
SEC Proposes Broad Executive Compensation Clawback Rules in Connection with Accounting Restatements

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Recovery provisions would apply on a no-fault basis to executive officers of virtually all exchange-listed companies who received incentive-based compensation during the three fiscal years preceding an accounting restatement to correct a material error. Issuers should consider how the proposed rules may affect their executive compensation policies and plans, clawback policies, employment agreements and indemnification arrangements.

On July 1, 2015, the SEC proposed its long-awaited clawback rules, which are the final set of proposed executive compensation rules required by the Dodd-Frank Act. The proposed rules, which are subject to a 60-day comment period, would obligate national securities exchanges to adopt listing standards that require listed companies to adopt and disclose clawback policies to recover from current and former executive officers excess incentive-based compensation attained during the three fiscal years preceding the date on which the company is required to prepare an accounting restatement to correct a material error. Issuers would be required to recover from their executive officers the difference in incentive-based compensation between amounts awarded to the executives and what they would have received based on the accounting restatement, and to disclose all such recovery efforts. Recovery is required whether or not any misconduct occurred and is without regard to an executive officer's responsibility for the erroneous financial statements. A copy of the proposed rules can be found [here](#).

Who is Affected by the Proposed Rules?

Listed Issuers. The proposed rules apply to virtually all issuers listed on a national securities exchange, including most notably emerging growth companies, smaller reporting companies, foreign private issuers and issuers that list only debt securities. Limited exceptions exist for certain registered investment companies and issuers of securities futures products and standardized options.

Executive Officers. The proposed rules largely adopt the definition of "officer" in Rule 16a-1(f) under the Securities Exchange Act of 1934 and cover the issuer's president, principal financial officer, principal

accounting officer or controller, any vice-president of the issuer in charge of a principal business unit, division or function, any other officer who performs a policy-making function, or any other person who performs similar policy-making functions. The proposed definition includes executive officers of an issuer's parent or subsidiary if they perform policy-making functions for the issuer. Under the proposed rules, executive officers include both current and former officers who qualify under this definition. The SEC has requested comment on whether the issuer's chief legal officer, chief information officer and other officers should be subject to the recovery policy regardless of their policy-making function.

How Would Application of the Proposed Clawback Policies Work?

Triggering Event. An issuer would be required to clawback incentive-based compensation when it is required to prepare an accounting restatement to correct a material error to previously issued financial statements. The obligation to prepare the restatement would trigger application of the recovery policy. Retrospective changes to an issuer's financial statements due to changes in accounting principles, internal restructurings or adjustments in connection with stock splits would not trigger a clawback.

Look-Back Period. The clawback policy must apply to all excess incentive-based compensation attained in the three completed fiscal years preceding the earlier of the date that the issuer's board (or equivalent) concludes, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error, or 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 Amount. The compensation subject to recovery would be the amount of incentive-based compensation received by the current or former executive officer that exceeds the amount that would have been received had such compensation been determined based on the accounting restatement. The recoverable amount would be calculated on a pre-tax basis. Issuers would be allowed to use reasonable estimates to determine the impact of the restatement with regard to stock price or total shareholder return measures.

What Types of Compensation are Subject to Recovery?

Compensation Covered. The proposed rules define incentive-based compensation in a principles-based manner as any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. Examples of financial reporting measures would include revenues, net income, financial ratios, EBITDA, return and earnings measures and measures based on stock price or total shareholder return. Examples of covered compensation would include options and other equity awards whose grant or vesting is based upon the attainment of any measure based upon or derived from financial reporting measures, proceeds received upon the sale of any shares acquired through such equity awards, non-equity incentive plan awards that are earned based on satisfying a financial reporting measure performance goal and bonuses paid from a bonus pool whose size is determined by satisfying a financial reporting measure performance goal.

Compensation Not Covered. Forms of compensation that would not be covered under the proposed rules includes salaries, bonuses paid solely at the discretion of an issuer's compensation committee or board that are not paid from a bonus pool tied to a financial reporting measure performance goal, bonuses paid solely upon satisfying subjective standards or continued employment, non-equity incentive plan awards earned solely based upon satisfying strategic or operational measures, and equity awards that vest solely upon completing a specified period of employment or other non-financial reporting measures.

What is the Extent of Board Discretion in Pursuing Clawbacks?

Boards have very little discretion to determine whether an executive officer may retain excess incentive-based compensation in the event of an accounting restatement. Under the proposed rules, issuers must recover excess incentive-based compensation unless: (i) after a reasonable attempt to recover the excess compensation is made, the issuer concludes that it would be impracticable to recover the excess because the direct expense of seeking recovery would exceed the recoverable amount; or (ii) in the case of a foreign private issuer, recovery would violate applicable home country laws.

Under the proposed rules, an issuer would be required to document its attempts to recover excess compensation and provide that documentation to the exchange. Before an issuer could conclude that recovery would violate home country laws, the issuer would need to obtain an opinion of home country counsel, acceptable to the applicable exchange, that recovery would result in a violation. The relevant home country law must have been adopted prior to the date of publication of the proposed rules.

What Are the Disclosure Requirements?

Issuers would have to adopt and file a clawback policy as an exhibit to their annual reports on Form 10-K or Form 20-F, as applicable. If an issuer had an accounting restatement that required recovery during its prior fiscal year, it would have to disclose in its next annual report and proxy statement, if applicable, the total dollar amount of excess compensation attributable to the accounting restatement and the amount of excess compensation that remains outstanding, the name of each person subject to recovery from whom the issuer decided not to pursue recovery, the amount forgone and a brief description of the reason the issuer decided not to pursue recovery.

How Do the Proposed Rules Interact with the Clawback Provisions of Sarbanes-Oxley?

The proposed rules would supplement the clawback provisions of Section 304 of the Sarbanes-Oxley Act. If there are overlapping recoveries, any amount repaid by an executive officer under Section 304 should be credited to the extent the recovery policy under the proposed rules required repayment of the same compensation by that executive officer. Recovery under the proposed rules would not preclude recovery under Section 304 to the extent applicable amounts have not been reimbursed to the issuer. The following chart depicts some key differences between the proposed rules and Section 304.

	SEC Proposed Rules	SOX Section 304
Standard for Recovery	No-fault	Misconduct is required, but not necessarily by covered executive officers
Look-Back Time Period	Three years from the date the issuer is required to prepare the accounting restatement	One year from the issuance or filing of the accounting restatement
Covered Executive Officers	Current and former executive officers	Chief Executive Officer and Chief Financial Officer
Covered Compensation	All incentive-based compensation affected by the accounting restatement	Any bonus or incentive-based or equity-based compensation, regardless of whether any such compensation is affected by the accounting restatement, and any profits from the sale of securities during covered period
Clawback Enforcement	Issuer	SEC

What Should Companies Be Doing in Response to the Proposed Rules?

The proposed rules may not be adopted as proposed. Nonetheless, issuers should consider the following, in consultation with in-house and outside counsel:

- Review any existing clawback policy with a view to conforming it to the anticipated new rules.
- Evaluate whether modifications need to be made to compensation plans, employment agreements and/or indemnification arrangements (including bylaws) to conform to the anticipated new rules.
- Evaluate the potential impact of the anticipated new rules on overall executive compensation. Boards and compensation committees should consider the likely consequence that executives will seek to have a higher percentage of their compensation not covered by the proposed clawback rules.
- Evaluate, in conjunction with outside auditors, whether accounting treatment of compensation subject to potential clawback will need to be changed and, if so, the anticipated ramifications.

What Are Some of the Likely Consequences if the Proposed Rules Are Adopted?

Accounting restatements that fall within the ambit of the proposed rules are fairly rare. However, because the proposed clawback rules cover three years of incentive-based compensation and are imposed on a “no-fault” basis, executives may be motivated to seek changes to their compensation to minimize the potential impact of a clawback. Some of these changes and their anticipated consequences are:

- Executive officers may seek higher compensation, either to take into account the risk of the proposed rules or to make themselves “whole” after having compensation clawed back. In addition, officers may seek to have more of their overall compensation weighted toward plans that are based on non-financial measures. Boards will need to consider whether or not agreeing to requests for changes in the size and/or overall mix of executive compensation will be in the interests of the issuer. It remains to be seen how ISS and other proxy advisory services will react to this anticipated development.
- The proposed rules make clear that issuers may not indemnify executives for the amounts of the clawed-back compensation. However, there is no prohibition on issuers indemnifying executives for legal fees and expenses incurred in defending actions initiated by issuers to clawback compensation. Executives may insist upon provisions in their employment agreements and indemnification agreements that obligate the issuer to bear such legal fees and expenses. In turn, issuers may insist upon coverage of these expenses by D&O insurers
- Under the proposed rules, issuers may not pay premiums (or reimburse executives for such premiums) for insurance policies covering any clawed-back amounts for executives. As with indemnification, there is no prohibition on executives purchasing such insurance themselves. Executives may consider purchasing insurance policies for themselves that cover clawed-back compensation amounts.

When will the Proposed Rules Go into Effect?

The proposed rules will go through a 60-day public comment period, after which the SEC may adopt them as-is or revise them substantially. Once final rules are published in the Federal Register, the national securities exchanges will have 90 days to propose the required listing standards, which must be effective (with SEC approval) within one year of publication of the final rules. Once the listing standards become effective, issuers will immediately be subject to the rules’ disclosure requirements for filings made after the effective date of the listing rules, and they will have 60 days to adopt a clawback policy. Only incentive-based compensation that is granted, earned or vested on or after the effective date of the SEC final rules

and that is subject to an accounting restatement for a fiscal period ended on or after such effective date will be required to be subject to an issuer's clawback policy.

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