2016 Disclosure Developments for Public Companies

Companies should be aware of several developments that may affect their 2016 year-end reporting and the 2017 annual meeting season documents. There have also been several other developments, including two final rules adopted by the Securities and Exchange Commission, that will potentially affect public companies during 2017 and filings to be made in 2018. In addition, several major SEC disclosure requirements remain in the proposal stage. These developments are discussed in separate sections below. With political and regulatory changes pending in the U.S. federal executive and legislative branches as well as the SEC and other federal regulatory agencies, it is possible that some of these developments may be modified or repealed in 2017. Companies should monitor developments during the coming year to ensure that their compliance and reporting efforts reflect any legislative or regulatory changes.

Disclosure Developments for 2016 Year-End/2017 Annual Meeting Documents

1. Nasdaq "Golden Leash" Disclosure

Nasdaq-listed companies should note that a new Nasdaq rule adopted this year requires them to inquire about certain director and nominee compensatory arrangements involving third parties and, potentially, to disclose those arrangements. Earlier in 2016 Nasdaq adopted a rule that will require each listed company to publicly disclose the material terms of all agreements and arrangements between any director or nominee and any person or entity (other than the company) relating to cash and non-cash compensation or other payments in connection with that person's service or candidacy as a director of the company. The SEC approved Nasdaq Rule 5250(b)(3) on July 1, 2016, and the rule became effective on July 31, 2016. Companies listed on the Nasdaq Stock Market at the time the rule became effective or initially listed thereafter must disclose all agreements and arrangements that are subject to the rule no later than the date on which the company files or furnishes a proxy or information statement in connection with the company's next security holders' meeting at which directors are elected (or, if the company does not file proxy or information statements, no later than when the company files its next Form 10-K).

Nasdaq-listed companies should modify their disclosure policies and procedures to ensure that they have taken reasonable steps to disclose the information required by the rule at the appropriate time and by the required means. Nasdaq has stated that this would include "asking each director or nominee [about any agreements and arrangements that may be subject to the new disclosure requirement] in a manner designed to allow timely disclosure" by the company. At a minimum, therefore, Nasdaq-listed companies should revise their director and officer questionnaires (including any questionnaires used for director nominees) to solicit information about any agreements or arrangements that the company may be required to disclose under the rule. NYSE-listed companies may wish to consider similar revisions to their director and officer questionnaires, even though NYSE rules do not require disclosure of this information.

The Goodwin alert, "*Nasdaq adopts "Golden Leash" Director Compensation Disclosure Requirement,"* is available on the Goodwin website.

2. Non-GAAP C&DIs

The SEC adopted new C&DIs earlier in 2016 that may require companies to revise disclosure of non-GAAP financial measures in their year-end earnings release, Form 10-K, proxy statement and annual report to

security holders. After months of repeated cautions by senior SEC officials about the use of non-GAAP financial measures, the SEC published 12 new or revised compliance and disclosure interpretations (C&DIs) on the use of non-GAAP financial measures on May 17, 2016. These C&DIs affected communications subject to Regulation G – which applies to all public disclosures by reporting companies that contain non-GAAP measures – as well as filings subject to Item 10(e) of Regulation S-K – which applies to certain reports filed with the SEC under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as earnings releases furnished pursuant to Item 2.02 of Form 8-K. Several of these C&DIs either stated new SEC staff disclosure interpretations or significantly revised existing interpretations. Some of the C&DIs targeted non-GAAP disclosure practices that have become common in recent years.

The C&DIs most significantly affect the following areas, although other disclosures may also be affected:

- the adjustments a company makes in presenting non-GAAP financial measures in its public communications;
- the relative prominence of, and emphasis on, non-GAAP financial measures in comparison to comparable GAAP financial measures in SEC filings and information furnished to the SEC under Item 2.02 of Form 8-K, which typically includes earnings releases;
- the presentation of forward-looking non-GAAP financial measures, such as guidance or similar forward-looking information presented in a company's earnings release or the MD&A section of its Form 10-Q and Form 10-K reports; and
- the presentation of per-share non-GAAP financial measures in SEC filings and information furnished to the SEC under Item 2.02 of Form 8-K.

Most public companies have had at least two fiscal quarters to deal with the impact of these C&DIs on their public communications and SEC filings, but calendar year-end companies should consider carefully reviewing their year-end documents – Form 10-K, proxy statement and annual report to security holders – to assess the impact of these C&DIs on the substance and the presentation of their non-GAAP disclosures.

Two Goodwin alerts on the SEC Non-GAAP C&DIs, *"SEC Non-GAAP Guidance: Impact on Earnings Releases, SEC Reports and Other Disclosures"* (June 20, 2016) and *"SEC Issues Important Non-GAAP Interpretations"* (May 19, 2016), are available on the Goodwin website.

3. Say-on-Pay Frequency Vote

Companies that held their first say-on-pay frequency vote at their 2011 annual meeting should be aware that SEC rules require them to hold another vote on this matter at their 2017 annual meeting. Although not a new disclosure development, Rule 14a-21(b) generally requires companies to submit to security holders at least every six calendar years a non-binding vote on how frequently the company will submit a "say-on-pay" vote to its security holders. Rule 14a-21(b) became effective for annual or other meetings of security holders at which directors are elected and for which the SEC rules require executive compensation disclosures in accordance with Item 402 of Regulation S-K occurring on or after January 21, 2011. Therefore, most U.S. public companies that were subject to SEC reporting requirements on January 21, 2011 and were not smaller reporting companies (SRCs) as of that date will need to include a vote on the frequency of their say-on-pay votes in their proxy statements for their 2017 annual

meetings. Newly-public companies that aren't emerging growth companies are required to solicit a say-on-pay frequency vote, as well as a say-on-pay vote, at the first annual meeting after their IPO.

Companies that qualified under SEC rules as an SRC as of January 21, 2011, and newly-public companies that qualified as an SRC after that date, were not subject to the say-on-pay rules until their first meeting on or after January 21, 2013. As a result, SRCs were not required to conduct say-on-pay and say-on-pay frequency votes until their first annual (or special in lieu of annual) meeting of security holders occurring on or after January 21, 2013. Therefore, in most cases SRCs will not need to include a say-on-pay frequency vote until their 2019 proxy statements (or six calendar years after their first say-on-pay vote, if later).

The Jumpstart Our Business Startups Act (JOBS Act) designated certain companies as "emerging growth companies" (EGCs), and exempted EGCs from the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) say-on-pay, say-on-pay frequency, and say-on-golden-parachute vote requirements while these companies remain EGCs. Companies that lose their qualification as an EGC should be aware that a say-on-pay frequency vote may be required as early as the first annual meeting that takes place after the company ceases to be an EGC.

Companies that will be submitting a say-on-pay frequency vote to security holders in 2017 should review the disclosure requirements of Item 24 of Schedule 14A, which applies to the say-on-pay frequency vote as well as the say-on-pay vote. Among other things, Item 24 requires companies to explain briefly the general effect of each vote, including whether the vote is non-binding, the current frequency of the say-on-pay votes, and when the next say-on-pay vote will occur. Rule 14a-4(b)(3) provides that companies should offer security holders four voting alternatives: whether the vote on executive compensation should occur every one, two or three years, and abstain. Companies should also be aware of related Form 8-K disclosure requirements concerning the say-on-pay frequency vote.

4. Proxy Statement Disclosure of Voting Options and Standards

In October 2016, the SEC proposed "universal proxy" rules. At the same time, the SEC proposed amendments to existing proxy statement disclosure about voting options and standards that would affect most domestic public operating companies. The **proposing release** may be found on the SEC website.

Although the proposed rules are not likely to be effective for the spring 2017 proxy season (and it is not clear whether the universal proxy rules will ever become effective), the proposed rules about voting options and standards disclosure reflect concerns about proxy statement disclosure that the SEC staff has expressed for several years. The SEC staff has issued a number of comment letters on this disclosure in 2016, and is likely to continue to focus on this disclosure in 2017. Companies should consider reviewing the disclosure in their proxy statements concerning voting options and standards in light of the proposed rules and consider appropriate revisions to their proxy statements and, in appropriate cases, their bylaws.

The concerns expressed by the SEC in the proposing release include ambiguities and inaccuracies in company disclosures about voting standards in director elections. The SEC staff focused on ambiguities or inaccuracies including (1) failure to include an "against" voting option on the proxy card when a majority voting standard applies; (2) mistaken use of an "against" option on the proxy card when a plurality voting standard applies and the only appropriate voting alternative would be "withhold"; and (3) incorrect statements that "withhold" votes are counted in determining director election outcomes. The proposed rules would require, in *all* director elections (contested and uncontested), the following:

- "against" and "abstain" voting options for the election of directors, in lieu of a "withhold" option, when applicable state law gives legal effect to a vote against a nominee;
- elimination of the current ability to provide a "withhold" voting option when an "against" vote has legal effect under applicable state law;
- an "abstain" voting option in a director election governed by a majority voting standard; and
- disclosure about the treatment and effect of a "withhold" vote in director elections.

In addition, the SEC specifically requested comment on the elimination of a "withhold" option where plurality voting standards apply, replacing this with an "abstain" option so that security holders are aware that such votes do not legally affect the outcome of the director election.

The Goodwin alert, *"SEC Proposes Rules on Universal Proxy and Voting Standards,"* is available on the Goodwin website.

5. Descriptions of Security Holder Proposals on Proxy Cards

Earlier this year, the SEC issued interpretive advice on the level of detail that companies must provide when identifying security holder and management proposals on proxy cards. Interpreting the requirement of Rule 14a-4(a)(3), which requires that the proxy card (form of proxy) must "identify clearly and impartially" each matter to be voted on, the SEC stated that companies must provide an "appropriate" degree of detail when identifying and describing specific actions on which security holders will be asked to vote. The full text of the interpretation is available on the SEC website and is reproduced below. Companies should review the examples provided in the interpretation, because examples of descriptions that the SEC says violate Rule 14a-4(a)(3) have been common in recent years.

> *Question 301.01*
>
> *Question: Rule 14a-4(a)(3) requires that the form of proxy "identify clearly and impartially each separate matter intended to be acted upon." How specifically must a registrant describe a Rule 14a-8 security holder proposal on its proxy card?*
>
> *Answer: The proxy card should clearly identify and describe the specific action on which security holders will be asked to vote. This same principle applies to both management and security holder proposals. For example, it would not be appropriate to describe a management proposal to amend a company's articles of incorporation to increase the number of authorized shares of common stock as "a proposal to amend our articles of incorporation." Similarly, it would not be appropriate to describe a security holder proposal to amend a company's bylaws to allow security holders holding 10% of the company's common stock to call a special meeting as "a security holder proposal on special meetings." The following descriptions of security holder proposals also would not satisfy Rule 14a-4(a)(3):*
>
> - *A security holder proposal on executive compensation;*
> - *A security holder proposal on the environment;*

- *A security holder proposal, if properly presented; and*
- *Security holder proposal #3.*

6. Form 10-K Summaries

As required by the Fixing America's Surface Transportation Act (FAST Act), the SEC has amended Form 10-K to specifically allow companies to provide a summary section in their annual reports, although this was already permitted by SEC rules. Companies should be aware that a summary section is *not* required by SEC rules.

As a result of the SEC amendment, Item 16 of Form 10-K specifically allows companies to provide a summary of information included in the Form 10-K, as long as the descriptions in the summary are presented fairly and accurately. SEC rules do not stipulate a specific location, nor do they address whether some or all of the 10-K should be covered in the summary. The summary must also include hyperlinks to the related, more detailed disclosure in the Form 10-K or an exhibit. Footnotes and cross-references are not permitted. The summary is limited to information included in the Form 10-K at the time of filing, rather than incorporated by reference.

SEC Rule 12b-13 provides that "[t]he statement or report shall contain the numbers and captions of all items of the appropriate form…[and] [u]nless expressly provided otherwise, if any item is inapplicable or the answer thereto is in the negative, an appropriate statement to that effect shall be made." In light of Rule 12b-13, companies should include the text of the new item ("Item 16. Form 10-K Summary.") in their Form 10-K reports after Item 15 (and preferably before the signature pages), and should include an appropriate response, such as "none," "not applicable" or "not included" if no summary is included.

7. Paper Copies of Annual Report to Security holders No Longer Required

Following up on its January 2016 announcement that the SEC would no longer scan paper ("glossy") annual reports to security holders and post them on the SEC EDGAR website, the SEC published an interpretation on November 2, 2016 stating that the SEC will not object if, instead of mailing paper copies or submitting the annual report via EDGAR, a company posts an electronic version of its annual report to the company's website not later than the date first sent or given to security holders. The report must remain accessible on the company's website for at least one year after posting.

8. Proxy Statement Audit Committee Report: References to AS 16

As a result of the reorganization of PCAOB standards, the prior reference to PCAOB Auditing Standard No. 16 in audit committee reports should be changed to Auditing Standard No. 1301 if companies wish to use the current reference. Note that Item 407 of Regulation S-K, which requires the audit committee report to state whether the audit committee has discussed with the company's independent auditors the matters required to be discussed by Auditing Standards No. 61, still refers to Auditing Standards No. 61 because the SEC never updated Item 407 to refer to Auditing Standard 16 after a prior PCAOB reorganization.

9. "Tandy" Representations No Longer Required

The SEC Division of Corporation Finance announced on October 5, 2016 that the staff of the Division of Corporation Finance will no longer require companies to include so-called "Tandy" representations in acceleration requests for

registration statements under the Securities Act of 1933 or response letters to staff comments on SEC filings. The policy was effective upon publication. In the future, the SEC staff will remind companies and their management of their responsibilities for accurate and adequate disclosures, but will no longer request the Tandy representations.

10. FAST Act Final Rules and Related Interpretations

On May 3, 2016, the SEC announced that it had adopted amendments to rules related to the thresholds for registration, termination of registration, and suspension of reporting under Section 12(g) of the Securities Exchange Act of 1934. These amendments implement provisions of the Jumpstart Our Business Startups Act (JOBS Act) and the Fixing America's Surface Transportation Act (FAST Act). As a result of the amendments:

- a company that is not is not a bank, bank holding company or savings and loan holding company will not be subject to the reporting obligations imposed by Section 12(g) of the Securities Exchange Act of 1934 until it has more than $10 million in assets and its securities are "held of record" by either 2,000 persons or 500 persons who are not accredited investors; and

- a company that is a bank, bank holding company or savings and loan holding company will not be subject to reporting obligations until it has more than $10 million in assets and the securities are "held of record" by 2,000 or more persons, and may terminate or suspend the registration of a class of securities under the Securities Exchange Act of 1934 if its securities are held of record by fewer than 1,200 persons.

In light of the various amendments adopted by the SEC, companies that are close to the thresholds for registration, deregistration or suspension of reporting under SEC rules may need to adopt procedures to monitor the number of security holders who are not accredited investors, since this will affect the timing of these events. Companies may also wish to review and modify their organizational or investment documents to allow the company require security holders to confirm accredited investor status (or to provide for the repurchase of securities from persons who are not accredited investors if advisable to avoid triggering registration under the Securities Act of 1934). Companies may also wish to review and modify employee compensation plans and related documents to provide for similar monitoring and protection against inadvertently triggering registration obligations.

11. Conflict Minerals Disclosure

There have been no developments during 2016 that change the current reporting requirements for companies that are subject to the SEC's conflict minerals rules.

12. Whistleblowers: SEC Expands Scope of Prohibited Provisions in Employment-Related Documents

In August 2016, the SEC announced its two significant enforcement action against an employer based on confidentiality and release provisions that the SEC asserted would discourage employees from participating in the SEC's whistleblower program. These enforcement actions follow last year's similar action against KBR, Inc. and expand the scope of prohibitions to certain waivers of remedies in employment separation agreements. Companies that have not evaluated the language in their agreements with current and former employees in light of these actions should consider doing so now. Those that have evaluated such agreements should consider whether the SEC's August 2016 enforcement actions warrant making further changes.

The August 2016 enforcement actions, and the action companies should consider, were summarized in two Goodwin alerts: *SEC Enforcement Expands Scope of Prohibited Provisions in Employment-Related Agreements* (August 16, 2016) and *Update: Another SEC Enforcement Action on Whistleblower Waivers and Releases* (August 22, 2016). Both are available on the Goodwin website.

13. Whistleblowers: Continuing Large Awards

The SEC's Office of the Whistleblower continues to announce significant awards. In its report for the fiscal year ended September 30, 2016, the Office of the Whistleblower said that during FY 2016 alone the SEC had issued 13 awards totaling more than $57 million. In total, the SEC issued awards totaling more than $136 million to 37 whistleblowers since the program was established in August 2011. The 10 largest awards issued by the SEC have each totaled more than $1 million, and the largest award exceeded $30 million. These figures exclude awards made since October 1, 2016, which include an award for $20 million in November 2016 and awards for $3.5 million and more than $900,000,000 in December 2016. Companies should review their policies with a view to encouraging reporting, protecting anonymity and ensuring that appropriate action is taken. More broadly, a company's corporate culture can play an important role not only in preventing unethical or illegal behavior but also encouraging timely internal reporting and responses. The continued growth of the SEC's whistleblower program, in both the number of cases and the size of its awards, provides a powerful motivation for companies to continue to review and improve the effectiveness of their internal policies and procedures.

Pending 2017 Developments

14. New Revenue Recognition Standard

The FASB has developed a new revenue recognition standard, ASC 606, *Revenue from Contracts with Customers*. ASC 606 will replace nearly all U.S. GAAP revenue recognition requirements, and will be effective for annual periods beginning on or after January 1, 2018, with early adoption permitted. The new revenue recognition standard is likely to affect not only companies' accounting and financial functions but to have broad impacts on sales, marketing and other business operations, as well as information systems. In many cases, ASC 606 will require companies to disclose new information about customer contracts and create budgets and forecasts on a new measurement basis. Companies should use the remaining time until ASC 606 becomes effective to prepare for the transition. Among other concerns arising from transition to the new revenue recognition standard is disclosure about the impact of the new standard. Companies may want to review recent comments by Sylvia E. Alicea, of the SEC Office of the Chief Accountant, on these disclosures and other matters related to adoption of the new standard.

15. T+2 Settlement

On September 28, 2016, the SEC proposed an amendment to its existing rules that will shorten the standard settlement cycle for most broker-dealer securities transactions from three business days after the trade date (T+3) to two business days after the trade date (T+2). The proposed amendment is designed to reduce the risks that arise from the value and number of unsettled securities transactions prior to the completion of settlement, including credit, market and liquidity risk directly faced by U.S. market participants.

The proposed rules would affect only secondary market transactions, and (as currently proposed) would not affect the current ability to settle most firm commitment underwritten transactions that price after 4:30 p.m. Eastern Time on a T+4 cycle. The proposed rules would also not affect the current ability to specify settlement on a cycle longer than

T+2 (currently, T+3) if the parties expressly agree. However, the SEC has solicited comments on whether the flexibility provided by current rules that permit settlement on a longer cycle should be changed, thus raising the possibility that primary transactions currently eligible for a longer settlement cycle might be required to settle on a cycle as short as T+2.

Final Rules Affecting Filings to be Made in 2018

16. CEO Pay Ratio Disclosure

As summarized in the Goodwin alert, *"SEC Adopts Final CEO Pay Ratio Disclosure Rule"* (August 19, 2015), most public companies that are subject to executive compensation disclosure requirements under Item 402(c)(2)(x) will be required to provide Item 402(u) pay ratio disclosure for their first fiscal year beginning on or after January 1, 2017, which will mean including this disclosure in proxy statements for their 2018 annual meetings. Smaller reporting companies, foreign private issuers, MJDS filers, emerging growth companies and registered investment companies will not be subject to the pay ratio disclosure requirement.

On October 18, 2016, the SEC Division of Corporation Finance published five C&DIs on the CEO pay ratio disclosure rule. Question 128C.05 provides guidance on (1) when a worker is "employed" and (2) whether the worker's compensation is determined by an unaffiliated third party so that the worker is considered an independent contractor or leased worker under Item 402(u). The other four C&DIs provide guidance on the requirement that companies identify the median employee using annual total compensation or any other consistently applied compensation measure that reasonably reflects the annual compensation of employees, such as information derived from the company's tax and/or payroll records

17. Resource Extraction Payments

New rules adopted by the SEC in June 2016 require companies to disclose payments made to the U.S. federal government or a foreign government if the company is engaged in the commercial development of oil, natural gas, or minerals and is required to file annual reports with the SEC under the Securities Exchange Act of 1934. The rules become effective September 26, 2016, and require resource extraction issuers to comply with the rules starting with their fiscal year ending no earlier than September 30, 2018. The original resource extraction rules were adopted by the SEC in 2012, but were vacated by the U.S. District Court for the District of Columbia.

Proposed Disclosure Rules

18. Smaller Reporting Company Definition

On June 27, 2016, the SEC proposed amendments to the definition of "smaller reporting company" in Item 10(f) of Regulation S-K and other SEC rules. SRCs are eligible for a variety of modified disclosure requirements under Regulation S-K and Regulation S-X. The proposed amendments would expand the number of companies that qualify as SRCs. If the SEC adopts the amendments as proposed, companies with a public float of less than $250 million, or with zero public float and revenues below $100 million in the most recently completed fiscal year for which audited financial statements are available, would qualify as SRCs. Currently, the SRC definition uses a $75 million threshold for the public float test and a $50 million threshold for the revenues test.

19. Exhibit Hyperlinks and HTML Format

On August 31, 2016, the SEC proposed rules that would require companies that file registration statements and periodic and current reports that are subject to the exhibit requirements under Item 601 of Regulation S-K to include a hyperlink to each exhibit listed in the exhibit index of these filings. To enable the inclusion of the hyperlinks, the proposed amendments would also require that companies submit all such filings in HTML, or HyperText Markup Language, format.

20. Pay for Performance Disclosure

On April 29, 2015, the SEC proposed rules that would require most public companies to provide disclosure in their proxy statements regarding the relationship between their executive compensation and total security holder return (TSR) for the last five completed fiscal years ("pay for performance"). The proposed disclosure, which remains proposed only as of early December 2016, would require the following information for the company's last five completed fiscal years, subject to phase-in provisions and a shorter three-year period for smaller reporting companies:

- a new "pay versus performance" table disclosing the following information for each completed fiscal year required to be shown in the table:
  - (1) total compensation for the principal executive officer (PEO) and (2) average total compensation for the company's other named executive officers (NEOs), showing both Summary Compensation Table total compensation and a new measure of compensation "actually paid"; and
  - the cumulative TSR of (1) the company and (2) a peer group from the beginning of the period shown in the table through the end of such year; and
- based on the information provided in the table, a "clear description" of the relationship between (1) the compensation "actually paid" to the company's PEO and the average compensation "actually paid" to the company's other NEOs and (2) the company's cumulative TSR for each year, including a comparison of the cumulative TSR of the company and its peer group.

The proposed pay for performance rules would apply to most companies that file proxy or information statements with the SEC. This includes smaller reporting companies, although they would be permitted to provide reduced or "scaled" disclosures, most of which result from existing scaled disclosure requirements for smaller reporting companies under Item 402(m) of Regulation S-K. The proposed rules would not apply to emerging growth companies, foreign private issuers or registered investment companies.

The provisions of the proposed pay for performance rules that specify which executives and what compensation are covered by the rule, the disclosure requirements of the rule and other related information are summarized in greater detail in the Goodwin alert, *"SEC Proposes Pay for Performance Rules"* (June 18, 2015).

21. Incentive Compensation Clawbacks

On July 1, 2015, the SEC proposed rules, consisting of new Rule 10D-1 and related rule and form amendments, that would require clawbacks of incentive compensation received by executive officers of listed companies in the event of subsequent accounting restatements. The SEC proposed these rules to implement Section 10D of the Securities

Exchange Act of 1934, which was added by Section 954 of the Dodd-Frank Act. As of early December 2016, these rules remain proposed only.

The proposed rules would require national securities exchanges, including the NYSE and Nasdaq, to adopt rules that would prohibit the initial or continued listing of any security of a company that does not adopt and comply with a written policy providing that, in the event the company is required to prepare an accounting restatement as a result of material non-compliance with any financial reporting requirement under the securities laws, the company will recover (i.e., "claw back") the amount of excess incentive‑based compensation received by the company's executive officers during the three fiscal years preceding the date on which the company is required to prepare the restatement. The proposed rules would also require each listed company to publicly file its written clawback policy and, if there is a restatement that is subject to the policy, to disclose specified information regarding the restatement and the company's application of its policy in connection with the restatement.

If the SEC adopts the proposed rules as currently proposed, the new clawback policies that the rule would require could raise a number of difficult issues, including the following:

- *Reasonable Estimates of Effect on Stock Price and TSR-Based Incentive Compensation.* Where compensation had been earned based on the company's stock price or total security holder return (TSR), the company would be required to recover compensation based on "a reasonable estimate" of the effect of the accounting restatement on the stock price or TSR.

- *No Tax Offset.* The proposed rules would require companies to compute clawback amounts without regard to taxes paid. If an executive were unable to obtain a full refund or credit for taxes paid on the compensation subject to the clawback, the executive could potentially be worse off financially than if the executive had never received the compensation in the first place.

- *Lack of Clarity for Determination of When a Restatement was Required.* The proposed rules would require companies to claw back excess incentive-based compensation received by executive officers during the three fiscal years preceding the date on which the company is required to prepare the restatement. The definition of the date on which the company is required to prepare the restatement includes the date on which the relevant decision maker at the company "concludes, *or reasonably should have concluded*, that the company's previously issued financial statements contain a material error" (emphasis added). As a result, in order to comply with its clawback policy, a company would need to determine whether it reasonably should have reached this conclusion earlier than it actually did. Because the date of this conclusion determines the fiscal years that are subject to the company's clawback policy, this would introduce uncertainty into the determination of which compensation needed to be clawed back and potentially expose companies to delisting in the event they are second-guessed as to when they reasonably should have determined that a material error existed in prior financial statements. This would also result in potential conflicts with the existing disclosure requirements of Form 8-K, which require companies to disclose the date on which they actually reached a conclusion that a restatement was required.

The clawback policies that would be required by the listing standards under the proposed rules would apply to all companies with a class of listed securities, subject to very limited exceptions. The proposed rules would not permit exceptions for smaller reporting companies, emerging growth companies or foreign private issuers, among others.

Covered Executives. If the SEC rules are adopted as proposed, the new clawback policies would be required to apply to any individual who served as an "executive officer" of the company at any time during the performance period for incentive-based compensation that is subject to the clawback policy. The proposed rules define "executive officer" in the same manner that the rules under Section 16 of the Securities Exchange Act define "officer."

Compensation Subject to Mandatory Recovery. Clawback policies under the proposed rules would require companies to claw back "incentive-based compensation," as defined by the proposed rules, that was received:

- during the three completed fiscal years immediately preceding the date that the company is required to prepare a restatement of its previously issued financial statements to correct a material error;
- while the company had a class of securities listed on a securities exchange; and
- by an individual who served as an executive officer at any time during the performance period for such incentive-based compensation.

The amount of incentive-based compensation that companies would be required to claw back would be the amount that exceeds the amount that otherwise would have been received if the incentive-based compensation had been determined based on the accounting restatement, computed without regard to any taxes paid.

"Incentive-Based Compensation." 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 a financial reporting measure. Financial reporting measures would be defined as:

- measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements;
- any measures that are derived wholly or in part from those measures (e.g., EBITDA, FFO, return on assets or invested capital, financial ratios, liquidity, return and earnings measures, and sales per square foot or same store sales, among others); and
- stock price and TSR.

Financial reporting measures would not be limited to measures presented within the company's financial statements or SEC filings.

Because the definition of incentive-based compensation includes compensation earned "in part" upon achieving a financial reporting measure, these clawback policies would also apply to compensation that is not tied to these measures in a strictly formulaic manner. This would include discretionary bonuses paid from a bonus pool, where the size of the pool is determined based wholly or in part on the attainment of a financial reporting measure, or awards based on the attainment of a financial reporting measure that are subject to discretionary increase or decrease. Incentive-based compensation would also include compensation that was earned based on the company's performance with respect to a financial reporting measure (for example, stock price and TSR) relative to a peer group.

The proposed rules would not apply to the following types of compensation:

- salary;
- bonuses or equity awards paid solely on a discretionary basis, other than those paid from a bonus pool the size of which was determined wholly or in part by satisfying a financial reporting measure;
- bonuses or equity awards paid solely on satisfaction of subjective standards, completion of a specified employment period or the achievement of goals that do not constitute financial reporting measures, such as opening a specified number of stores, obtaining regulatory approvals of a product, consummating a merger or divestiture or completing a restructuring plan or financing transaction.

Mandatory Recovery. The stock exchange listing standards mandated by the proposed rules would require a company to recover excess incentive-based compensation in accordance with its clawback policy unless the company's compensation committee determines recovery is impractical because either (1) the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered or (2) the recovery would violate home country law adopted prior to July 14, 2015. The proposed rules contain a number of conditions to these exceptions, which narrowly limit a company's discretion not to seek recovery. A company that does not comply with its clawback policy will be subject to delisting. The proposed rules would prohibit companies from indemnifying executive officers against the loss of any excess incentive-based compensation.

For additional information about the SEC's proposed rules governing listing standards for clawback policies, see the Goodwin client, *"SEC Proposes Mandatory Incentive Compensation Clawback Rules"* (July 16, 2015).

22. Hedging Policy Disclosure

On February 9, 2015, the SEC proposed a rule that would require companies to disclose their policies with respect to hedging of equity securities of the company, as well as its parent and subsidiaries of the company or its parent, by the company's employees, officers and directors. As of early December 2015, these rules remain proposed only.

Companies and SEC Filings Covered. The proposed rule would require hedging policy disclosure in proxy and information statements for the election of directors by companies subject to the federal proxy rules, including smaller reporting companies, emerging growth companies, and registered closed-end investment companies with shares listed and registered on a national securities exchange. The proposed rule would not require companies to adopt anti-hedging policies. However, many companies have already done so, and, depending on the scope of the final rule, other companies may choose to do so.

Persons Covered. The proposed disclosure of hedging policies would apply to hedging activities by any employees (including officers) and directors of the company and any of their designees. A company that permits hedging transactions by some, but not all, of the categories of persons covered by the proposed rule would be required to disclose the categories of persons who are permitted to engage in hedging transactions and those who are not.

Hedging Activities Covered. The proposed rule would require a company to disclose whether it permits its employees, officers or directors (1) to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) or (2) otherwise to engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities that (A) have been granted to the employee, officer or director by the company as part of the compensation of the employee, officer or director or (B) are held, directly or indirectly, by the employee, officer or director.

The proposed rule would require a company to disclose the categories of hedging transactions that it permits and those that it prohibits. The proposed rule would permit a company to disclose that it prohibits or permits particular categories and permits or prohibits, respectively, all other hedging transactions, if true. If a company does not permit any hedging transactions, or permits all hedging transactions, it would be required to disclose that fact and would not be required to describe specific categories of hedging transactions. A company that permits hedging transactions would be required to disclose sufficient detail to explain the scope of the permitted hedging transactions.

The proposed rule would apply to hedging policies with respect to equity securities that are registered under Section 12 of the Securities Exchange Act of 1934 and that have been issued by the company, any parent of the company, any subsidiary of the company, or any subsidiary of any parent of the company.

For additional information about the SEC's proposed hedging policy disclosure rules, see the Goodwin alert, *"SEC Proposes Hedging Policy Disclosure Rule"* (February 26, 2015).