

**ALERTS**

## Corporate, Securities And Financial Institutions Law Alert - New Executive Compensation Clawback Rules Proposed By SEC; Update On Pay Ratio Disclosure And Pay Vs. Performance Rules

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There has been a flurry of activity at the Securities and Exchange Commission (SEC) over the past several weeks and months regarding executive compensation-related rulemakings required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Earlier this month, the SEC proposed new rules that would require listed companies to adopt policies obligating executive officers to pay back incentive-based compensation that was awarded erroneously and to disclose such policies and the subsequent actions taken under those policies (the Clawback Rules). The proposed Clawback Rules were adopted under Section 954 of the Dodd-Frank Act. Under the proposed new SEC Rule 10D-1, listed companies would be required to develop and enforce recovery policies that, in the event of an accounting restatement, “claw back” from current and former executive officers incentive-based compensation they would not have received based on the restatement, regardless of fault.

In addition, the SEC is working on finalizing rules originally proposed in April that would require public companies to disclose the relationship between compensation paid to executives and the financial performance of the company (the Pay vs. Performance Rules). For more information regarding the Pay vs. Performance Rules, see our [May 14 legal alert](#).

Also, the SEC has indicated that it may soon finalize rules originally proposed in October 2013 requiring public companies to disclose the median of the annual total compensation of all employees of the company (excluding the CEO), the annual total compensation of the company’s CEO, and the ratio of the median of the annual total compensation of all employees to the annual total compensation of the CEO (the Pay Ratio Disclosure Rules).

If adopted, the new Clawback Rules would greatly expand upon the clawback policies many public companies currently have in place, and will require companies to amend these policies in significant ways, or adopt entirely new policies. Following is a summary of the proposed Clawback Rules, as well as an update on the Pay vs. Performance Rules and Pay Ratio Disclosure Rules.

### Proposed Clawback Rules

#### *Listing Standards*

The proposed rules would require national securities exchanges and

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associations to establish listing standards that would require listed companies to adopt and comply with a compensation recovery policy in which:

- Recovery would be required from current and former executive officers who received incentive-based compensation during the three fiscal years preceding the date on which the company is required to prepare an accounting restatement to correct a material error. The recovery would be required on a “no fault” basis, without regard to whether any misconduct occurred or an executive officer’s responsibility for the erroneous financial statements.
- Companies would be required to recover the amount of incentive-based compensation received by an executive officer that exceeds the amount the executive officer would have received had the incentive-based compensation been determined based on the accounting restatement.
- Companies would have discretion not to recover the excess incentive-based compensation received by executive officers if the direct expense of enforcing recovery would exceed the amount to be recovered.
- A company would be subject to delisting if it does not adopt a compensation recovery policy that complies with the applicable listing standard, disclose the policy in accordance with SEC rules, or comply with the policy’s recovery provisions.

#### *Definition of Executive Officers*

Under the proposal, the rules would include a definition of an “executive officer” that is modeled on the definition of “officer” under Section 16 of the Securities Exchange Act of 1934, which includes the company’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 who performs policy-making functions for the company.

#### *Incentive-Based Compensation Subject to Clawback*

Under the proposal, incentive-based compensation that is granted, earned, or vested based wholly or in part on the attainment of any financial reporting measure would be subject to clawback. Financial reporting measures are those based on the accounting principles used in preparing the company’s financial statements, any measures derived from such financial information, and stock price and total shareholder return.

#### *Proposed Disclosure*

Each listed company would be required to file its compensation recovery policy as an exhibit to its annual report on Form 10-K. In addition, if during its last completed fiscal year the company either prepared a restatement that required recovery of excess incentive-based compensation, or there was an outstanding balance of excess incentive-based compensation relating to a prior restatement, a listed company would be required to disclose:

- The date on which it was required to prepare each accounting



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restatement, 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 company decided not to pursue recovery, the amounts due from each such person, and a brief description of the reason the company 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 at the end of the company's last completed fiscal year.

The proposed disclosure would be included along with the other executive compensation disclosures in the company's 10-K and/or any proxy or information statements in which executive compensation disclosures are required.

#### *Covered Companies*

Under the proposal, the rules would apply to all listed companies, except for certain registered investment companies to the extent they do not provide incentive-based compensation to their employees. In this regard, smaller reporting companies, emerging growth companies, foreign private issuers, and controlled companies would not be exempt from the rules.

#### *Transition Period*

The proposal requires the national securities exchanges to file their proposed listing rules no later than 90 days following the publication of the adopted version of Rule 10D-1 in the Federal Register. Such listing rules are to become effective no later than one year following the publication date. Companies would be required to adopt their recovery policies no later than 60 days following the date on which the respective exchange's listing rule becomes effective.

#### *Comment Period*

The proposed rules are subject to a comment period lasting until Sept. 14. If the SEC finalizes the rules shortly thereafter, it is possible that public companies would be required to adopt compliant clawback policies and provide the new disclosures in time for the 2016 proxy season.

### **Update on Pay vs. Performance Rules**

The SEC proposed the Pay vs. Performance Rules on April 29, and they have been met with a considerable amount of commentary from business and shareholder groups and practitioners. Despite these headwinds, the comment period on the proposed rules ended on July 6, and the SEC has given every indication that it intends to push forward with finalizing these rules. However, it is still uncertain at this time whether these rules will be in place for the upcoming 2016 proxy season.

### **Update on Pay Ratio Disclosure Rules**

The Pay Ratio Disclosure Rules were proposed in October 2013, and the comment period ended in December 2013. These proposed rules have created a great deal of controversy, but the SEC is under considerable

pressure from certain factions in Congress and shareholder groups to finalize the rules. In this regard, SEC officials have been reported as stating SEC Chairman Mary Jo White is committed to adopting the final rules by this fall.

## **Barnes & Thornburg Outlook**

In sum, these rules will require a substantial amount of additional work for companies and their financial reporting, treasury, human resources, and corporate governance departments. Companies should consider having a plan in place so they are ready when the final rules are adopted.

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