

## SEC PROPOSES INCENTIVE COMPENSATION CLAWBACK RULES

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In July 2015, the SEC proposed new Exchange Act Rule 10D-1 to require national securities exchanges (NYSE, Nasdaq) to adopt listing rules that require listed companies to adopt and disclose clawback policies. These policies must be designed to recover incentive-based executive compensation from current and past executive officers that was based on financial statements that are subsequently restated. The proposed rule is the final in a series of many executive compensation rules mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The SEC believes that the proposed rule will “result in increased accountability and greater focus on the quality of financial reporting, which will benefit investors and the markets.”

### **AFFECTED COMPANIES AND INDIVIDUALS**

The proposed rule requires all listed issuers to comply. Emerging growth companies, smaller reporting companies, and foreign private issuers are subject to the rule’s requirements without exception. Limited exceptions exist for certain security futures products, standardized options products, and registered investment companies.

Proposed Rule 10D-1 covers incentive-based compensation awarded to an “executive officer”, which includes a company’s president; principal financial officer; principal accounting officer; any vice-president in charge of a business entity, division, or function; and any person who performs policymaking functions for the listed company. The definition parallels the definition of “officer” used in Section 16 of the Exchange Act.

### **INCENTIVE-BASED COMPENSATION**

Proposed Rule 10D-1 defines incentive-based compensation as money awarded, earned, or vested based in whole or part on the achievement of a financial reporting measure. Financial reporting measures are: measures based on accounting principles used to prepare financial statements; measures rooted in the financial statements; and stock price or total shareholder return. The proposed rules do not apply to incentive compensation based on non-financial metrics.

The compensation is considered to be “received” by the executive officer in the period the relevant financial measure is attained, even if payment occurs after the end of that period. Incentive-based compensation is subject to reporting and claw back only if the executive received the compensation while the company has listed securities. The amount subject to claw back is the amount received above the amount that should have been received based on restated financial statements. If stock price or shareholder return is the measure for the incentive-based compensation, the rule permits determination of recovery based on reasonable estimates as opposed to the accounting restatement figures.

Companies would be prohibited from indemnifying executive officers for losses of excess incentive-based compensation.

### **REQUIRED RECOVERY POLICY DISCLOSURE**

Each listed issuer would be required to establish and file as an exhibit with its Form 10-K its clawback policy. The policy must explain the incentive-based compensation financial measures and accounting restatement process. Under the proposed rule, when an accounting restatement is required to correct a prior accounting error due to material noncompliance (regardless of any fault or wrongdoing on the part of the executive officers covered by the clawback policies), the clawback provisions are triggered. The proposed rule defines “materiality” as the already-established standards of materiality under the securities laws. Further, if the company prepared a restatement that triggered a recovery of excess incentive-based compensation, the company must disclose in its 10-K or proxy statement:

- the date the accounting restatement was required to be prepared;
- the amount of excess incentive-based compensation that is attributed to the restatement and recoverable under the clawback policy;
- the recipients and amounts of erroneously awarded compensation that the issuer has decided not to recover and the reasons why the issuer is not seeking to claw back that compensation; and
- the recipient and amounts of any erroneously awarded compensation that remained outstanding for more than 180 days at year end.

### **LIMITED EXCEPTIONS**

Proposed Rule 10D-1 permits issuers to forego recovery of the incentive-based compensation if recovery imposes undue costs on the shareholders or the issuer itself or if it violates the issuer's home country law, subject to additional conditions.

### **APPLICABLE RECOVERY PERIOD AND FINAL RULES TIMING**

Proposed Rule 10D-1 applies to excess incentive-based compensation awarded or paid to executive officers within three fiscal years of the date the listed company is required to prepare a restatement. This is the date when the board or management concludes that the filed financial statements contain a material error or another authorized body requires the issuer to file a restatement. It is not the date the restatement is filed.

Once the final rules are adopted, the exchanges will have 90 days to propose compliant listing rules implementing the clawback policy requirements, and those rules must then become effective no more than one year after the publication date of the proposed rules. Each company must adopt a recovery policy no more than 60 days after its exchange's listing rules become effective.

### **PRACTICE POINTERS**

We do not believe that these rules will be effective until late 2016 or 2017. Nevertheless, many companies that have not yet adopted a clawback policy may benefit with institutional investors and others that focus on corporate governance best practices by adopting now a clawback policy that complies with the proposed rules. In addition, companies should review their compensation programs, including any employment agreements, in advance of the adoption of the final clawback rules to determine whether the rules conflict with current programs and agreements and pursue any required changes or amendments to current programs or agreements. Finally, companies should assess their compensation committee charters and indemnification provisions (indemnification agreements and/or bylaws) for conformity with the proposed rules.

### **ADDITIONAL INFORMATION**

Our Securities and Capital Markets attorneys will be pleased to meet with you to discuss the impact of the rules. Please contact your Tucker Ellis attorney or any of the following attorneys.

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