The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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SEC Proposes Clawback Rule and Related Form Amendments

[29181]

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 16-15
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 17-15
ETF ADVISORY COMMITTEE No. 17-15
SEC RULES COMMITTEE No. 23-15
SMALL FUNDS COMMITTEE No. 21-15
UNIT INVESTMENT TRUST COMMITTEE No. 6-15 RE: SEC PROPOSES CLAWBACK RULE AND RELATED FORM AMENDMENTS

Earlier this month, the SEC proposed a new rule and form amendments to implement the provisions of Section 954 of the Dodd-Frank Act [1] by a 3-2 vote. [2] Section 954 added Section 10D to the Securities Exchange Act of 1934 (the "Exchange Act"). Section 10D requires the SEC to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not develop and implement a policy providing for:

- disclosure of the issuer's policy on incentive-based compensation that is based on financial information reported under the securities laws; and
- recovery of incentive-based compensation that the issuer's executive officers receive during the preceding 3-year period in excess of what they would have received under an accounting restatement.

Applicability of the Proposed Rule and Form Amendments

In crafting Proposed Rule 10D-1 under the Exchange Act (the "Proposed Rule"), the SEC decided to exempt security futures products, standardized options, and the securities of most registered investment companies because "the compensation structures of issuers of these securities render application of the rule and rule amendments unnecessary." [3] The Proposed Rule and form amendments would apply only to those registered funds that:

- list their securities on an exchange (i.e., exchange-traded funds and closed-end funds);
- have internal management (i.e., have paid employees of their own, as opposed to relying on an investment adviser's employees, whom the adviser pays); and

- pay their executive officers incentive-based compensation. [4]

Terms of the Proposed Rule

The Proposed Rule would require:

- each national securities exchange and national securities association that lists securities to file with the SEC, for approval, proposed rules that comply with any final SEC rule; and
- a listed issuer to adopt a written policy providing for the recovery of erroneously awarded incentive-based compensation [5] to executive officers. [6]

The preparation of an accounting restatement due to the issuer's material noncompliance [7] with any financial reporting requirement under the securities laws would trigger application of issuer's policy, and the policy would apply to all executive officers irrespective of fault.

The Proposed Rule contains detailed provisions about: how to determine the relevant 3-year time period for measuring the incentive-based compensation subject to recovery; what constitutes "receipt" of incentive-based compensation; how to calculate erroneously awarded compensation [8] (including that based on stock price or total shareholder return); and how to recover erroneously awarded compensation and determine whether recovery would be "impracticable." The Proposed Rule would prohibit an issuer from indemnifying executive officers against the loss of erroneously awarded compensation.

Proposed Form Amendments Applicable to Funds

The Proposed Rule would subject certain funds to new disclosure requirements. Amended Form N-CSR would require these funds to provide annual disclosure about accounting restatements that required recovery of excess incentive-based compensation [9] and file as exhibits their recovery policies. Amended Schedule 14A would require similar disclosure about accounting restatements and recoveries in proxy statements and information statements relating to the election of directors.

Timing and Compliance

The Proposed Rule specifies when:

- each exchange must file its proposed listing rules (and when they must take effect); and
- each listed issuer must: adopt a compliant recovery policy; begin recovering erroneously awarded incentive-based compensation; and begin including the required disclosures in the applicable SEC filings. [10]

Comments on this Proposal are due to the SEC by September 14. ICI intends to submit a brief comment letter focusing on the Proposal's treatment of funds. If you have questions or comments, please reach out to me (202-371-5406 or matt.thornton@ici.org).

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endnotes

[1] Listing Standards for Recovery of Erroneously Awarded Compensation, SEC Release No. 33-9861 (the "Proposal"), available at www.sec.gov/rules/proposed/2015/33-9861.pdf.

[2] SEC Commissioners Gallagher and Piwowar did not support the proposal.

[3] Proposal at 11.

[4] The Proposed Rule expressly exempts unit investment trust securities and "[a]ny security issued by a management company, as defined in 15 U.S.C. 80a-4(3), that is registered under section 8 of the Investment Company Act of 1940…, if such management company has not awarded incentive-based compensation to any executive officer of the company in any of the last three fiscal years, or in the case of a company that has been listed for less than three fiscal years, since the listing of the company."

[5] The Proposed Rule defines "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 are measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures that are derived wholly or in part from such measures, and stock price and total shareholder return." The Proposal lists, as examples of financial reporting measures, net assets and net asset value per share, among several others.

[6] The Proposed Rule defines "executive officer" as "the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer."

[7] Under the Proposed Rule, "a restatement to correct an error that is material to previously issued financial statements shall be deemed to result from material noncompliance of the issuer with a financial reporting requirement under the securities laws.

[8] An issuer would make this calculation without regard to taxes paid by the executive officer.

[9] Specifically, a fund would disclose, for each restatement, the date on which the fund was required to prepare an accounting restatement; the aggregate dollar amount of excess incentive-based compensation attributable to such accounting restatement; the estimates that were used in determining the excess incentive-based compensation, if the financial reporting measure related to a stock price or total shareholder return metric; and the aggregate dollar amount of excess incentive-based compensation outstanding. If a fund decided not to pursue recovery, it would describe its reason and disclose the name of the executive officer and amount forgone. A fund would also disclose, if applicable, the name of each individual from whom excess incentive-based compensation had been outstanding for 180 days or longer, along with the outstanding amount owed. A fund would also provide this disclosure as a filing exhibit in XBRL format.

[10] See Proposed Rule 10D-1(a)(2)(i) and (ii) and Proposal at 99-100.