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# Recent SEC and PCAOB Guidance Affecting Foreign Private Issuers

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## INTRODUCTION

Recently, the U.S. Securities and Exchange Commission (the “SEC”) and the U.S. Public Company Accounting Oversight Board (the “PCAOB”) issued proposals and concept releases that, once implemented, could significantly affect U.S. listed companies, including foreign private issuers. As described below, these releases include (i) proposed rules that would mandate that listed companies implement policies requiring the “clawback” of certain incentive compensation, if the company subsequently restates its financial statements because of material noncompliance with relevant requirements, (ii) a concept release discussing detailed qualitative and quantitative “audit quality indicators” about auditors and audits that would be intended, among other things, to allow audit committees to measure and compare the performance of their auditors and (iii) a concept release suggesting increased disclosure by issuers of the manner in which their audit committees supervise the independent auditor and discharge their other responsibilities. The purpose of this memorandum is to highlight some of the key features of these regulatory initiatives. Final implementation of any of these measures will be preceded by additional regulatory proposals and public comment periods.

## SEC PROPOSED RULES FOR “CLAWBACK” OF ERRONEOUSLY AWARDED COMPENSATION

On July 1, 2015, the SEC proposed rules that would require (i) all national securities exchanges and national securities associations to adopt listing standards directing issuers to adopt and comply with policies to recover incentive-based compensation from current and former executive officers in the event of a financial restatement to correct a material error and (ii) all listed issuers to make certain disclosures about their clawback policies (the “clawback rules”).<sup>1</sup> The proposed clawback rules implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) but, in certain respects, go beyond what that section requires. As proposed, the clawback rules would apply to almost all listed issuers, including foreign private issuers and emerging growth companies, controlled companies and issuers whose only listed security is debt or preferred stock. The clawback rules would require national securities exchanges to prohibit the listing of any securities of issuers not in compliance with the rules.

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<sup>1</sup> Listing Standards for Recovery of Erroneously Awarded Compensation, 80 Fed. Reg. 41143 (proposed July 1, 2015) (to be codified at 17 C.F.R. § 240.10D-1), available at <https://www.sec.gov/rules/proposed/2015/33-9861.pdf>.

### Key Elements of Clawback Rules

- The proposed clawback rules would be triggered when an issuer has to prepare an accounting restatement due to “material noncompliance” with the SEC’s financial reporting requirements. The SEC has declined to define “material” for this purpose, instead leaving issuers to rely on accounting literature and judicial and regulatory interpretations of the securities laws. Clawback would not be required where the republishing of a company’s financial statements does not involve the correction of a material error but instead results from, for example, a change in accounting principle or change in the issuer’s structure, accounting segments or the reporting entity.
- Under the proposed rules, the issuer must recover from current and former “executive officers” on a no-fault basis any incentive-based compensation in excess of the compensation that would have been paid to those officers had the restated financial statements been issued originally. The clawback rules require recovery of incentive-based compensation in the event of a covered financial restatement unless: (i) the expense paid to a third party in order to enforce the policy is greater than the amount that would be recovered or (ii) recovery of such compensation would violate the laws of a company’s home country.
- The proposed clawback rules’ definition of an executive officer covers an issuer’s president, principal financial officer, principal accounting officer (or if none, the controller), any vice president in charge of a principal business unit or function or any other officer who performs policy-making functions for the issuer. This definition is the same as the definition of an “officer” in Rule 16a-1 under the Securities Exchange Act of 1934 (the “Exchange Act”) and is slightly broader than the definition of an “executive officer” in Rule 3b-7 under the Exchange Act. As a result of the broad scope of this definition, it covers officers who may not have had any involvement in the error or in the preparation or review of the issuer’s financial statements.
- The proposed rules define incentive-based compensation as compensation granted or earned due to the attainment of a financial reporting measure, which includes both GAAP measures such as revenue, net income and operating income as well as non-GAAP measures such as EBITDA, and also includes changes in stock prices or total return. Payments such as salaries and awards or bonuses paid after the satisfaction of subjective standards (*e.g.*, demonstrated leadership), completion of a specific period of employment and the occurrence of non-financial events (*e.g.*, consummating a merger or opening a specific number of stores) do not qualify as incentive-based compensation.
- Incentive-based compensation is deemed “received” in the fiscal period during which the required performance measure is attained, even though the compensation may not be paid in that year or may be subject to other requirements such as time vesting.
- Under the proposed clawback rules, incentive-based compensation must be recovered for the three fiscal years preceding the date on which the issuer was required to prepare a restatement due to “material noncompliance” with the SEC’s financial reporting requirements. This three-year period begins on the earlier of two dates: (i) the date on which the issuer’s board, board committee or authorized officers conclude, or reasonably should have concluded, that the issuer’s previous financial statements contained a material error and (ii) the date on which a court, regulator or similar body requires the issuer to restate its financial information.
- The proposed clawback rules prohibit indemnification of executive officers against the loss of erroneously awarded incentive-based compensation.

### Disclosure Requirements

- Under the clawback rules, all issuers listed on any U.S. exchange would be required to disclose their clawback policies and how they have implemented and enforced those policies in specific cases. Listed foreign issuers are required to include these disclosures in their annual Forms 20-F, 10-K or 40-F, as applicable. Listed U.S. issuers are required to include these disclosures in their annual Form 10-K and any proxy or information statements that require executive compensation disclosure under Item 402 of Regulation S-K.
- The rules would require that issuers file copies of these policies as exhibits to annual reports and, in the event of a restatement, disclose detailed information regarding the recovery of incentive-based compensation, including, in certain cases, the identity of each person from whom a recovery is being sought or from whom the issuer decided not to pursue recovery.

## General

Comments on the proposed rules are due by September 14, 2015. Once final clawback rules are adopted, the national securities exchanges must still adopt listing standards which are also subject to SEC approval and public comment. Accordingly, final implementation is unlikely to happen this year and may take much longer. While it is difficult to predict the ultimate effect of the clawback rules on compensation policies, some companies may respond to the rules by adding a discretionary element to incentive compensation. Depending on the final rules, doing so may allow companies to determine that executives should be entitled to retain a portion of their compensation, even in the event of a restatement that would otherwise be the result of “material noncompliance” with the SEC’s financial reporting requirements.

The proposed rules can be found at: <https://www.sec.gov/rules/proposed/2015/33-9861.pdf>.

## PCAOB CONCEPT RELEASE ON AUDIT QUALITY INDICATORS

On June 30, 2015, the PCAOB issued a concept release seeking public comment on the content and possible uses of a group of potential “audit quality indicators”.<sup>2</sup> Through the use of specific indicators of audit quality, the PCAOB seeks to enhance the communication between an issuer’s audit committee and the auditors they supervise, as well as provide useful information to the audit firm, investors and regulators. In the PCAOB’s view, the use of audit quality indicators should strengthen audit planning and may also enhance competition based on quality among audit firms.

### Background – Current Audit Committee Communications

Currently, auditors are required to report to the audit committee under Auditing Standard 16 on a variety of matters relating to their engagement, including significant issues discussed with management, audit planning, (including risk assessments, accounting policies and significant estimates) unusual transactions, the quality of the company’s financial reporting and internal controls.<sup>3</sup> In August 2012, the PCAOB issued “Information for Audit Committees About the PCAOB Inspection Process”.<sup>4</sup> Among other things, this release suggests questions that audit committees should consider asking their auditors about PCAOB inspections of the auditor and its audits (including any inspection of the company’s audit and inspection of comparable audits). Those questions focus on audit quality and on deficiencies noted by the PCAOB. The PCAOB expanded on this guidance in May 2015,<sup>5</sup> urging auditors and audit committees to communicate on (i) key areas of recurring audit concerns, including internal controls, deficiencies in work referred to other audit firms in cross-border audits and deficiencies in auditing accounting estimates and (ii) emerging audit risks, such as increases in mergers and acquisitions, falling oil prices and undistributed foreign earnings.

### Proposed Audit Quality Indicators

In the concept release, the PCAOB states that the greatest use of the audit quality indicators may be as generators of questions for the outside auditor. The PCAOB release notes that most of the proposed indicators would require the audit firm to produce data relating to the particular engagement and engagement team, as well

<sup>2</sup> Concept Release on Audit Quality Indicators, PCAOB Release No. 2015-005, PCAOB Rulemaking Docket Matter No. 041 (July 1, 2015), available at [http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release\\_2015\\_005.pdf](http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf).

<sup>3</sup> Auditing Standard No. 16, PCAOB Release No. 2012-004, PCAOB Rulemaking Docket Matter No. 030 (Aug. 15, 2012), available at [http://pcaobus.org/Rules/Rulemaking/Docket030/Release\\_2012-004.pdf](http://pcaobus.org/Rules/Rulemaking/Docket030/Release_2012-004.pdf).

<sup>4</sup> Information for Audit Committees about the PCAOB Inspection Process, PCAOB Release No. 2012-003 (Aug. 1, 2012), available at [http://pcaobus.org/Inspections/Documents/Inspection\\_Information\\_for\\_Audit\\_Committees.pdf](http://pcaobus.org/Inspections/Documents/Inspection_Information_for_Audit_Committees.pdf).

<sup>5</sup> PCAOB, Audit Committee Dialogue (May 2015), available at <http://pcaobus.org/sites/digitalpublications/audit-committee-dialogue>.

as firm-wide comparative data, so that the audit committee and other users of the information can have an informed discussion and make informed comparisons of quality. Accordingly, audit committees may wish to consider if there is additional information from their auditors that would be useful to them now.

Set out below is a chart prepared by the PCAOB which sets out the 28 potential audit quality indicators.

<b>AUDIT PROFESSIONALS</b>	Availability	1. Staffing Leverage 2. Partner Workload 3. Manager and Staff Workload 4. Technical Accounting and Auditing Resources 5. Persons with Specialized Skill and Knowledge
	Competence	6. Experience of Audit Personnel 7. Industry Expertise of Audit Personnel 8. Turnover of Audit Personnel 9. Amount of Audit Work Centralized at Service Centers 10. Training Hours per Audit Professional
	Focus	11. Audit Hours and Risk Areas 12. Allocation of Audit Hours to Phases of the Audit
<b>AUDIT PROCESS</b>	Tone at the Top and Leadership	13. Results of Independent Survey of Firm Personnel
	Incentives	14. Quality Ratings and Compensation 15. Audit Fees, Effort and Client Risk
	Independence	16. Compliance with Independence Requirements
	Infrastructure	17. Investment in Infrastructure Supporting Quality Auditing
	Monitoring and Remediation	18. Audit Firms' Internal Quality Review Results 19. PCAOB Inspection Results 20. Technical Competency Testing
<b>AUDIT RESULTS</b>	Financial Statements	21. Frequency and Impact of Financial Statement Restatements for Errors 22. Fraud and Other Financial Reporting Misconduct 23. Inferring Audit Quality from Measures of Financial Reporting Quality
	Internal Control	24. Timely Reporting of Internal Control Weaknesses
	Going Concern	25. Timely Reporting of Going Concern Issues
	Communications between Auditors and Audit Committee	26. Results of Independent Surveys of Audit Committee Members
	Enforcement and Litigation	27. Trends in PCAOB and SEC Enforcement Proceedings 28. Trends in Private Litigation

The release can be found at: [http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release\\_2015\\_005.pdf](http://pcaobus.org/Rules/Rulemaking/Docket%20041/Release_2015_005.pdf).

## SEC CONCEPT RELEASE REGARDING POSSIBLE REVISIONS TO AUDIT COMMITTEE DISCLOSURES

On July 1, 2015, the SEC issued a concept release seeking public comment on possible changes to issuers' required disclosures regarding the structure and functioning of their audit committees.<sup>6</sup> The majority of audit committee disclosure requirements were adopted in 1999, but the passage of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") changed listing requirements for audit committees and implemented additional requirements for communications between audit committees and independent auditors. The July 1, 2015 concept release focuses on the audit committee's oversight of an independent auditor and the committee's process for selecting an auditor. It asks whether foreign private issuers should be subject to the full disclosure requirements for audit committees.

Among other things, the concept release seeks public comment on the following:

- whether to modify the current disclosure requirements to include all required reporting by auditors to the audit committee;
- whether to modify the current disclosure requirements to include the additional disclosures required in the United Kingdom and other foreign jurisdictions;
- whether the current disclosure requirements should be changed for smaller reporting companies or emerging growth companies;
- whether to require increased disclosure regarding the criteria used to appoint or retain an auditor and the length of the audit relationship;
- whether to require increased disclosure regarding the audit committee's involvement in evaluating and approving the auditor's compensation;
- whether to require increased disclosure of disagreements between the management and the auditor;
- whether to require increased disclosure regarding the substance and timing of audit committee meetings with the auditor;
- whether to require disclosure of additional information regarding the audit process for multiple locations, including locations visited by the auditor and how the audit committee considered the scope of the audit;
- whether to require increased disclosure of internal and PCAOB review of the audits as well as the most recent PCAOB inspection report;
- whether to require detailed disclosure of the audit committee's supervision, assessment and reinforcement of the auditor's objectivity and professional skepticism;
- whether to require increased disclosure with respect to the board of directors' policy for an annual shareholder vote on auditor selection and the audit committee's consideration of those voting results;
- whether to require increased disclosure regarding the names and qualifications of key members of the engagement team and the audit committee's role in selecting an engagement partner; and
- whether increased disclosure requirements could decrease communications between the audit committee and the auditor.

Comments on the concept release are due by September 8, 2015. The concept release can be found at the following: <https://www.sec.gov/rules/concept/2015/33-9862.pdf>.

*This memorandum relates to general information only and does not constitute legal advice. Facts and circumstances vary. We make no undertaking to advise recipients of any legal changes or developments.*

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<sup>6</sup> Possible Revisions to Audit Committee Disclosures, 17 C.F.R. Part 240 (July 1, 2015), available at <https://www.sec.gov/rules/concept/2015/33-9862.pdf>.