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THE CLS BLUE SKY BLOG
COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS

Wachtell Lipton discusses SEC's Proposed Compensation Clawback Rules

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July 8, 2015

The SEC proposed its long-awaited compensation clawback rules under the Dodd-Frank Act. The proposed rules would require public companies to adopt and enforce compensation recovery policies that recoup from executive officers incentive compensation resulting from specified accounting restatements. Failure to comply with these rules would result in delisting by the applicable exchange.

Which companies would be covered? With very limited exceptions, the rules would apply broadly to all issuers with listed securities, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and issuers of listed debt whose stock is not also listed.

Which individuals would be covered? The recovery policy would apply to an issuer's current and former executive officers who served in that capacity at any time during the applicable look back period. Under the proposed rules, "executive officer" means the issuer'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 (including executive officers of a parent or subsidiary) who performs similar policy-making functions for the issuer.

What type of restatements would trigger application of the recovery policy? A restatement to correct an error that is material to previously issued financial statements would trigger application of the recovery policy. The determination regarding materiality would be based on facts and circumstances and existing judicial and administrative interpretations.

How would the applicable look back period be determined? Incentive-based compensation *received* during the three completed fiscal years immediately preceding the date that a restatement is required to correct a material error would be subject to the recovery policy. Incentive-based compensation would be deemed *received* in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs before or after that period.

What types of incentive-based compensation would be covered? Under the proposed rules, "incentive-based compensation" means any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. "Financial reporting measures" include measures that are determined and presented in accordance with the accounting principles used in an issuer's financial statements, as well as an issuer's stock price and total shareholder return. Importantly, stock options and other equity awards that vest exclusively on the basis of service, without any performance condition, and bonus awards that are discretionary or based on subjective goals or goals unrelated to financial reporting measures, would not constitute incentive-based compensation.

How would the recovery amount be determined? The recovery amount would equal the amount, calculated on a pre-tax basis, of incentive-based compensation received in excess of what would have been paid to the executive officer upon a recalculation of such compensation based on the accounting restatement. For incentive-based compensation that is not subject to mathematical recalculation based on the information in an accounting restatement (*e.g.*, compensation based on stock price goals or total shareholder return), the recoverable amount may be determined based on a reasonable, documented estimate of the effect of the accounting restatement on the applicable measure.

For equity awards that are incentive-based compensation, if the shares or options are still held at the time of recovery, the recoverable amount would be the number of shares or options received in excess of the number that should have been received after applying the restated financial reporting measure. If options have been exercised, but the underlying shares have not been sold, the recoverable amount would be the number of shares underlying the excess options applying the restated financial measure. If shares have been sold, the recoverable amount would be the sale proceeds received by the executive officer with respect to the excess number of shares.

Would the board have discretion whether to seek recovery? Board discretion would be very limited. An issuer would be required to recover compensation in compliance with its recovery policy except to the extent that pursuit of recovery would be impracticable because it would impose undue costs on the issuer or would violate home country law based on an opinion of counsel. Before concluding that pursuit is impractical, the issuer would first need to make a reasonable attempt to recover the incentive-based compensation. Finally, a board would be required to apply any recovery policy consistently to executive officers and an issuer would be prohibited from indemnifying any current or former executive officer for recovered compensation.

What additional disclosure requirements would the new proposed rules impose? A listed U.S. issuer would be required to file its recovery policy as an exhibit to its Form 10-K. In addition, the proposed rules would require disclosure in an issuer's annual proxy statement regarding the application of the recovery policy if, during the prior fiscal year, either a triggering restatement occurred or any balance of excess incentive-based compensation was outstanding. Required disclosure would include, for the prior fiscal year, (1) the names of individuals from whom the issuer declined to seek recovery, and (2) the name, and amount due from, each person from whom excess incentive-based compensation had been outstanding for 180 days or longer. In addition, any amounts recovered would reduce the amount reported in the applicable Summary Compensation Table column for the fiscal year in which the amount recovered initially was reported as compensation.

When would the new rules become effective? The rules will not take effect for some time. There is a 60-day comment period applicable to the proposed rules. Thereafter the SEC must issue final rules. Once the final rules are published (the "SEC Publication Date"), each exchange will have 90 days to file proposed listing standards that must become effective within one year of the SEC Publication Date. Issuers would be required to adopt a compliant recovery policy no later than 60 days following the effective date of the applicable listing standards and to recover excess incentive-based compensation received on or after the SEC Publication Date if that compensation was based on financial information for any fiscal period ending on or after the SEC Publication Date. The additional proxy statement disclosures would apply immediately following the effective date of the applicable listing standards.

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Most public companies have adopted remuneration recovery policies and there is no meaningful disagreement that there are circumstances in which it is appropriate to recoup improperly awarded compensation. Recognizing that the statute does not leave much room for flexibility, the most troubling element of the proposed rules is that they impose a strict liability framework that strips a board of directors of discretion, continuing a trend that hampers a board's ability to effectively direct a company.

The preceding post comes to us from Wachtell, Lipton, Rosen and Katz. It is based on a memorandum circulated by the firm on July 2, 2015.