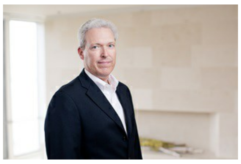
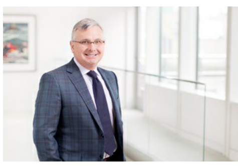
Key Contacts

Chris Del Rosso
Newport Beach
D: +1-949-823-7983



Warren Fox
San Francisco
D: +1-415-984-8725

Wayne Jacobsen
Newport Beach
D: +1-949-823-6912



Robert Plesnarski
Washington, DC
D: +1-202-383-5149

Jeff Walbridge
Newport Beach
D: +1-949-823-7179

PDF

SEC Proposes Clawback Rule

July 8, 2015

On July 1, 2015, the SEC proposed a new rule to implement Section 954 of the Dodd-Frank Act, which would require listed issuers to adopt, disclose and comply with a new mandatory compensation recovery policy (the "Proposed Rule"). This Alert summarizes some of the key features of the Proposed Rule and includes our thoughts on some implementation considerations and potential action items. The full text of the adopting release for the Proposed Rule is available here.

The Proposed Rule requires the national securities exchanges to adopt compliant proposed listing rules or rule amendments within 90 days after publication of the final version of the Proposed Rule (the "Final Rule"). The rules or rule amendments adopted by the national securities exchanges must be effective no later than one year after publication of the Final Rule. Listed issuers are required to adopt a compliant compensation recovery policy (a "clawback policy") within 60 days after the date the exchanges' rules become effective and to comply with the new clawback disclosure requirements described below in applicable SEC filings after the date the exchanges' rules become effective.

Importantly, listed issuers are required to clawback erroneously awarded compensation that is granted, earned or vested on or after the effective date of the Final Rule if the compensation is received as a result of the attainment of a financial measure for any fiscal period ending on or after the effective date of the Final Rule. This is the case even if the compensation was earned or vested under an award that had been granted before the effective date of the Final Rule.

Related Practices

Executive Compensation & Employee Benefits

New Clawback Policy Requirements

The Proposed Rule requires listed issuers to adopt and comply with a written clawback policy providing that, in the event the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover the amount of erroneously awarded incentive-based compensation.

While many public companies have already voluntarily adopted clawback policies that go beyond the clawback requirements of the Sarbanes-Oxley Act of 2002, it is likely that most (if not all) existing policies will need to be amended to incorporate the substantive requirements mandated by the Proposed Rule. The key requirements of the Proposed Rule's clawback policy are highlighted below:

- *Restatement Trigger*: Recovery under the clawback policy is only triggered if a covered accounting restatement has occurred. An accounting restatement is defined as the result of the process of revising previously issued financial statements to reflect the correction of one or more errors that are material to those financial statements. In order to trigger application of the clawback policy, the issuer must be required to prepare an accounting restatement to correct a material error. Changes to previously issued financial statements that do not represent error corrections would not trigger a clawback (*e.g.*, retrospective changes due to a change in accounting principles, discontinued operation reclassification or change in reporting entity would not trigger a clawback).

- *Covered Executives*: The universe of executives potentially subject to clawback is the issuer's "executive officers." The definition of "executive officer" is modeled after the definition of "officer" used for Section 16 purposes, so that all of an issuer's Section 16 executives will potentially be subject to clawback. The Proposed Rule also provides that any person identified as an executive officer in the issuer's proxy statement or annual report who is not also a Section 16 officer will be presumed to be an executive officer subject to the clawback rules. An individual "executive officer" is subject to clawback on compensation if the individual served as an "executive officer" at any time during the performance period applicable to that compensation. For example, if an individual is promoted to an "executive officer" position in November 2017, and had been granted a performance-based stock unit award in February 2015 that is earned based on performance over a three-year period consisting of calendar years 2015-2017, all of these performance-based stock units would potentially be subject to clawback. Similarly, if the individual ceased being an "executive officer," any such incentive-based compensation would remain subject to potential clawback.

- *Covered Incentive-Based Compensation*: Compensation is potentially subject to clawback if it is incentive-based compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure. Financial reporting measures include measures that are determined and presented in accordance with the accounting principles used in the issuer's financial statements (such as revenues, net income or operating income), any measures derived wholly or in part from such financial information (such as EBITDA, FFO, return on invested capital or assets, working capital or relative performance against a peer group or index where performance is measured based on such financial information), and stock price and total shareholder return. Equity awards such as options or stock units would only be subject to clawback if the awards are either granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure. Time-based equity (and cash) awards that vest based solely on continued employment, as well as discretionary cash (or equity) bonuses, are not subject to clawback. However, supplemental non-qualified retirement or deferred compensation benefits calculated based on incentive-based compensation amounts are subject to clawback. The SEC Staff has requested comments on whether all stock options, including those subject only to time-based vesting requirements, should be considered incentive-based compensation.

- *Covered Time Period*: Recovery under the clawback policy generally applies to covered incentive-based compensation that is received during the three completed fiscal years immediately preceding the date the issuer is required to prepare a covered accounting restatement (*e.g.*, if an issuer is required to prepare a covered restatement in fiscal 2018, clawback would apply to covered incentive-based compensation received in fiscal 2017, 2016 and 2015). For these purposes, compensation is treated as received in the issuer's fiscal period when the applicable financial reporting measure is attained (even if payment occurs in a later period or the award is subject to additional time-based vesting requirements after the financial reporting measure is attained). For example, if a restricted stock unit is subject to performance-based vesting for the 2017 fiscal year, the award will be treated as received in the 2017 fiscal year for these purposes, even if actual payment of the award is deferred to later years. In addition, for these purposes, the date an issuer is required to prepare a covered accounting restatement will be the earliest of (A) the date the issuer's board of directors (or a committee thereof) concludes or reasonably should have concluded that the issuer's previously issued financial statements contain a material error (which date is generally expected to coincide with the date a Current Report on Form 8-K is triggered under Form 8-K Item 4.02(b) to disclose non-reliance on the previously-filed issuer financial statements) and (B) 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. Recovery under the clawback policy only applies to compensation received while the issuer has a class of securities listed on an exchange.

- *Amount of Erroneously Awarded Compensation*: Recovery under the clawback policy applies to erroneously awarded compensation, which is defined to mean the amount of covered incentive-based compensation received that exceeds the amount of compensation that otherwise would have been received had it been determined based on the accounting restatement. For example, if an executive earned a $1,000,000 bonus based on EBITDA performance as originally reported and would have earned a $750,000 bonus based on EBITDA performance as corrected in the restatement, the recoverable amount would be $250,000. For compensation based on stock price or total shareholder return where the amount of erroneous compensation is not subject to mathematical recalculation (because the issuer is required to determine the stock price impact of the restatement), issuers must use a reasonable estimate of the recoverable amount. Importantly, the recoverable amount is determined on a pre-tax basis without giving effect to any taxes already paid by the executive on the recoverable amount.

- *Recovery Options*: The Proposed Rule does not codify any specific manner or means to accomplish a required recovery of erroneously awarded compensation amounts. Rather, the SEC stated that it believes the appropriate means of recovery may vary by issuer and by type of compensation arrangement, and that issuers should be able to exercise discretion in how to accomplish recovery, as long as the erroneously awarded compensation is recovered “reasonably promptly” (although no guidance is offered as to what time period would be considered “reasonably promptly”).

- *Limited Board Discretion*: Issuers are required to recover erroneously awarded compensation unless it would be impracticable to do so. The concept of impracticability is a narrow one and is limited to situations where the direct expenses paid to a third party to enforce the policy would exceed the amount recovered, or where recovery would violate home country law. Before an issuer may rely on the impracticability exception, it must satisfy certain procedural requirements (including certification by the compensation committee or other committee of independent directors responsible for executive compensation that recovery would be impractical). The issuer will also be required to make additional disclosures described below.

- *No Indemnification*: Issuers are prohibited from indemnifying executive officers against the loss of erroneously awarded compensation. Issuers are also prohibited from paying or reimbursing executive officers for the premiums of an insurance policy that would cover the loss of erroneously awarded compensation.

New Disclosure Requirements

The Proposed Rule contains new disclosure requirements. Listed issuers will be required to file their clawback policies as exhibits to their annual reports. In addition, new disclosures will be required for any year if, at any time during the last completed fiscal year, either a covered accounting restatement was completed or there was an outstanding balance of erroneously awarded compensation from a prior covered restatement. If this disclosure obligation is triggered, issuers are required to disclose for each restatement:

- The date the issuer was required to prepare a covered restatement.

- The total amount of erroneously awarded compensation attributable to the restatement (including a description of the estimates used to determine amounts attributable to stock price or total shareholder return metrics).

- The total amount of erroneously awarded compensation that has yet to be clawed back at the end of the last completed fiscal year (including the name of each individual for whom erroneously awarded compensation has remained outstanding for 180 or more days and the clawback amount owed by such individual).

- If the issuer determined in the last completed fiscal year not to pursue clawback from any executive officer in reliance on the impracticability exception, the name of the executive officer, the amount foregone and a description of the reason why.

Like the newly proposed pay-for-performance disclosures, these new disclosures are required to be provided in XBRL format in a new separate tagged exhibit.

Very Limited Number of Exempted Companies

The Proposed Rule contains exemptions for security futures products, standardized options and certain registered management investment companies that have not awarded incentive-based compensation to any executive officer in any of the last three fiscal years (or since initial listing). All other listed issuers—including JOBS Act emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies—are subject to the requirements of the Proposed Rule.

OMM Comments

Our thoughts on some implementation considerations and potential action items are highlighted below:

- *Issuers Should Review Executive Officer Determinations*. All of an issuer's Section 16 executives will potentially be subject to clawback under the Proposed Rule, and the Proposed Rule also provides that any person identified as an executive officer in the issuer's proxy statement or annual report who is not also a Section 16 executive will be presumed to be an executive officer subject to the clawback rules. In light of this application of the clawback rules, issuers should review their executive officer determinations now to confirm that all individuals classified as executive officers are appropriately classified based on their current functions.

- *Issuers Should Review Current Incentive-Based Compensation Agreements*. It is possible that compensation awarded prior to the