CORPORATE COUNSEL INSIGHT

Busy SEC Proposes Clawback, Approves Pay Ratio Rules

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A little more than a month apart, the U.S. Securities and Exchange Commission revealed its proposed clawback rule and approved a final version of its pay ratio rule.

Both measures are components of the Dodd-Frank Act-mandated rules issuers have been anticipating since the act's 2010 passage.

On July 1, the SEC issued proposed rules that would require issuing companies to adopt a clawback provision, which under certain circumstances would force executive officers to give back a portion of incentive-based compensation they earned following an accounting restatement.

Generally speaking, the amount recovered would be the difference between what executive officers would have earned under the corrected performance metrics and what they originally received under the misstated figures.

The clawback proposal is the last of the major rules the SEC must introduce as part of the Dodd-Frank reform package.

The SEC followed up on the clawback introduction by announcing Wednesday its approval of a pay ratio rule.

Under that rule, a listed company would need to calculate and report its chief executive officer's total compensation compared to the total annual compensation of its median employee. The commission originally proposed the rule September 2013.

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Mary Jo White, SEC Chair

"To say that the views on the pay ratio disclosure requirement are divided is an obvious understatement," said SEC Chair Mary Jo White in a public statement. She mentioned the commission received more than 287,400 comment letters regarding the proposed requirement.

The final pay ratio rule would exempt emerging growth companies and smaller reporting companies, and issuing companies would have some flexibility regarding how they calculate median employee compensation.

Five percent of foreign employees can be excluded from that figure, and companies can apply cost-of-living adjustments to it, White said.

Both the clawback proposal and the pay ratio approval passed in 3-2 votes with dissents by the two Republican commissioners, Daniel Gallagher and Michael Piwowar.

The clawback rule is one of the SEC's less controversial proposals from its Dodd-Frank regime — at least in principle, according to Thomas Romer, a shareholder with Greenberg Traurig's Denver office.

THOMAS ROMER

"But when you get into the details … of how this has been proposed by the (SEC) majority, that's where the controversy lies," Romer said.

When triggered by a financial restatement, the recovery would apply to compensation tied to not only accounting-related metrics but also total shareholder return.

Figuring an accurate recovery amount based on the latter could be a complicated formula.

To recalculate TSR, companies would have to speculate to the best of their ability as to how the market would have responded had the company presented the correct financial reports, Romer said, adding, "How do you unscramble the eggs and determine what the market would have done with the correct information?"

The SEC agreed that TSR should be included in the clawback determination, "but it also recognizes that it's an impossibly complex calculation to get right," Romer said, adding that even if companies achieve "pretty good" accuracy on the TSR recalculation, they may still be subject to shareholder lawsuits.

Brad Hamilton, a shareholder at Jones & Keller's Denver office, said the SEC's proposed clawback rules are broader than expected, as they imply a strict company-wide liability in misreporting financials.

The rules also apply to any employee who leads a division that has income reporting responsibilities.

"Let's say I run a sales division, and a lot of my compensation is based on the sales we achieve," Hamilton said. "So another completely unrelated line of business blows its reporting, and two years from now that causes a restatement of the financials. … (A)ny portion of my compensation that was based on the financial reporting metrics of the organization as a whole gets restated, then my compensation is subject to clawback."

BRAD HAMILTON

Most Fortune 100 companies have instituted their own clawback provisions in anticipation of the SEC mandate, "but those clawback provisions by and large target only the people responsible for reporting those financial metrics and those people who are culpable," Hamilton said.

If the SEC likewise adopted a culpability requirement for any officers to have their earnings clawed back, the rule would be difficult to enforce, as it would require proof of which employees or divisions were responsible for the company having to restate its financials.

"When you add that, you really up the ante with the evidentiary burden," Hamilton said.

The clawback rule may receive substantial public comment on the breadth of employees who fall under the rule in addition to its TSR calculation issue.

MARY JO WHITE

The SEC seems to acknowledge the controversial nature of the rules it is congressionally mandated to issue and enforce.

The clawback rule as published includes commissioner dissents, in which Gallagher and Piwowar voice disapproval in no uncertain terms.

Gallagher likened the majority's interpretation of the Dodd-Frank clawback rule to a "tortured and nightmarish" Goya painting.

Hamilton said the self-acknowledged embattlement within the commission "points to a higher likelihood that the final rules are going to look different from the proposed rules."

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