



SEC Rule Addresses Clawback of Executive Compensation

The SEC recently proposed a rule directing national securities exchanges and associations to establish listing standards that would require listed companies to develop and implement a policy to recover incentive-based compensation that executive officers were awarded erroneously.¹

Key Facts

- All companies listed on a national securities exchange or association would be required to adopt and comply with a written recovery policy for all incentive-based compensation received by executive officers. Companies would be required to disclose the recovery policy in an exhibit to the annual report.
- In the event of a material accounting restatement, a company would be required to determine and recover the amount of incentive-based compensation for certain executive officers in excess of what otherwise would have been awarded based on the restated financial statements.
- The proposed rule would generally apply to all listed companies, including emerging growth companies, smaller reporting companies, and foreign private issuers. Limited exemptions would be provided for certain listed securities futures, standardized option products, and certain registered investment companies.

Key Impacts

- If a recovery policy has not been adopted, or if an existing policy does not comply with the SEC's proposed rule, a company would have to write or amend its current recovery policy to comply with the proposed rule.
- The recovery policy would be filed as a new exhibit to the company's annual report and tagged for XBRL.²

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¹ SEC Proposed Rule, Listing Standards for Recovery of Erroneously Awarded Compensation, July 1, 2015, available at www.sec.gov.

² XBRL stands for Xtensible Business Reporting Language, which is an interactive data reporting standard required by the SEC.

Dodd-Frank Act Requirements

The SEC proposed a new rule and amendments to rules and forms to implement the provisions of Section 954 of the Dodd-Frank Act.³ Section 954 added Section 10D to the Securities Exchange Act of 1934. It also requires the SEC to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of companies that do not comply with Section 10D(b). This section requires companies to develop and implement a policy providing:

- (1) For the disclosure of the company’s policy on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
- (2) That, in the event that the company is required to prepare an accounting restatement due to the material noncompliance with any financial reporting requirement under securities laws, the company will recover incentive-based compensation (including stock options) in excess of what should have been paid under the accounting restatement during the preceding three fiscal years.

Implementation

The proposed rule would apply to a broader group of executive officers than named executive officers for which compensation information is disclosed under Item 401 of Regulation S-K. Current and former executives, as defined in the proposed rule, would consist of the positions listed below.

Executive Officer				
Chief Executive Officer and President	Principal Financial Officer	Principal Accounting Officer or Corporate Controller	VP in Charge of Principal Business Unit, Division, or Function	Other Officers Performing a Policy-Making Function

³ Dodd-Frank Wall Street Reform and Consumer Protection Act.

Incentive-Based Compensation

Incentive-based compensation is any compensation that is granted, earned, or vested based wholly or in part on the attainment of a financial reporting measure.

Incentive-based compensation subject to the SEC's proposed rule may be in the form of cash, bonuses paid from a bonus pool, equity awards that are granted or become vested based on satisfying a financial reporting measure performance goal, and proceeds from the sale of shares granted or vested based on satisfying a financial reporting measure performance goal. Salaries, discretionary bonuses, or bonuses paid upon satisfaction of subjective standards or operational measures (e.g., opening a certain number of stores, increase in market share) are not subject to the proposed recovery rules.

Financial Reporting Measure

A financial reporting measure is a measure taken directly from or derived from the financial statements or a performance measure based on stock price or total shareholder return. Examples of financial reporting measures would include, but not be limited to, the following items.

Financial Statement Measures

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| <ul style="list-style-type: none"> • Revenues • Net income • Operating income • Profitability of one or more reportable segments • Financial ratios (e.g., accounts receivable turnover and inventory turnover rates) • Net assets or net asset value per share • EBITDA • Funds from operations and adjusted funds from operations • Liquidity measures (e.g., working capital, operating cash flow) • Tax basis income • Return measures (e.g., return on invested capital, return on assets) | <ul style="list-style-type: none"> • Earnings measures (e.g., earnings per share) • Sales per square foot or same store sales, where sales are subject to an accounting restatement • Revenue per user, or average revenue per user, where revenue is subject to an accounting restatement • Cost per employee, where cost is subject to an accounting restatement • Any financial reporting measures relative to a peer group, where the company's financial reporting measure is subject to an accounting restatement |
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Fault is not required to be established in order to recover excess incentive compensation from executive officers.

Material Accounting Restatement

The proposed rule would require that a restatement to correct a material error to previously issued financial statements would trigger the company's recovery policy. In the SEC's release, it does not describe any type or characteristic of an error that would be considered material because materiality is a determination that must be analyzed in the context of particular facts and circumstances. The SEC said that companies should consider whether a series of immaterial error corrections, regardless of whether they resulted in amendments to previously filed financial statements, could be considered a material error when viewed in the aggregate.

A restatement would trigger recovery regardless of the executive officers' fault. The SEC believes this would be required because Section 304 of the Sarbanes-Oxley Act of 2002 mandates recovery from certain executive officers if a company's material restatement results from misconduct and Section 10D does not include a similar provision. The SEC also believes that recovery for inadvertent errors may promote high-quality financial reporting.

Revisions to previously issued financial statements that are not error corrections do *not* trigger recovery. These revisions are generally required under GAAP and would include retrospective revision for:

- A change in accounting principle;
- Reportable segment information due to a change in the structure of a company's internal organization;
- A discontinued operation;
- A change in reporting entity, such as a reorganization of entities under common control;
- Provisional amounts in connection with a prior business combination;⁴ and
- Stock splits.

The SEC considers the date on which a company is required to prepare an accounting restatement to be the earlier of:

- The date the company's board of directors, a committee of the board or the officer(s) concludes, or reasonably should have concluded, that its previously issued financial statements contain a material error; or
- The date a court, regulator, or other legally authorized body directs the company to restate its previously issued financial statements to correct a material error.

⁴ The FASB issued a proposed Accounting Standard Update, *Simplifying the Accounting for Measurement-Period Adjustments*, which would eliminate the requirement to retrospectively apply adjustments to provisional amounts in connection with a prior business combination.



In some cases, a company may be required to estimate what its stock price or total shareholder return would have been had the restated financial statements originally been published.

Look-back Period

The three-year look-back period for applying the recovery policy would be the three completed fiscal years immediately preceding the date the company is required to prepare an accounting restatement. The SEC proposes that incentive-based compensation would be deemed received for purposes of triggering the recovery policy in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained. This would occur even if the payment or grant occurs after the end of that period.

Recoverable Amount

The incentive-based compensation awarded erroneously would be determined by recalculating the applicable financial reporting measure and the amount of incentive-based compensation using the restated numbers. The company would be required to recover from the executive officers the excess amount of incentive compensation that was paid based on erroneous data, before personal income taxes.

For incentive-based compensation based on stock price or total shareholder return, the recovery amount would not be subject to a mathematical calculation. Companies would be required to reasonably estimate the effect of the accounting restatement on the applicable measure. The SEC said that companies may need to engage in complex analyses that require significant technical expertise. This specialized knowledge may involve substantial exercise of judgment to determine the stock price impact of a material misstatement.

Companies would not have to pursue recovery if it would be impracticable, which is generally based on third-party cost to enforce the policy or violation of home-country law. The determination that recovery is impracticable must be made by the committee of independent directors responsible for executive compensation after collection attempts have been made. The company may not settle for an amount less than the full amount calculated under its policy, or indemnify any current or former executive officer against the loss of erroneously awarded compensation.

Required Disclosures

Listed companies would be required to file their written recovery policies as an exhibit to their annual reports. The disclosure would be tagged using XBRL.

In the event that a material accounting restatement triggers recovery, the company would be required to disclose details in its annual report about how the recovery amount was determined and to whom it relates. If the company did not pursue recovery, it would also disclose the reason.

Foreign Issuers and Investment Companies

The SEC proposes to revise Forms 20-F and 40-F for foreign companies and Form N-CSR for investment companies to facilitate the new disclosures.

Timing

Comments on the proposed rule are due by September 15, 2015.

Each exchange would be required to file its proposed listing rule no later than 90 days following publication of the final adopted version of Rule 10D-1 in the Federal Register. It would need to be effective no later than one year following the publication date.

Listed companies must adopt the required recovery policy no later than 60 days following the date the exchange's rule becomes effective. Recovery of erroneously awarded incentive-based compensation would begin with compensation resulting from attainment of a financial reporting measure based on or derived from financial information for any fiscal period ending on or after the effective date of Rule 10D-1 that is granted, earned, or vested on or after the effective date. Disclosure would be required after the rule becomes effective.

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