Securities Law / Employee Benefits & Executive Compensation ADVISORY ■

JULY 9, 2015

SEC Proposes Compensation Clawback Rules

On July 1, 2015, the Securities and Exchange Commission (SEC) issued proposed rules that would require each listed issuer to adopt a compensation clawback policy pursuant to Section 954 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. Under such a policy, any listed issuer required to prepare an accounting restatement to correct a material error must recover erroneously awarded compensation from any current or former executive officer who received incentive-based compensation (including stock options) during the three-year period before the date on which the restatement is required to be made. Erroneously awarded compensation includes the amount of incentive-based compensation received by such persons that exceeds the amount that would have been received based on the accounting restatement. The compensation clawback policy must mandate such recovery, with limited exceptions and without regard to fault or misconduct on the part of the covered executive officers.

Commissioners Luis Aguilar, Kara Stein and Chair Mary Jo White voted in favor of the rules, with Commissioner Aguilar noting that the proposed rules would promote a culture of compliance and send the message that "if you did not earn your compensation, you should not keep it." Commissioners Daniel Gallagher and Michael Piwowar dissented and voiced concerns about the broad scope of the proposed rules.

Which issuers would be covered by the new rules?

All listed issuers – including emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies – would be required to comply with the proposed rules, with limited exemptions for the listing of securities futures products, standardized options and securities issued by certain registered investment companies.

What would qualify as an accounting restatement for purposes of the new rules?

The proposed rules define an accounting restatement 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." Notably, as proposed, the rules do not define what types of errors might be material for this purpose, leaving issuers to make this determination based on a facts and circumstances analysis.

To what group of "executive officers" would the clawback policy apply?

As proposed, an issuer's "executive officers" for purposes of its required clawback policy would be the same as its officers subject to Section 16, which includes its president, principal financial officer, principal accounting officer (or if there is no accounting officer, the controller), any vice president in charge of a principal business unit, division or function

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(such as sales administration or finance), any other officer who performs a policymaking function for the issuer, or any other person who performs similar policymaking functions for the issuer. Executive officers of the issuer's parents or subsidiaries would be deemed executive officers of the issuer if they perform policymaking functions for the issuer.

How is the three-year lookback period measured?

The applicable three-year lookback period covers the three completed fiscal years immediately preceding the date on which the issuer is required to prepare an accounting restatement. That date would be considered to occur on the earliest of (1) the date the board or committee concludes that the issuer's financial statements contain a material error, (2) the date the board or committee *should have* made such a conclusion, or (3) the date a court, regulator or other legally authorized body directs the issuer to restate its financial statements to correct a material error. Incentive-based compensation would be deemed to have been "received" by the executives in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award was attained, even if the payment or grant occurred after the end of that period.

What types of compensation would be subject to the clawback policy?

The clawback policy would apply to "incentive-based compensation," which is defined to include any compensation (including options and other equity awards) that is granted, earned or vested based wholly or in part upon the attainment of any "financial reporting measure." Financial reporting measures include any measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from such financial information and stock price and total shareholder return.

The release provides the following examples of compensation that would be considered to be "incentive-based":

- Non-equity incentive plan awards earned based wholly or in part on satisfying a financial reporting measure performance goal;
- Bonuses paid from a "bonus pool," the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal;
- Restricted stock, restricted stock units, performance share units, stock options and stock appreciation rights that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal; and
- Proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal.

Examples of compensation that would *not* be considered "incentive-based" include:

- Salaries;
- Bonuses paid solely at the discretion of the compensation committee or board that are not paid from a bonus pool, the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal;
- Bonuses paid solely upon satisfying one or more subjective standards and/or completion of a specified employment period;
- Non-equity incentive plan awards earned solely upon satisfying one or more strategic or operational measures; and

- Equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more non-financial reporting measures.

How would issuers determine the recoverable amount?

As proposed, the recoverable amount would be the amount of incentive-based compensation received by the executive officer or former executive officer during the three-year lookback period that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement. Recoverable amounts related to incentive-based compensation that was based on stock price or total shareholder return must be determined by the issuer based upon a reasonable estimate of the effect of the accounting restatement on the issuer's stock price or total shareholder return. Notably, the proposed rules require that erroneously awarded compensation be computed without regard to any taxes paid by the executive officer or former executive officer.

Would an issuer be afforded any discretion to determine whether or not to recover amounts that would otherwise be subject to its clawback policy?

An issuer would have discretion to determine *not* to recover otherwise recoverable amounts only in very limited circumstances:

- Where, after making a reasonable attempt at recovery, the issuer determines that further pursuit of recovery would be impracticable because it would impose undue costs on the issuer or its shareholders (i.e., the cost of recovery would exceed the clawback amount); or
- Where the issuer determines that recovery would violate home country law, provided certain conditions are met.

What disclosure would be required?

Issuers would be required to file their clawback policies as an exhibit to their Annual Report on Form 10-K or 20-F. In addition, the proposed rules would amend the executive compensation disclosure rules to require disclosure regarding the issuer's enforcement of the policy. Specifically, if at any time during its last completed fiscal year the issuer triggered its clawback policy, or there was an outstanding balance subject to recoupment related to a prior enforcement of the policy, the issuer would be required to disclose:

- The date on which it was required to prepare the accounting restatement triggering the clawback policy, the aggregate dollar amount of excess incentive-based compensation attributable to the restatement and the aggregate dollar amount that remained outstanding at the end of its last completed fiscal year;
- The name of each person subject to recovery from whom the issuer decided not to pursue recovery, the amounts due from each such person and a brief description of the reason the issuer decided not to pursue recovery; and
- If amounts of excess incentive-based compensation are outstanding for more than 180 days, the name of, and amount due from, each person subject to recovery at the end of the issuer's last completed fiscal year.

Listed companies would also be required to block tag the disclosure in an interactive data format using eXtensible Business Reporting Language (XBRL).

What are the consequences of noncompliance?

An issuer would be subject to delisting if it does not: (1) adopt a clawback policy that complies with the applicable listing standard, (2) disclose the policy in accordance with SEC rules, including providing the information in tagged data format, and (3) comply with the policy's recovery provisions.

When will the new rules be effective?

The SEC will collect public comments on the rules for 60 days following their publication in the *Federal Register* and will hold a second vote before the rule can go into effect. Each exchange would be required to file its proposed listing rules no later than 90 days following publication of the SEC's final rules, and, as proposed, the listing rules must become effective no later than one year following that publication date.

If approved, the listing rules would not likely be applicable before the end of 2016; however, companies should contact their counsel to proactively evaluate their existing clawback policies under the proposed rules.

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