
- Some of the disclosure requirements, which are primarily designed to provide full disclosure to investors, may be an example of "regulation by humiliation," even if unintentionally so. The requirement to disclose the name of each executive from whom the company decided to not pursue recovery and the reason for that decision or the requirement to name executives with amounts outstanding for more than 180 days may provide almost as much of a deterrence to the company and its executives as the clawback itself. Companies' justifications for not pursuing executives who owe money may be criticized and second-guessed, and executives will surely want to avoid embarrassing disclosures as to why they would not or could not repay.

Consequences of noncompliance

The proposed rule provides that a company will be subject to delisting if it does not adopt, disclose and comply with a compliant policy. The proposal does not specify when the recovery must be completed; rather, the exchange on which the company is listed would be responsible for determining whether the company was making a good faith effort to pursue recovery in compliance with its own policy.

Timing and transition

Comments on the proposal are due by September 14, 2015. Once the final version of the rule is published in the *Federal Register*, the exchanges will then have 90 days to file their proposed listing rules, with an effective date of no later than one year after filing. Companies will then have 60 days following the effective date of the applicable exchange rules to adopt their clawback policies.

In addition, for transition purposes, incentive-based compensation will be subject to recovery if it was "received" as a result of attainment of a targeted 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.

On the horizon

This proposal is the third Dodd-Frank compensation-related proposal for which we await final rules. The comment period for the SEC's proposed internal pay equity rules closed on December 2, 2013, and rumor has it that final rules may be coming in August. The comment period for the SEC's proposed pay-versus-performance rules closed on July 6, 2015. In politically charged dissenting statements about the clawback proposal, both Commissioners Gallagher and Piwowar voiced the now-familiar chorus that the time spent developing proposals to implement any of the compensation-related provisions of Dodd-Frank represents a misallocation of SEC resources, particularly because the subject matter of these provisions, in their view, had nothing to do with the financial crisis. It remains to be seen whether the impending departures of SEC Commissioners Aguilar and Gallagher and the upcoming election year will influence the SEC's rulemaking process and expedite or delay adoption of final rules.

If you have any questions about this *Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

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