

SEC Proposes Rules Mandating Executive Compensation “Clawback” Policies

JULY 6, 2015

On July 1, 2015, the Securities and Exchange Commission (the SEC) proposed new rules that would mandate U.S. stock exchanges to establish and enforce standards requiring listed companies to adopt compensation recovery policies for erroneously earned incentive-based compensation.

Proposed as new Rule 10D-1 under the Securities Exchange Act of 1934 (the Exchange Act), these rules represent the last of the executive compensation proposals to be issued as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Since 2013, the SEC has proposed rules requiring increased disclosure requirements with respect to pay ratios, pay-for-performance, and hedging policies.

Covered Companies and Timing of Coverage

The proposed rules apply to all companies listed on U.S. stock exchanges, except for certain registered investment companies not providing incentive-based compensation to their employees. The proposed clawback triggers when a listed company is required to issue an accounting restatement to correct a material error to previously-issued financial statements.

Clawback policies under the proposed rules extend back three fiscal years prior to the date upon which a listed company is required to restate its financial statements in response to a material error. Moreover, such recovery is on a “no fault” basis, meaning the clawback occurs regardless of whether the executive officer committed misconduct or had any responsibility for the financial statements containing a material error.

Listed companies are required to pursue recovery of excessive incentive-based compensation, unless doing so imposes undue costs on itself or its shareholders, or violates any relevant non-U.S. home country law.

Covered Compensation

Under the proposed rules, compensation subject to recovery includes incentive-based compensation earned, granted, or vested based on stock price, total shareholder return, or the accounting principles used to construct financial statements.

Listed companies would recover compensation in the amount of the difference between the incentive-based compensation actually paid to an executive officer and the amount that should have been paid as measured by the restated financial statements. In the event that such compensation is based off of stock price or total shareholder return, the proposed rules allow the listed company to reasonably estimate how the incentive-based compensation in question was affected by the material error in the original financial statements.

Covered Executives

The proposed rules apply to current and former “executive officers” of listed companies, modeled off of the definition of “officer” used under Section 16 of the Exchange Act. Accordingly, the rules would apply to a company’s current or former president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division, or function, or any other employee performing policy-making functions for the company. Compared to clawback requirements originally enacted in response to the WorldCom and Enron scandals in the early 2000’s, which affected only CEO’s and CFO’s, the proposed rules represent a significant broadening in the reach of this concept.

Disclosure Obligations

Each listed company will be required to file its clawback policy as an exhibit to its Form 10-K annual reports.

In the event that a listed company has to issue an accounting restatement under the proposed rules, it must disclose the date it was required to prepare the restatement, the aggregate dollar amount of excess incentive-based compensation attributable to the restatement, and the aggregate dollar amount still outstanding at the end of its last completed fiscal year.

Additionally, if the company chooses not to pursue recovery from any executive officer, it must disclose the reason for not doing so and the amounts due from each such individual. If any executive officer fails to return within 180 days incentive-based compensation owed, the company must disclose that executive officer’s name and the amount due to the company.

Transition Period

As currently proposed, U.S. stock exchanges must finalize listing rules implementing the proposed clawback provisions within 90 days of the final rule’s publication, and these rules are to become effective within one year of such publication. Listed companies would then be required to adopt clawback policies no later than 60 days after the stock exchange rules go into effect.

Implications

As has often been the case in recent SEC rulemaking efforts, the proposed clawback rules passed by a narrow 3-2 vote, along party lines. As framed by the Democrat-appointed Commissioners, the proposed rules “should increase accountability and bring greater focus to the quality of financial reporting.” However, as depicted by the Republican-appointed Commissioners voting in opposition, the proposed rules “reflect a view that a corporate board is the enemy of the shareholder, not to be trusted to do the right thing.”

Be aware that it has also been suggested that various financing sources may seek to impose similar policies on their financed private companies.

Comments on the proposed rules are due within 60 days after their publication in the Federal Register. A copy of the proposed rules can be found [here](#) and for additional information on the proposed rules, please refer to the [press release](#) issued by the SEC.

We will follow the comments and final rulemaking process. Please contact one of the attorneys listed below or any of the attorneys in the Corporate & Securities Practice Group at Benesch to discuss the implications and effective

Megan L. Mehalko | mmehalko@beneschlaw.com | 216.363.4487