



# WRMarketplace

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**TOPIC:** Q&A - SEC's Proposed Rules for Stock Exchanges to Adopt Policies Requiring Member Companies to "Clawback" Excess Incentive-Based Compensation.

**MARKET TREND:** There continues to be serious concern over the compensation of certain public company executives. The SEC's proposed rules, stemming from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, attempt to address the matter.

**SYNOPSIS:** The SEC's proposed rules define the issuers and executives to whom a compensation recovery policy must apply. These rules specify the circumstances in which the recovery policy would be triggered, the compensation subject to recovery, and the methodology for determining the recoverable amounts.

**TAKE AWAYS:** Listed (public company) issuers should review their existing clawback policies in light of the proposed rules. While well-accepted compensation theories advocate tying compensation to a company's financial performance, given the SEC's proposed rules and the current market trend, issuers may wish to reduce the amount of compensation that is contingent upon the satisfaction of financial reporting measures, so as to reduce their executive officers' exposure to clawback. To the extent that compensation will be based on the achievement of financial reporting measures, per

the proposed rules, the compensation awards should include explicit language to facilitate clawback, if required.

## **MAJOR REFERENCES: SEC RELEASE NO. 33-9861 - PROPOSED RULE - "LISTING STANDARDS FOR RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION."**

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The SEC published proposed rules that can result in the loss of a company's listing on a stock exchange if it does not implement a policy that provides for the rescission of incentive-based compensation paid to certain individuals in the event of a restatement of the company's financial statements. Specifically, the SEC rules require the various stock exchanges to implement rules that require listed companies to adopt a "compensation recovery policy" governing the clawback of certain incentive compensation if the financial metrics on which that compensation was based are changed in the company's restated financial statements. The following questions and answers explain the proposed rules.

### **To which issuers do the new rules apply?**

The rules would apply generally to **all** listed issuers, including issuers of listed debt or preferred securities. There are limited exceptions to these rules, most notably for listed registered investment companies that have not awarded incentive-based compensation to any of their executive officers within the last three fiscal years.

### **What individuals are subject to potential clawback?**

The clawback policy would cover current "executive officers," and certain former executive officers. A former executive officer would be included in a clawback if he or she served as an executive officer at any time during the performance period for the incentive-based compensation subject to the clawback.

### **What is "incentive-based compensation"?**

"Incentive-based compensation" is any compensation granted, earned, or vested based wholly or in part on the attainment of any financial reporting measure. For this purpose, a "financial reporting measure" is (1) a measure that is determined and presented in accordance with accounting principles used in preparing the issuer's financial statements, (2) any measures that are derived wholly or in part from these measures, and (3) stock price and total shareholder return.

Note that an incentive plan award that is granted, earned, or vested based solely upon the occurrence of certain non-financial events, such as opening a number of stores, obtaining regulatory approval of a product, or consummating an acquisition, divestiture, or similar transaction would not be subject to clawback.

Similarly, “incentive-based compensation” does not include salaries, bonuses awarded on the basis of solely subjective factors, and equity compensation that vests solely on the passage of time.

### **Under what circumstances is the clawback required?**

The clawback is required if an issuer must prepare a restatement that corrects a **material** error to previously issued financial statements. The SEC has not defined materiality, instead indicating that it must be determined in the context of particular facts and circumstances. Fault in creating the erroneous financial statements is not required to trigger a clawback, but certain exceptions, such as restatements due to changes to accounting principles, certain internal restructurings, and certain adjustments in connection with business combinations and revisions due to stock splits would **not** trigger a clawback.

### **What incentive-based compensation is subject to a particular clawback?**

A clawback would apply to incentive-based compensation **received** during the three completed **fiscal years** immediately preceding the date that the issuer is **required** to prepare restated financial statements.

Incentive-based compensation is considered “received” during the fiscal period when the financial reporting measure on which the compensation is based is attained – even if the payment or grant occurs after the end of that period or not all conditions for payment have been satisfied. For equity awards that vest on the basis of the attainment of financial measures, the compensation is received on vesting.

The issuer is “required” to prepare restated financial statements on the earlier of the date that the issuer concludes, or reasonably should have concluded, that the issuer’s previously issued financial statements contain a material error, or the date a court or regulator directs the issuer to restate previously issued financial statements to correct a material error.

### **How much incentive-based compensation is subject to a clawback?**

The “**recoverable amount**” of incentive-based compensation is the excess of what the executive officer received over what he would have received had the incentive-based compensation been calculated on the basis of the financial measures set forth in the restated financial statements. The clawback is to be made on a pre-tax basis.

If the incentive-based compensation was paid on the basis of stock price or total shareholder return, the amount to be recovered will not be able to be calculated directly from a comparison of the original and restated financial statements. Accordingly, the proposed rules indicate that the recoverable amount may be based on a reasonable estimate of the effect of the accounting restatement on the relevant measure. The issuer must maintain documentation of its calculation methodology and provide it to its stock exchange.

If the incentive-based compensation was paid in the form of equity awards, the recoverable amount will depend on whether the underlying shares have been sold. If the award is still held at the time of the clawback, the recoverable amount will be the number of shares or awards received in excess of the number that would have been received if the restated financial measure had initially been used. If stock options have been exercised, but the shares have not been sold, the recoverable amount is the number of shares acquired with the excess options. If the shares have been sold, the recoverable amount will be the sales proceeds received from the excess shares received or acquired on the exercise of excess options. In the case of options, the recoverable amount is calculated net of any exercise price paid to acquire the recoverable shares.

#### **Can executive officers be provided any protection against clawback?**

No. The proposed rules make it clear that an issuer may **not** indemnify an executive officer or reimburse the executive officer for the application of the clawback. Similarly, an issuer is prohibited from paying any premiums on an insurance policy that might cover an executive’s potential clawback obligations.

#### **Are there circumstances in which clawback may be avoided in the case of a financial restatement?**

Possibly. Clawback in the case of a financial restatement is generally mandatory. There are two exceptions, however, that may enable the issuer to forego clawback:

1. The direct expense paid to a third-party to assist in enforcing the clawback would exceed the recoverable amount; and
2. Recovery would violate the law of the executive officer's home country law in existence as of the date of the publication of the proposed rules.

Issuers must make a reasonable effort at recovery before applying the first exception and must document its efforts for provision to its stock exchange.

### **What disclosures are required with respect to clawbacks?**

An issuer will be required to file its clawback policy as an exhibit to its Annual Report on Form 10-K. In addition, if the clawback policy is triggered by a financial restatement, disclosures about the triggering event, the amounts subject to clawback, and information about certain persons subject to the clawback policy are required.

### **TAKE AWAYS**

Listed (public company) issuers should review their existing clawback policies in light of the proposed rules. While well-accepted compensation theories advocate tying compensation to a company's financial performance, given the SEC's proposed rules and the current market trend, issuers may wish to reduce the amount of compensation that is contingent upon the satisfaction of financial reporting measures, so as to reduce their executive officers' exposure to clawback. To the extent that compensation will be based on the achievement of financial reporting measures, per the proposed rules, the compensation awards should include explicit language to facilitate clawback, if required.

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