**SEC proposes rules on clawback policies for executive compensation**

July 10, 2015

**In brief**

On July 1st, the Securities and Exchange Commission (SEC) proposed new Exchange Act Rule 10D-1 (‘Proposed Rules’) that would direct national securities exchanges and national securities associations (together, the ‘Securities Exchanges’) to establish listing standards requiring issuers to have policies for the recovery of erroneously awarded compensation, which are commonly referred to as clawbacks. Section 10D to the Securities Exchange Act of 1934, which was added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires the SEC to adopt such rules.

The Proposed Rules would require issuers to develop and disclose clawback policies that obligate issuers to recover incentive-based compensation that was erroneously paid to executive officers during the three fiscal years prior to the date the issuer is required to prepare an accounting restatement. In the event of a restatement, the issuer would be required to determine if any incentive compensation was erroneously paid based on the restated results. If so, the issuer would generally be required to recover such incentive compensation. The Proposed Rules would also require issuers to disclose a written clawback policy as an exhibit to its annual reports, as well as any actions taken by the issuer pursuant to such policy.

The Proposed Rules are minimum standards to be used by the Securities Exchanges in developing their own listing standards, which may be more extensive than those in the Proposed Rule. Each Securities Exchange would be required to develop draft listing standards which the SEC would then review and approve before they become final. The SEC is currently seeking public comment on the Proposed Rules, which are due 60 days from when the Proposed Rules are published in the Federal Register.

**In detail**

**Background**

With the passage of the Sarbanes-Oxley Act of 2002 (SOX), CEOs and CFOs have been ‘on the hook’ to return incentive-based or equity-based compensation and profits from sales of company stock during the 12 months after the issuance of financial statements if they were later determined to require restatement as a result of misconduct. Clawback policies have also received heightened attention in recent years and have been a topic of discussion among companies’ various stakeholders as well as in the media and courts. Companies may use clawbacks to incentivize certain behaviors, generally ones focused on long-term success versus short-term profit, while also using them to hold employees accountable for their actions. The use of clawbacks has been on the rise with many companies. Some have also modified their policies in anticipation of these Proposed Rules.
In PwC’s most recent study, we found that 40% of the companies reviewed had made some type of change to their policy in 2013.1

**Applicable companies**
The Proposed Rules (available at [http://www.sec.gov/rules/proposed/2015/33-9861.pdf](http://www.sec.gov/rules/proposed/2015/33-9861.pdf)) would apply to all listed issuers with only limited exceptions. Security futures products and standardized options are exempt from these rules similar to the exemptions the SEC adopted for the audit committee and compensation committee listing standards. The SEC reasoned that the issuers of security futures products and standardized options are fundamentally different than that of other listed issuers and believe that information about their business, officers, and compensation is not as relevant as the information of the issuer of the underlying security.

Registered investment companies that have not paid incentive compensation to its officers during the last three fiscal years would also be exempt. Many registered investment companies are externally managed and often have few employees that are compensated by the registered management investment companies. Some registered investment companies are internally managed and some of them do pay incentive compensation to their officers. As such, registered investment companies are not categorically exempt.

All other listed companies would be subject to the Proposed Rules, including emerging growth companies, smaller reporting companies, issuers of debt or preferred securities, controlled companies and foreign private issuers, unless clawbacks violate their local laws and as long as certain conditions are met.

**Executive officer**
The Proposed Rules would apply to any current or former executive officers that performed services in this capacity during the three year period. This group of executive officers is broader than those currently subject to SOX clawback policies, which only include the chief executive officer and chief financial officer. It is also broader than the named executive officer group included in the proxy statements. The SEC used the broader definition of officer from Exchange Act Section 16a-1(f). Specifically, the definition also includes the company’s president, principal financial officer, principal accounting officer, any vice president responsible for a principal business unit or function, or an individual who has policy making responsibilities at the company.

**Observation:** Under the Proposed Rules, all executive officers would be subject to the clawback policies during the three years prior to the restatement. This could include officers who were hired after financials were filed which require restatement (e.g., incentive compensation is based on increased revenue and base year is restated). The clawback policies are applicable even if there is no misconduct and apply to all executive officers regardless of the officer’s involvement with the financial reporting process.

**Clawback trigger**
Under Proposed Rules, an accounting restatement occurs when previously issued financial statements are revised to reflect the correction of one or more errors that are material to those financial statements.

To ensure consistency among issuers in determining the date that an accounting restatement is required, and also to limit potential abuse of other definitions, the SEC provided that the trigger would be the earlier of:

- The date an issuer concludes, or reasonably should have concluded, that the issuer’s previous financial statements contain a material error; or
- The date a legally authorized party (e.g., court, regulator, etc.) directs the issuer to restate previously issued financial statement to correct a material error.

Changes to previously issued financial statements to apply a change in accounting principle or to revise reportable segment information because of a change to a company’s internal structure are not considered error corrections and would not trigger a clawback.

**Incentive compensation**
Incentive compensation that is subject to the Proposed Rules includes compensation that is granted, earned, or vested based on the achievement of a financial reporting measure. Financial reporting measures include measures from financial statements or other financial metrics presented outside the financial statements, such as in Management’s Discussion and Analysis of Financial Conditions and Results of Operations (MD&A), or based on stock price or total shareholder return. Compensation based on individual performance goals, product development, or a merger is not financial in nature and would not be subject to the clawback policies.

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Compensation that is subject to the clawback policies would include non-equity and equity incentive plans, and bonuses paid from a bonus pool, but would not include salaries or bonuses paid at the discretion of the board or compensation committee.

**Observation:** While many companies have, at least in part, adopted the financial performance goals in both short-term and long-term incentive plans, there are still many potential forms of incentive compensation not subject to these rules. It appears all forms of equity-based compensation which vest solely based on service conditions (i.e., solely due to the passage of time) would not be subject to potential clawback. Additionally, individual goals, event-based goals, or operational goals, if not based on financial reporting measures, appear to be exempt under the Proposed Rules.

The clawback policies imposed by the Proposed Rules require a look-back period of three completed fiscal years that precede the date a company is required to prepare an accounting restatement. For example, for a calendar year company that determined in October 2018 to restate its financial statements and released previously issued financial statements in February 2019, the three-year period subject to clawback would include 2015, 2016, and 2017.

If a company changed its fiscal year-end during the three-year look-back period, it would need to look to the three-completed fiscal years and the transition period (i.e., the period in between the fiscal year-end of the previous fiscal year and the beginning of the new fiscal year). A transition period of nine to 12 months would be considered a full year in applying the three-year look-back period requirement.

### Calculation of erroneously paid incentive amounts

The amount of compensation that a company would need to recover is the amount of the incentive-based compensation received by the executive officers that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement. That is, the amount of incentive-based compensation attributable to the material error would need to be recovered. The amount would be calculated without regard to the impact of taxes.

Cash awards paid from bonus pools require additional consideration. The bonus pool would need to be recalculated based on the restated financial measure. If the reduced bonus pool would have been sufficient to cover the individual bonuses that were paid, then no recovery would be necessary. However, if the recalculated pool were less than the aggregate amount of individual bonuses paid, then the individual bonuses would be reduced by a pro rata portion. Under the Proposed Rules, a company’s board of directors would not be allowed to pursue different recovery approaches for different executive officers, even in ‘pool plans’ where the Board exercised discretion in allocating a bonus pool. In such cases, a pro rata recovery based on the original allocation of the pool would be appropriate instead of a discretion approach.

For incentive compensation based on stock price and total shareholder return, calculating what the financial measure would have been absent the error may be complex. The proposal only provides broad guidance on how the effect on the stock price and total shareholder return should be determined. The amount to be recovered may be determined based on a reasonable estimate of the impact from the accounting restatement. The company would need to maintain and provide documentation to the exchange on how the reasonable estimate was determined.

**Observation:** This appears to be one of the most difficult aspects of the proposed rule to apply. As the impact on stock price may vary based on the nature of the restatement, companies may need to consider how different underlying causes of restatements, and their respective effects on the stock price, should be taken into account.

Equity awards also require different considerations. If an equity award is held at the time of recovery, then the number that was originally received in excess of the recalculated number would be recovered. However, if options or SARs were already exercised but the underlying shares were not yet sold, then the number of shares in excess of the recalculated number of options or SARs would be recovered. On the other hand, if shares were sold, then the sale proceeds on the excess number of shares would be recovered.

**Recovery of amounts erroneously paid**

A company must recover erroneously awarded compensation in accordance with its clawback policy unless the pursuit of recovery would be impracticable either because of the extensive costs involved in recovering the amounts or if it would violate the laws in the international jurisdiction and certain conditions are met.

Prior to determining that recovery would be impracticable based on significant costs, a company would first need to attempt to recover those amounts and then determine that the costs involved in recovering the amounts would exceed the recoverable amounts. The company would need to document its attempt.
to recover the compensation, provide that documentation to the exchange, and then disclose why it decided not to pursue recovery.

Similarly, before determining recovery would be impracticable because of international laws, a company would first need to obtain an opinion from international jurisdiction counsel that recovery would violate the law in the respective jurisdiction and that opinion would need to be acceptable to the respective exchange. The international law would also need to be in place before publication of the Proposed Rules in the Federal Register.

In some situations, recovery would be required by both the Proposed Rules and by SOX clawback policies. In the case where amounts are recovered under SOX rules but are also subject to recovery under the Proposed Rules, those amounts should be credited from repayment. The Proposed Rules though would not preclude a clawback under SOX rules if amounts were not already recovered under the Proposed Rules.

Observation: To the extent amounts were recovered after an individual already paid taxes, an executive may be able to claim a federal tax deduction under the claim of right doctrine. Executives will need to consult with their tax advisors to determine how to report amounts paid back under a clawback.

From an accounting perspective, clawback features on equity awards do not impact the value of the equity award value and expense recognition under existing accounting rules. If the clawback were invoked, the accounting recognition would only be needed at that time to reflect the recoupment of the cash or shares.

Disclosures
The objectives of the disclosure requirements would be to inform shareholders and listing exchanges regarding the substance of a company’s recovery policy and how that company implements that policy. The disclosures required under the Proposed Rules would require an issuer to file its recovery policy as an exhibit to its annual report on Form 10-K.

If an accounting restatement occurred during the completed fiscal year or if recovery of excess compensation from a prior restatement was outstanding, an issuer would need to disclose the following information with the rest of its executive compensation disclosures under Item 402 of Regulation S-K:

1. For each restatement:
   a. the date an issuer was required to prepare a restatement;
   b. the total amount of excess compensation attributable to the restatement;
   c. the estimates used for determining excess compensation if related to stock price of total shareholder return; and
   d. the total amount of the excess compensation still outstanding as of its last completed fiscal year.

2. If the issuer decided not to pursue recovery for any executive officer, the name of the officer, the amount forgone, and the reason for not pursuing the recovery.

3. If amounts being recovered have been outstanding for more than 180 days, the name of the officer and the amount still owed.

If amounts were recovered pursuant to these Proposed Rules, a company should reduce the amounts reported in the applicable Summary Compensation Table column for the fiscal year in which such compensation was initially reported and identify it with a footnote.

These proposed disclosures would also be required for foreign private issuers in the annual reports they file on Form 20-F, Form 10-K, and Form 40-F, as applicable.

Transition
Exchanges will need to file their proposed listing rules within 90 days after the final version of Rule 10D-1 is published in the Federal Registrar. The respective rules should be effective within one year of that publication date. Companies would need to adopt a clawback policy that meets the requirements of these Proposed Rules within 60 days after the exchange rules become effective.

The Proposed Rules would be applied prospectively. Incentive compensation that would be subject to clawback based on these Proposed Rules would be from financial information for fiscal periods ending on or after the effective date of Rule 10D-1.

The takeaway
Companies with existing or contemplated policies should consider the impact of the proposed listing standards on such policies. Companies will ultimately need to comply with the actual listing standards to be proposed and adopted by the Securities Exchanges. As these may be more comprehensive than the Proposed Rules, companies should consider delaying changes until such guidance becomes final.

Additionally, companies should consider reviewing any legal implications associated with such clawback policies, especially those subject to jurisdiction outside the United States. To the extent any particular aspect of the Proposed Rules may be of concern to a
company, it should consider issuing a comment letter to the SEC. The comment period for the proposal ends 60 days after the date the rule is published in the Federal Register (the due date is expected to be early September).

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