Employee Relations
LAW JOURNAL

Electronically reprinted from Winter 2015

Employee Benefits

Five Years Later: The SEC's Proposed Rule for Clawbacks of Incentive-Based Compensation

Mark E. Bokert and Alan Hahn

This column provides a summary of certain aspects of the Securities and Exchange Commission's proposed rule that would require issuers to recover (or "clawback") incentive-based compensation from executive officers in the event of a restatement of financial reports due to material noncompliance, regardless of whether the executive officer was at fault for the restatement. The column then considers potential issues that may arise if it were to be adopted as proposed and discusses potential steps issuers may wish to consider taking now while they wait for the final rule to be released.

The Securities and Exchange Commission (SEC) recently issued a proposed rule that would require issuers to recover (or clawback) incentive-based compensation from executive officers in the event of a restatement of financial reports due to material noncompliance, regardless of whether the executive officer was at fault for the restatement. The proposed rule is one of the last remaining pieces of executive compensation regulatory action required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank), which Congress passed in 2010 in response to the earlier financial crisis. Section 954 of Dodd Frank requires the SEC to adopt rules requiring issuers to recover incentive-based compensation from any current or former executive officer who received incentive-based compensation during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement due to material noncompliance.[1] If adopted, the proposed rule would implement Section 954.[2] This column provides a summary of certain aspects of the proposed rule and then considers

Mark E. Bokert is a partner and co-chairs the Benefits & Compensation Practice Group of Davis & Gilbert LLP. His practice encompasses nearly all aspects of executive compensation and employee benefits, including matters related to equity plans, deferred compensation plans, phantom equity plans, qualified retirement plans, and welfare plans. Mr. Bokert may be contacted at *mbokert@dglaw.com*. Alan Hahn is a partner and co-chairs the Benefits & Compensation Practice Group of Davis & Gilbert LLP. His practice is devoted to advising clients of all sizes, including in the design and implementation of a wide variety of creative, unique, and tax-effective employee benefit plans and programs. Mr. Hahn may be contacted at *ahahn@dglaw.com.* Gabrielle White assisted in the preparation of this column.

potential issues that may arise if it were to be adopted as proposed. The column then discusses potential steps issuers may wish to consider taking now while they wait for the final rule to be released.

Summary of Proposed Rule

The proposed rule would apply to almost all issuers listed on a national exchange, including smaller reporting companies and foreign private issuers. The only exemptions would be for security futures products, standardized options, and the securities of certain registered investment companies.[3] Impacted issuers would not be allowed to indemnify executive officers or otherwise provide a gross-up for any amount subject to recovery.[4] This prohibition would include the payment, or reimbursement, of premiums on insurance policies.

The proposed rule's definition of "executive officer" generally corresponds with the definition of a Section 16 officer and includes the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice president in charge of a principal business unit, division, or function, any other officer who performs a policy-making function, or any other person, including executive officers of a parent or subsidiary, who perform similar policy-making functions for the issuer.[5] It is important to note that the proposed definition includes both current and former executive officers. Former executive officers would include any individual who served as an executive officer at any time during the performance period for the erroneously awarded compensation.[6]

Incentive-based compensation is deemed "received" by an executive officer in the fiscal period in which the financial reporting measure is attained, even if the payment of the compensation occurs after the end of that period.[7] The date on which an issuer is "required" to prepare an accounting restatement is the earlier to occur of the date when the issuer "concludes, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error."[8] Material noncompliance is a restatement to correct an error that is material to previously issued financial statements.[9]

The proposed rule defines incentive-based compensation as any compensation, both cash and equity, that is "granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure."[10] This definition would include compensation based on financial reporting measures used in preparing the issuer's financial statements as well as stock price and total shareholder return metrics. Incentive-based compensation would not include cash or equity compensation based on nonfinancial business goals, including any time- or service-based vesting requirements.

The amount of incentive-based compensation that is subject to the clawback policy would be the excess between the amount received and the amount that would have been received had the incentive-based compensation been calculated using the restated financial information, without regard to any taxes paid.[11] The SEC acknowledged that determining this amount would be difficult with respect to awards based on stock price or total shareholder return. As such, issuers would be allowed to use a reasonable estimate of the effect of the accounting restatement on the stock price to determine the amount required to be repaid with respect to such awards. Issuers would be required to maintain documentation of the determination of that estimate.[12]

With respect to equity awards, the method of recovery depends on whether the shares underlying the award have been sold. If they have not, the recoverable amount would simply be the number of shares or awards received in excess of the number that should have been awarded applying the restated financials. If the underlying securities have been sold, the recoverable amount would be the sale proceeds received by the executive officer with respect to the excess number of shares, net of any exercise price paid by the executive officer to acquire the shares.[13]

If an issuer uses a "pool plan" to award bonuses whereby the size of the available pool is determined based on the attainment of financial reporting measures but specific amounts are granted to individual executive officers on a discretionary basis, recovery should be done by determining how much of the bonus pool was in excess of the amount that would have been granted had the restated financials been used. This excess should then be recovered from all applicable executive officers on a pro rata basis.[14]

Issuers must recover any erroneously awarded compensation with very limited exceptions. Issuers may only decline to pursue recovery if such pursuit would be impracticable because the expense of recovering the compensation would exceed the amount to be recovered, or if recovery would violate home country law. Before determining that recovery would be impracticable, issuers must make reasonable attempts to recover the erroneously awarded compensation. Before determining that recovery would be impracticable due to a violation of home country law, issuers must obtain an opinion of home country counsel, acceptable to the applicable national securities exchange or association, indicating that recovery would result in a violation of home country law. Furthermore, such law must have been adopted prior to the date of the proposed rule's publication.[15]

Issuers will be required to disclose their clawback policies as an exhibit to their Annual Report on Form 10-K. In addition, in the event that an issuer is required to apply its clawback policy, the following disclosures would be required in the issuer's annual proxy statement:

- the date of the restatement;
- the aggregate amount of excess compensation attributable to such restatement to be recovered;

- the remaining aggregate amount of excess compensation that remains outstanding at the end of the issuer's most recently completed fiscal year;
- the estimates that were used in determining the excess compensation if the financial reporting measure related to a stock price or total shareholder return metric;
- the name of each person subject to recovery for whom the issuer decided not to pursue recovery, the amounts due from that person, and a brief description of why no recovery was warranted; and
- the name of each individual from whom, as of the end of the last completed fiscal year, excess compensation had been outstanding for 180 days or longer since the date the issuer determined the amount owed, and the dollar amount of outstanding excess compensation due from such individual.[16]

Potential Issues and Concerns under the Proposed Rule

While in practice the actual implementation of a clawback pursuant to these rules may be unlikely (given the infrequency of accounting restatements), the proposed rule presents a number of potential concerns and consequences relating to the adoption of an appropriate policy, several of which are discussed here. Moreover, given that the timing and application of final rules is uncertain (at least as of the date that the proposed rules were issued), compensation committees may want to act now to consider some of these thorny issues.

One of the more unsettled issues is the interplay of the proposed rule with Section 409A of the Internal Revenue Code of 1986, as amended (Section 409A). The proposed rule gives issuers a significant degree of discretion over how to recover erroneously awarded compensation. If issuers were to authorize the use of funds in deferred compensation accounts for the settlement of any clawback, such action could violate Section 409A. Section 409A provides that deferred compensation plans may allow for the settlement of a debt to the company if the entire amount of such reduction does not exceed $5,000 and the reduction is made in the same time and in the same amount as otherwise would have been due.[17] If these requirements are not met, any reduction would be an impermissible acceleration of payment and the executive officer could be subject to excise taxes under Section 409A.[18]

Executive officers would also face a potential tax issue due to the extended time during which any recovery may apply. Because issuers would be required to recover erroneously awarded compensation on a pre-tax basis, an executive officer may be required to repay an amount on which he or she has already paid income tax, meaning that the executive officer will need to seek to recover income tax paid in prior tax years. Because the executive officer would have had the use of the recovered compensation, he or she would not be able to file an amended tax return for the applicable year and instead would have to seek a credit or deduction in the year of the clawback.[19]

The proposed rule may also have the effect of reversing the general trend with respect to executive compensation, which has been to increase incentive-based compensation as a proportion of an executive officer's compensation package. Many compensation consultants believe that providing incentive-based compensation as a greater proportion of an executive officer's compensation package provides greater alignment between the interests of shareholders and executive officers. The proposed rule may have the effect of causing executives to discount the value of incentive-based compensation and negotiate compensation packages that have a higher ratio of service-based compensation, which would be exempt from the proposed rule. Because the proposed rule applies to such a broad group of executive officers, it may be particularly concerning for those individuals who have little to no control over the financial statements. The three-year clawback period and the proposed rule's applicability to former executive officers further increase the uncertainty with respect to incentive-based compensation. Although the SEC suggests that the proposed rule could have the effect of causing executive officers to have a greater interest in the preparation of financial statements and ensuring they are accurate, this may not be possible for many executive officers.

Steps Employers Should Consider Taking While Waiting for the Final Rule

The SEC accepted comments for 60 days after publication of the proposed rule, and it is to be expected that the comments will be extensive. After review of the comments, the SEC will issue final rules. Each exchange would then have 90 days to file its proposed listing rules, and such listing rules would be effective no later than one year following such publication. Employers would be required to adopt the recovery policy outlined in the listing rules no later than 60 days following the date on which the exchange's rules become effective.[20]

Because the final rule may be substantially different than the proposed rule, employers are unlikely to want to begin revising existing policies, or drafting new ones, until the final rule is issued. However, employers will have only a limited time after the release of the final rule in which to adopt or amend clawback policies. Thus, employers, working with their executive compensation and securities counsel, may want to consider what actions they can take now to prepare. Below are a few actions employers may wish to consider taking now. Employers should work with their executive compensation and securities counsel to determine whether the below actions, or any others, would be appropriate.

- As a threshold matter, employers should review existing arrangements to determine whether they allow for the recovery of erroneously awarded compensation. If not, employers may wish to consider whether to amend existing arrangements to subject compensation payable under such arrangements to any clawback policy that is adopted in the future. Similarly, employers should consider whether to add provisions to new arrangements indicating that amounts payable would be subject to any clawback policy that is adopted in the future.

- Employers should also begin to evaluate any indemnification provisions that apply to their executive officers. Employers should review articles, bylaws, individual arrangements, and D&O insurance policies to determine which policies would apply to erroneously awarded compensation, and thus which policies may need to be amended.

- As a more general matter, employers may wish to review applicable bylaws to determine whether there is any prohibition on the recovery of compensation. Employers should also review committee charters to determine whether compensation committees have the requisite authority to oversee clawback policies. If they do not, employers should consider whether to amend the applicable charters now.

- Finally, employers should make an initial determination of who would qualify as an executive officer under the proposed rule and may wish to consider communicating information regarding the proposed rule to the affected individuals.

Notes

1. 15 U.S.C. § 78j-4, *reprinted in* Sec. Exch. Act, 1934, at 100.

2. The proposed rule builds on previous requirements regarding the recovery of compensation, including under The Sarbanes-Oxley Act (SOX), which Congress passed in 2002 after the Enron, WorldCom, and Tyco scandals. The SOX rule allows the SEC to recover incentive-based compensation received by the chief executive and chief financial officers during the 12-month period preceding a restatement of financial statements due to misconduct. 15 U.S.C. § 7243. However, the proposed rule is significantly broader as it expands the group of officers for whom clawbacks are required, increases the clawback period from one year to three years, and applies regardless of culpability. The SEC indicated that to the extent executive officers would be required to repay amounts under both SOX and the proposed rule, any amounts recovered under SOX would be credited

against the amounts to be recovered under the proposed rule. 80 Fed. Reg. 41160 (proposed Jul.1, 2015).

3. 80 Fed. Reg. 41192 (to be codified at 17 C.F.R. pt. 240, § 240.10D-1(b)(2)).

4. *Id.* (to be codified at 17 C.F.R. § 240.10D-1(b)(1)(v)).

5. *Id.* at 41193 (to be codified at 17 C.F.R. § 240.10D-1(c)(3)).

6. *Id.* at 41192 (to be codified at 17. C.F.R. § 240.10D-1(b)(1)(i)(B)).

7. *Id.* at 41193 (to be codified at 17 C.F.R. § 240.10D-1(c)(6)).

8. *Id.* (to be codified at 17 C.F.R. § 240.10D-1(c)(2)).

9. The SEC indicated that the following retrospective changes to an issuer's financial statements would not trigger a clawback: (i) application of a change in accounting principle; (ii) revision to reportable segment information due to a change in the structure of an issuer's internal organization; (iii) reclassification due to a discontinued operation; (iv) application of a change in reporting entity; (v) adjustment to provisional amounts in connection with a prior business combination; and (vi) revision for stock splits. *Id.* at 41150-1.

10. *Id.* at 41193 (to be codified at 17 C.F.R. § 240.10D-1(c)(4)).

11. *Id.* at 41192 (to be codified at 17 C.F.R. § 240.10D-1(b)(1)(iii)).

12. *Id.*

13. *Id.* 41160.

14. *Id.* at 41163.

15. *Id.* at 41192 (to be codified at 17 C.F.R. § 240.10D-1(b)(4)).

16. *Id.* at 41193 (to be codified at 17 C.F.R. § 240.14a-101 Item 22 (b)(20)).

17. Treas. Reg. § 1.409A-3(j)(4)(xiii).

18. The SEC asked for comments regarding the treatment of nonqualified deferred compensation with respect to the proposed rule.

19. *See* I.R.C. § 1341.

20. 80 Fed. Reg. 41192 (to be codified at 17 C.F.R. § 240.10D-1(a)(2)).