

On July 1, 2015, the US Securities and Exchange Commission (SEC) proposed a rule implementing Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which added Section 10D to the Securities Exchange Act of 1934 (Exchange Act).

The proposed rule requires US national securities exchanges (e.g., NYSE and NASDAQ) to prohibit the listing of securities of issuers that have not adopted a written policy regarding the recovery, or clawback, of incentive-based compensation. The proposed rule also requires listed issuers to disclose their incentive-based compensation recovery policy and compliance-related actions.

The proposed rule applies to all listed issuers, including foreign private issuers, smaller reporting companies and emerging growth companies, except for certain registered investment companies. Although some US national securities exchanges permit foreign private issuers to follow their home country rules in lieu of certain corporate governance requirements, the proposed rule as currently drafted does not permit the exchanges to exempt foreign private issuers from compliance with the clawback requirements. Under the proposed rules, US national securities exchanges are permitted to commence de-listing proceedings for issuers that fail to adopt and comply with their incentive-based compensation clawback policies or to make the required disclosures.

Overview of Recovery Rule

Under the proposed rule, an issuer with securities listed on a US national securities exchange would be required to adopt a written clawback policy to recover excess incentive-based compensation received by current or former executive officers if the issuer's financial statements during the three most recent fiscal years were restated due to a material error that affects a financial reporting measure based on which executive officers received incentive-based compensation.

The executive officers covered under the proposed rules include the president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit or division and any other person who performs a significant policy-making functions for the issuer.

The incentive-based compensation that would be subject to clawback includes any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure, including performance measures based on stock price and total shareholder return. Compensation not tied to financial reporting measures, such as base salaries or bonuses paid upon completion of a specified employment period, would not be subject to recovery under the proposed rule. Recovery of incentive-based compensation applies to any incentive-based compensation paid to such executive officers in excess of what would have been received if the financial statements in any of the previous three fiscal years had been prepared as later restated.

Unlike some of the current recovery policies adopted by issuers, no misconduct or mistake by an executive officer is required for recovery to apply to the executive officer under the proposed rule; any excess incentive-based compensation awarded is subject to the clawback whether or not the executive officer contributed to the restatement. Under the proposed rule, issuers are prohibited from indemnifying (or paying insurance premiums that indemnify) executive officers against losses incurred under the clawback policy.

Exceptions to Recovery Policy

The proposed rules generally require issuers to promptly recover erroneously paid incentive-based compensation from its executive officers, except under two limited situations:

- if the aggregate direct costs of seeking recovery under the clawback policy would exceed the recoverable amount; or
- if recovery would violate a foreign private issuer's home country's laws, but only if such laws were adopted prior to the date of publication of the proposed rule in the Federal Register.

In both instances, however, the issuer must make a reasonable attempt to recover excess incentive-based compensation and document such attempts to recover the compensation. Under the SEC's proposal, a listed issuer would be required to disclose the reasons why it decided not to pursue recovery. In addition, before concluding that it would be impracticable to recover any amount of erroneously awarded compensation based on violation of home country law, the issuer must obtain an opinion of home country counsel, provided to the applicable securities exchange, that recovery would result in a violation.

If the issuer decided not to pursue recovery of the excess incentive-based compensation from an individual, then it must disclose the name of the current or former officer, the dollar amount that would have been recovered and the issuer's rationale for deciding against such recovery.

Disclosure Requirements

Under the proposed rule, a listed issuer would be required to file its clawback policy as an exhibit to its annual report (i.e., Form 10-K, Form 20-F or Form 40-F). In addition, a listed issuer would be required to disclose the following information about the recovery of incentive-based compensation under its clawback policy in its next proxy statement or, if the issuer does not file a proxy statement, in its next annual report:

- the date on which the relevant accounting restatement occurred;
- the aggregate dollar amount of incentive-based compensation deemed to be in excess based on the restatement;
- if the performance metric for the incentive-based compensation was stock price or total shareholder return, the estimates used to determine the excess incentive-based compensation based on the restatement; and
- the aggregate amount of outstanding excess incentive-based compensation at the end of the last completed fiscal year.

If the issuer has attempted to recover excess incentive-based compensation, but the excess compensation has not been recovered and remains outstanding for 180 days or more, then the issuer must disclose the name of the current or former officer and the dollar amount of outstanding compensation. In addition, if the issuer decided not to pursue recovery, then it must disclose the name of each person subject to recovery, the amounts due from each such person and a brief description of the reason the issuer decided not to pursue recovery.

Effectiveness of Proposed Rules

The SEC is currently requesting comments on the proposed rules, which are due by September 14, 2015. The US national securities exchanges must propose their own rules for compliance with the new rule no more than 90 days after the final rule is published in the Federal Register. Each US national securities exchange's rule must be approved by the SEC and become effective no later than one year after the final rule's publication date. Once the national securities exchanges' rules become effective, listed issuers have 60 days to adopt a compensation recovery policy, which policy must be filed as an exhibit to the annual report.

Practical Action Items That Issuers Should Consider Now

Although the SEC's rule is currently in its proposal stage, companies should consider taking the following actions now in preparation for when the rule is finalized:

- Identify executive officers that may be subject to the proposed rule.
- Review for any incentive-based compensation in existing or proposed employment plans and consider whether changes to such plans are required under the proposed rule.
- Review current compensation clawback policies for any inconsistencies with the proposed rule.
- Begin the planning process for the required disclosure and filing obligations under the proposed rule.
- Consult with legal counsel to prepare for the upcoming compensation clawback requirements.

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