

## SEC Proposes Rule Regarding Clawback of Erroneously Awarded Incentive-Based Compensation

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The SEC has proposed Rule 10D-1 under the Securities Exchange Act of 1934 to implement the clawback provisions contained in Section 954 of the Dodd-Frank Act. Under the proposal, in the event that a public company restates its financial statements due to material noncompliance with the financial reporting requirements of the securities laws, it must clawback from any current or former executive officer who received incentive-based compensation in the preceding three year period any amount in excess of what he or she would have been received under the restated financial measures. The national securities exchanges must prohibit the listing of any security of any issuer not in compliance with these requirements.

### Key Points

- Listed issuers must adopt a policy requiring recovery of erroneously awarded incentive-based compensation and the policy must be filed as an exhibit to their Form 10-K.
- Incentive-based compensation is compensation granted, earned or vested based upon the attainment of any financial reporting measure, including stock price performance.
- Clawback is triggered by issuer's material noncompliance with a financial reporting requirement that results in an accounting restatement and would apply to all current and former executive officers that had received incentive-based compensation in any performance period within a three year look-back period prior to the restatement.
- The clawback amount is the difference between the amount paid based on the financial reporting measure using the original erroneous financial statements and the amount that is calculated applying the recalculated financial reporting measure.

### What triggers application of the clawback?

As proposed, the clawback is triggered whenever there is "material noncompliance" with a financial reporting requirement under the securities laws resulting in an accounting restatement. "Material noncompliance" is defined as an error that is material to previously issued financial statements. "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. The proposed rule does not describe any type of error that would be considered material. The determination must be analyzed in the context of particular facts and circumstances.

### To what compensation does the clawback apply?

The clawback applies to “incentive-based compensation” which is defined as “any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure.” “Financial reporting measures” are measures that are determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements (such as revenue and net income), any measures derived wholly or in part from such financial information (such as sales per square foot or same store sales) and stock price and total shareholder return.

Salary, bonuses awarded upon satisfaction of subjective standards (i.e. demonstrated leadership) and other compensation that is contingent solely upon the occurrence of certain non-financial events, such as opening a specified number of stores, obtaining regulatory approval of a product, consummating a merger or divestiture, completing a restructuring plan or financing transaction, would not be “incentive-based compensation” because these measures of performance are not financial reporting measures. However, salary increases based on the attainment of a financial reporting measure would be subject to clawback.

### Who is subject to the clawback policy?

As proposed, the clawback policy applies to any individual who served as an executive officer at any time during the applicable performance period affected by the accounting restatement. An “executive officer” is defined as the issuer’s president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. The clawback would apply, for example, to incentive-based compensation attributable to an award that was authorized before an individual becomes an executive officer, and awards to new hires, as long as the individual served as an executive officer at any time during the award’s performance period.

### What is the look-back period?

As proposed, there is a look-back period consisting of the three completed fiscal years immediately preceding that the date the issuer is required to prepare an accounting restatement. This date is defined as the earlier to occur of: (1) the date the issuer concludes, or reasonably should have concluded, that its previously issued financial statements contain a material error;<sup>1</sup> or (2) the date a regulatory body directs the issuer to restate its previously issued financial statements to correct a material error. For example, if a calendar year issuer determines in November 2018 that its financial statements must be restated, the recovery policy would apply to compensation received in 2015, 2016 and 2017.

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<sup>1</sup> The proposing release notes that “the issuer merely needs to have concluded that previously issued financial statements contain a material error, which may occur before the precise amount of the error has been determined.”

When is incentive-based compensation “received” by the executive officer?

As proposed, incentive-based compensation is “received” in the fiscal period during which the financial reporting measure specified in the applicable award is achieved regardless of whether the payment or grant occurs after the end of that period. The date of “receipt” depends upon the terms of the award. For example, if the grant of an award is based on achieving a financial reporting measure, the award is “received” in the fiscal period during which the measure is satisfied. If an award vests upon satisfaction of a financial reporting measure, the award is “received” in the fiscal period when it vests. Similarly, a non-equity incentive plan award is “received” in the fiscal year that the executive earns the award when the relevant financial reporting measure performance goal is achieved, regardless of whether the award is paid in a subsequent fiscal period.

How does the issuer determine excess compensation?

As proposed, the excess compensation subject to clawback is the difference between the amount paid to the executive officer based on the financial reporting measure using the original erroneous financial statements and the amount that should have been paid applying the recalculated financial reporting measure. The issuer must take into account any discretion that was exercised at the time of the initial payment to reduce the amount originally received. The clawback amount would be determined on a pre-tax basis. Where the affected incentive-based compensation was based on stock price or total shareholder return, the clawback amount must be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. Issuers must document their determination of their reasonable estimate and provide the documentation to the relevant exchange.

May the board exercise discretion in administering the clawback policy?

As proposed, an issuer must clawback erroneously awarded compensation in compliance with its recovery policy unless recovery would impose undue costs on the issuer or its shareholders or would violate home country law. Before concluding that recovery would be impracticable based on enforcement costs, the issuer must make a reasonable attempt to recover the incentive-based compensation and is required to document its attempts to recover and provide that documentation to the exchange. The issuer also would be required to disclose why it determined not to pursue recovery. A board may not discriminate among executive officers, including in “pool plans,” where it may have exercised discretion in allocating the bonus pool among participants. Recovery must be pro rata based on the size of the original award.

What disclosures must be made regarding compliance with the clawback policy?

An issuer would be subject to delisting if it does not adopt and comply with its clawback policy. As proposed, the listing standards of each exchange must require that issuers record their clawback policies in writing, and the policies must be filed with the SEC as an exhibit to its annual report on Form 10-K. The SEC also proposes to amend Item 402 of Regulation S-K to require issuers to disclose how they have applied their recovery policies if at any time during its last completed fiscal year there is a restatement that triggered clawback of excess incentive-based compensation or there is an outstanding balance of excess incentive-based compensation as a result of a prior restatement.

## Indemnification

As proposed, issuers are prohibited from indemnifying any executive officer or former executive officer against the loss of compensation that has been clawed back. The indemnification prohibition would prohibit an issuer from paying or reimbursing the executive for premiums paid for a third-party insurance policy to fund potential recovery obligations.

## Timing and Effectiveness

As proposed, the SEC's timetable for implementation of the clawback rule is:

- no later than 90 days following publication of final Rule 10D-1 in the Federal Register, each exchange must file its proposed listing rules.
- no later than one year following publication of final Rule 10D-1 in the Federal Register, each exchange's proposed listing rules must be effective.
- no later than 60 days following the date on which the exchanges' rules become effective, listed companies must adopt a clawback policy.
- each listed company would be required to clawback erroneously awarded incentive-based compensation that is based on financial reporting measures derived from financial information for any fiscal period ending on or after the effective date of Rule 10D-1 and that is granted, earned or vested on or after the effective date of Rule 10D-1.
- listed companies are required to make the required disclosures in the applicable SEC filings required on or after the date on which the exchanges rules become effective.

Comments on proposed Rule 10D-1 must be received on or before 60 days after date of publication in the Federal Register.



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