

LEGAL UPDATES AND NEWS

SEC Proposes Rule on Incentive Compensation Clawbacks

On July 1, 2015 the Securities and Exchange Commission proposed Rule 10D-1 which would direct the national securities exchanges to establish listing standards that require issuers to develop and implement clawback policies for recovering erroneously paid incentive-based compensation. The rule would apply to compensation received by current and former executive officers during the three year period preceding the date an issuer is required to prepare an accounting restatement. This is the final rulemaking required by the executive compensation provisions of the Dodd-Frank Act (“Dodd-Frank”), and are *in addition to* the current Sarbanes-Oxley Act of 2002 (“SOX”) clawback requirements.

General Requirements of Proposed Rule 10D-1

- Each public company must develop and maintain a written clawback policy that provides for recoupment of incentive compensation erroneously paid to executive officers if the company is required to perform a restatement due to a material error in previously issued financial statements.
- In the event of a restatement, a clawback is required regardless of any fault, misconduct or responsibility of an executive officer for the misstatement, and would apply to any current or former executive officer who received incentive-based compensation during the three year look-back period (the three completed fiscal years preceding the date the issuer is required to prepare an accounting restatement).
- The term executive officer is based on the “officer” definition in Section 16 of the Securities Exchange Act of 1934 and includes a company’s president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division or function, and any other person who performs policy-making functions for the company.
- Compensation will be considered incentive based if it is granted, earned or vested based wholly or in part on attaining any financial reporting measure, i.e., measures based on the accounting principles used in preparing the financial statements, stock price or total shareholder return.
- Proposed Rule 10D-1 would amend Regulation S-K and require modification of certain SEC forms to address the new clawback requirements.
- The new national securities exchange listing standards would apply to almost all public companies, including emerging growth companies and smaller reporting companies.

Incentive Compensation Defined

Incentive compensation would include non-equity incentive plan awards, bonuses paid from a bonus pool, restricted stock, RSUs, performance share units, stock options, and SARs, in each case to the extent based on satisfying a financial reporting measure performance goal, as well as proceeds received from the sale of shares underlying such awards. Incentive compensation would not include salaries, time-

based equity awards (i.e., stock option and restricted stock awards typically granted to executive officers of community banks), discretionary bonuses or bonuses based on satisfying subjective conditions.

Under the proposed rule, incentive compensation is considered received in the fiscal year in which the financial reporting measure is attained, even if the payment or grant occurs in a subsequent fiscal year. Incentive compensation would be subject to the issuer's recovery policy to the extent that it is received while the issuer has a class of securities listed on an exchange. Incentive compensation received prior to listing would not be subject to clawback.

The Clawback Policy and Amount

If a restatement is required due to a material error in a company's financial statements, the incentive compensation required to be clawed back would be the amount in excess of what would have been received based on the accounting restatement determined on a pre-tax basis. The SEC acknowledged the potential difficulty in terms of determining the amount to be recovered when the relevant financial reporting measure relates to stock price, and the rule would permit issuers to use reasonable estimates to determine the impact of a restatement on stock price and total shareholder return. Incentive compensation received in the three fiscal years preceding the date on which the accounting restatement is required to be prepared would be subject to clawback. A company would be required to recover erroneously awarded incentive compensation except to the extent that pursuit of recovery would be impractical because it would impose undue costs to the company or its shareholders, which determination must be made by the compensation committee or a majority of independent directors.

A public company's clawback policy would be required to be included as an exhibit to its Form 10-K. Additionally, if, during the last completed fiscal year, the company either prepared an accounting restatement that required a clawback or if there was an outstanding balance of excess compensation under a prior restatement, the company would be required to disclose the following in its annual reports and in any proxy or information statements in which disclosure of executive compensation is required (and would be required to block tag the disclosure using XBRL):

- the date on which the restatement was required to be prepared, the aggregate amount of compensation that may be clawed back under the policy and aggregate recoverable compensation that has not been clawed back as of the end of the fiscal year;
- the estimates used to determine the excess incentive compensation if a financial reporting measure related to a stock price or total shareholder return metric;
- the name of each executive who could, but did not, have compensation clawed back, how much should have been clawed back, and a description why the company did not to pursue the claw back; and
- the name of, and amount due from, each executive at the end of the last completed fiscal year if excessive compensation under the policy is outstanding for more than 180 days.

In years subsequent to a restatement, the Summary Compensation Table would reflect the reduction in previously reported pay due to the recovery, with appropriate footnote disclosure (i.e., if \$300,000 of previously reported \$1,000,000 in compensation was recovered, the subsequent years' SCT would report \$700,000 of applicable compensation for that year, with a footnote explaining the recovery). An issuer would be prohibited from indemnifying an executive officer for recovered compensation, and from paying for premiums for insurance for such reimbursement.

Dodd-Frank Clawbacks and SOX Clawbacks

The following table summarizes the differences between the proposed Dodd-Frank clawback requirements and the current SOX Section 304 requirements:

	SOX Section 304	Dodd-Frank Section 954
Trigger	Any misconduct that requires a restatement of any financial reporting that is required under securities laws	An accounting restatement that is due to material noncompliance with reporting requirements under securities laws
Which Executives	CEO and CFO only	All executive officers
Type of Compensation	Bonus or other incentive-based or equity-based compensation (full amount of the compensation, not just the excess over what would have been paid); and in addition to compensation, the recovery of profits of certain sales of securities	Incentive-based compensation in excess of what would have been paid under the accounting restatement
Lookback Period	The 12-month period following the first to occur of the first public issuance or filing with the SEC of the financial document that gives rise to the restatement	Three-year period preceding the date the company is required to prepare the accounting restatement

Expected Timing

The proposed rule is subject to a 60-day comment period. Within 90 days after the rule is finalized by the SEC, the national securities exchanges will be required to propose new listing standards which must be made effective within one year after they are approved by the SEC. Public companies would then have 60 days to adopt clawback policies and would be required to disclose required clawback information for any filings made on or after the effective date of the final listing standards. The clawback policy would apply only to incentive-based compensation received for a fiscal period ending on or after the effective date of the final rule. Based on these proposed timelines, it is expected that the new clawback rules would not be effective prior to 2017.

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