



SEC Proposes New Compensation Clawback Rules

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Restatements Triggering Application of Recovery Policy

The proposed rules provide that an issuer must develop and implement a recovery policy that would be triggered if the issuer is required to prepare an accounting restatement to correct an error that is material to previously issued financial statements. In its adopting release, the SEC declined to describe any type or characteristic of an error that would be considered material and instead noted that materiality must be analyzed in the context of particular facts and circumstances, as well as judicial and regulatory guidance.

Issuers Subject to the Proposed Rules

The proposed rules would apply to all listed issuers, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and registered investment companies with listed securities (unless the investment company does not provide incentive-based compensation for its employees).

Executive Officers Subject to Recovery Policy

Under the proposed rules, an issuer's recovery policy would apply to any current or former executive officer of the issuer who served in that role at any time during the performance period for the incentive-based compensation. For purposes of the proposed rules, the term "executive officer" would tie to the definition of "officer" in Rule 16a-1(f) of the Exchange Act and thus include the issuer's president principal financial officer principal accounting officer (or, if none the controller) any vice president in charge of a principal business unit division or

function any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the issuer.

Incentive-Based Compensation Subject to Recovery Policy

The proposed rules define incentive-based compensation as “any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure.” “Financial reporting measure” is defined to mean measures based on the accounting principles used in preparing an issuer’s financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return.

The proposing release provides the following examples of financial reporting measures:

- revenues
- net income
- operating income
- profitability of one or more reportable segments
- financial ratios
- net assets or net asset value per share
- earnings before interest, taxes, depreciation and amortization
- funds from operations and adjusted funds from operations
- liquidity measures (e.g., working capital, operating cash flow)
- return measures (e.g., return on invested capital, return on assets)
- earnings measures (e.g., earnings per share)
- sales per square foot or same store sales
- revenue per user or average revenue per user
- cost per employee
- any of such financial reporting measures relative to a peer group
- tax basis income.

Specific types of compensation that would be subject to the recovery policy include:

- non-equity incentive plan awards that are earned based wholly or in part on satisfying a financial reporting measure performance goal

- bonuses paid from a “bonus pool,” the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal
- equity awards that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal
- proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal.

The amount of compensation required to be recovered would equal, on a pretax basis, the excess of the amount of incentive-based compensation received by the executive officer over the amount of incentive-based compensation that would have been paid to the executive officer under the accounting restatement. In the case of incentive-based awards that are based on stock price or total shareholder return, the proposed rules would permit issuers to use a reasonable estimate of the effect of the restatement on the applicable measure to determine the amount to be recovered. Issuers would be required to maintain documentation evidencing their method of reasonable estimation.

Time Period Covered by Recovery Policy

An issuer’s recovery policy would apply to incentive-based compensation received during the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement. Under the SEC’s proposed rules, incentive-based compensation would be considered 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 after the end of that period.”

Limited Exceptions

An issuer would not be required to pursue recovery in only very limited circumstances. First, an issuer would not be required to pursue recovery if doing so would be impracticable because the direct expense of seeking recovery would exceed the recoverable amounts. An issuer would need to make a reasonable attempt to recover the excess incentive-based compensation before concluding that it would be impracticable to recover. In addition, exchanges could permit a foreign private issuer to forego recovery as impracticable if recovery would violate the laws of the issuer’s home country based on an opinion of counsel. Issuers would be prohibited from (i) indemnifying or reimbursing any current or former executive officer against the loss of erroneously awarded compensation or (ii) paying the

premiums on an insurance policy that would cover an executive's potential clawback obligations.

New Disclosure Requirements

The proposed rules would require each listed issuer to file its recovery policy as an exhibit to its Form 10-K. In addition, the proposed rules would add a new subsection (w) to Item 402 of Regulation S-K, which would require the issuer to disclose the following for each restatement during the last completed fiscal year:

- the date on which the issuer was required to prepare an accounting restatement
- the aggregate dollar amount of excess incentive-based compensation attributable to the restatement
- the estimates used to determine the excess incentive-based compensation attributable to such accounting restatement, if the financial reporting measure related to a stock price or total shareholder return metric
- the aggregate dollar amount of excess incentive-based compensation that remained outstanding as of the end of the last completed fiscal year.

In addition, in the event that an issuer did not pursue recovery from any individual in the last completed fiscal year, for each individual, the issuer would also have to disclose the name, amount foregone and the reason the issuer did not pursue recovery. The issuer must also disclose the name of each individual from whom, as of the end of the last completed fiscal year, excess incentive-based compensation had been outstanding for 180 days or more and the amount of such outstanding compensation.

Timing for Implementation

The comment period for the proposed rules will run for 60 days after publication in the Federal Register. If the SEC adopts the proposed rules, the national stock exchanges must propose new listing standards implementing the SEC clawback rules within 90 days of the publication of the SEC clawback rules in the Federal Register. The proposed new listing standards, which would be subject to public comment, would be required to become effective within a year of the publication of the SEC clawback rules in the Federal Register. Given this interaction between the SEC and the national stock exchanges, it is unlikely that any new clawback listing standards will be in effect before late 2016.

Once any new clawback listing standards are in effect, a listed issuer will be required to comply with the disclosure requirements in its first annual report on Form 10-K or proxy or information statement, as well as meet the applicable standards within 60 days in order for its shares to continue trading on that exchange. A listed issuer would be required to recover all excess incentive-based compensation that is granted, earned or vested on or after the effective date of the SEC clawback rules that results from attaining a financial reporting measure based on financial information for any fiscal period ending on or after that effective date.

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