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Meridian Client Update

SEC Issues Proposed Rule on Mandatory Clawback

On July 1, 2015, the Securities and Exchange Commission (SEC) approved (by a 3 to 2 vote) a proposed rule that would require public companies to adopt and implement a mandatory clawback policy.

At today's hearing on the Proposed Rule, the SEC staff articulated the following key terms of the Proposed Rule, a couple of which will take many by surprise.

- **Covered Executive.** The first surprise is that the Proposed Rule would apply to **all current and former Section 16 officers** who earned "incentive" compensation during a three-year "look back period" (see discussion below as to the determination of look back period). Many commentators had speculated that the proposed rule would solely apply to named executive officers.
- **Trigger Event and Look Back Period.** Under the Proposed Rule, a public company would be required to clawback "excess" incentive compensation earned by a covered executive during the look back period in the event of a financial restatement due to a violation of the federal securities laws. Unlike the Sarbanes-Oxley clawback requirement, the clawback trigger **would not require misconduct on the part of a covered executive**. The look back period is defined as the three-year period ending on the date that a public company knew or should have known that it would be required to issue restated financial statements or, if earlier, the date a regulator advised a public company of the need to restate its financial statements.
- **Definition of Incentive Compensation.** The second surprise is the Proposed Rule definition of incentive compensation. The Dodd-Frank Act defines excess incentive-based compensation as "the amount by which incentive compensation previously paid to the executive officer exceeds what would have been paid to the executive officer under the restated financial statements." This statutory provision appears to limit the scope of the mandatory clawback policy to incentive compensation linked to the achievement of specific financial metrics. **Nonetheless, the SEC staff broadly interpreted this provision to also mean incentive compensation linked to the achievement of a specific stock price or to total shareholder return (TSR).**
- **Non-Covered Compensation.** The Proposed Rule would not apply to time-based restricted stock/restricted stock units, base salary or discretionary bonus payments.
- **Calculation of Excess Incentive Compensation.** The third (very big) surprise is the Proposed Rule's methodology for calculating excess incentive compensation for incentive compensation linked to the achievement of a specific stock price or TSR goal. This would appear to defy determination. The achieved stock price or TSR is a known and objective figure. However, what would have been a

company's stock price or TSR if it had initially issued correct financial statements is not known or knowable. **Undaunted by this challenge, the SEC staff crafted the Proposed Rule to require a public company to “estimate” this stock price or TSR through any reasonable method.** For incentive compensation linked to the achievement of a financial statement goal (e.g., EBITDA goal), the calculation of excess incentive compensation should be relatively straightforward since it would be determinable based on the effect of a restatement on a financial statement goal.

- **Mandatory Clawback.** The Proposed Rule would require a public company to clawback excess incentive compensation from each covered executive upon a trigger event, subject to two exceptions. A public company would not be required to clawback excess incentive compensation if the cost of recovery would exceed the amount subject to clawback. Also, a foreign private issuer would not be required to clawback excess incentive compensation if it would violate home country laws.
- **Listing Standard.** The Proposed Rule would direct the national securities exchanges and associations to adopt a listing standard that would require each listed company to adopt and implement a mandatory clawback policy.
- **Covered Entities.** Every company listed on a national securities exchange or association would be subject to the Proposed Rule, including foreign private issuers and, in certain cases, management investment companies. It also appears that emerging growth companies under the JOBS Act and smaller reporting companies would be subject to the Proposed Rule.
- **Disclosure Requirements.** Under the Proposed Rule, the SEC would amend Item 402 of Regulation S-K to require a public company to disclose that (1) it had recovered excess incentive compensation upon a financial restatement triggering the requirement to recoup such compensation, and (2) it had an outstanding balance in which a covered executive had not repaid upon a trigger event. In addition, the Proposed Rule would require a public company to disclose its clawback policy in an exhibit to its Form 10-K.

We will have more to say on this topic after the SEC has published the text of the Proposed Rule.

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The **Client Update** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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