

## SEC Proposes Rules on Clawback Policies

### Broad Sweeping, No Fault Recoupment of Incentive Compensation Based on Financials, Stock Price, or TSR

Nearly five years after enactment of the Dodd-Frank Wall Street Reform Act of 2010 (DFA or the Act), the Securities and Exchange Commission (SEC) has issued long-awaited guidance on Section 954 of the Act concerning recoupment of excess executive incentive compensation triggered by an accounting restatement (commonly known as “clawback” provisions). The proposed rules (Proposal or Proposed Rules) will satisfy the last remaining executive compensation provision in the DFA for which rules have not been proposed or finalized, unsurprising considering the tough interpretative questions this provision raised for the SEC.

#### Overview and Implementation Schedule

The legislative text of the clawback provision is brief and ambiguous. The Act requires the SEC to direct the exchanges to prohibit listing of (and delist) any company that does not adopt, implement, and disclose clawback policies as dictated by the exchanges and SEC. The specific text covers two items:

- Disclosure of a company’s clawback policy; and
- Recovery from any current or former executive officer of incentive-based compensation received in the three years prior to a restatement in an amount equal to the excess of what would have been paid to the executive officer under the accounting restatement.

***The SEC has taken a relatively simple and common sense concept – repay what should never have been paid in the first place – and created a voluminous set of regulations that will result in additional cost, complexity, and unintended consequences.*** A far better methodology would have taken a principles-based approach. While we do not disagree that recoupment is appropriate in cases where payments should not have been made due to erroneous financial reporting, we believe the SEC has produced a dogmatic set of rules requiring public companies to go beyond the mandates of the Act. Specifically, the Proposal:

- Covers incentive-based compensation tied not only to financial accounting measures, but also to stock price and total shareholder return (TSR), which will necessitate extensive research, testing, and expense to understand how stock price and TSR would have been impacted by a restatement; and
- Provides almost no company discretion for enforcement.



On the positive side, implementation is not immediate. The SEC has requested robust input on more than 100 areas, with the comment period closing in September. At that point, the SEC has an unspecified period of time to issue Final Rules, after which the exchanges must propose and finalize their own listing standards. As a result of this process, it is unlikely that compliance will be required prior to 2017 filings.

## The Proposed Rules at a Glance

<b>Covered Companies</b>	<ul style="list-style-type: none"> <li>• Generally all public filers, including emerging growth companies, smaller reporting companies, foreign private issuers (FPIs), and controlled companies</li> <li>• Limited exceptions for issuers of security futures, standardized options, registered investment companies that do not use incentive compensation, and unit investment trusts</li> </ul>
<b>Covered Executives</b>	<ul style="list-style-type: none"> <li>• All Section 16 executive officers who were executive officers during the performance period covered by the incentive-based compensation</li> </ul>
<b>Compensation Covered</b>	<ul style="list-style-type: none"> <li>• Incentive-based compensation granted, earned, or vested based on attainment of any financial reporting measure, as well as stock price or TSR</li> <li>• Excludes salaries, bonuses based on strategic or operational measures, discretionary bonuses, time-based equity awards, and equity awards tied to non-financial reporting measures</li> </ul>
<b>Type of Restatement &amp; Triggering Event</b>	<ul style="list-style-type: none"> <li>• Broadly applicable to almost any restatement to correct an error material to previously issued financial statements</li> <li>• Clawback policy triggered regardless of misconduct or specific executive officer involvement (“no fault”)</li> <li>• The Triggering Event occurs on the date the Board concludes the company’s previous financial statements contain a material error or the date a legal entity directs the company to restate its financials, whichever is earlier (i.e., the filing of the restatement is not the Triggering Event)</li> </ul>
<b>Look-Back Period for Recoupment</b>	<ul style="list-style-type: none"> <li>• The clawback is applied to incentive-based compensation <b>received</b> during the three completed fiscal years immediately preceding the Triggering Event</li> </ul>



<b>Amount of Recoupment</b>	<ul style="list-style-type: none"> <li>• The amount subject to clawback is the excess of the incentive compensation received during the three-year period over the incentive compensation that would have been received based on the restatement</li> <li>• A reasonable estimate of the impact of the restatement on TSR/stock price must be made where incentive compensation was tied to such measures</li> </ul>
<b>Required Disclosure</b>	<ul style="list-style-type: none"> <li>• Policy must be filed as an exhibit to Form 10-K</li> <li>• If there was a restatement in the past fiscal year or there are outstanding balances of excess compensation from a prior year's restatement, the proxy statement must include:             <ul style="list-style-type: none"> <li>• Date of restatement, aggregate incentive compensation excess related to the restatement, and the total amount of outstanding excess for the fiscal year</li> <li>• If the company did not pursue recovery for any executive officer, the name of the executive and the amounts forgone, as well as the company's rationale for not pursuing recovery</li> <li>• If any executive officer had excess incentive compensation outstanding for more than six months, the executive's name and the amount still due must be disclosed</li> </ul> </li> <li>• Adjustments to the Summary Compensation Table for recoupment</li> </ul>
<b>Limited Exceptions</b>	<ul style="list-style-type: none"> <li>• Where cost of recovery would exceed excess compensation</li> <li>• For FPIs, where recovery would violate home country law</li> </ul>
<b>Remedies Prohibited</b>	<ul style="list-style-type: none"> <li>• No reimbursement for recouped pay or insurance policy premiums</li> </ul>

## Companies and Executives Subject to the Rules

### *Which Companies are Subject to the Proposed Rules?*

The SEC took an expansive view of which companies were covered by the Proposed Rules. All public companies (including smaller reporting companies, emerging growth companies, foreign



private issuers, controlled companies, and issuers of private debt) are covered. Very narrow exceptions were made for issuers of security futures products and standardized options, registered investment companies that have not awarded incentive-based compensation to any executive officers of the company for the past three years (or since initial listing, if shorter), and unit investment trusts.

## **Which Executives are Subject to Clawback Policy?**

### *Section 16 Definition*

Executive officers are defined with reference to Section 16, and will include the company's president, principal financial officer, principal accounting officer (or controller), any vice president in charge of a principal business unit, division, or function, and any other officer who performs a policy-making function (including officers at the subsidiary level who have policy-making responsibility for the company).

***Pearl Meyer Observation:*** *As the rule extends below top corporate positions into unit or division heads, clawback policies may have disparate impact depending on compensation plan design. For example, an annual incentive program for one division head may be tied all or in part to financials, while a division head of equal policy-making stature may have an incentive plan based wholly or in part on non-financial measures. Only that executive whose plan is tied to financial measures will be subject to mandatory clawback under the Proposal.*

### *Timing*

If a person served as an executive officer at any time during the performance period relevant to the incentive compensation, then all incentive compensation received during the three-year look-back period would be subject to clawback under the policy. Accordingly, recovery would not be applied to any person who was not an executive officer during the performance period covering the incentive-based compensation subject to clawback.

### *No Fault*

Recovery will be required from each executive officer whether or not the executive officer had responsibility for, or was involved in any way in, preparing financial statements.

## **Restatements**

### ***What Type of Restatement Triggers a Clawback Policy?***

Clawback policies apply if a company is required to restate previously issued financial statements to correct a material error. The SEC declined to specify what constitutes "material" or an "error", but generally indicates most restatements would likely trigger the policy. However, certain retrospective changes to financial statements would not be considered errors triggering the policy, including: (i) application of a change in accounting principle; (ii) revisions to reportable segment information due to a change in internal organization; (iii) reclassification due to a discontinued operation; (iv) application of a change in reporting entity, such as from a reorganization of entities under common control; (v) adjustments to provisional amounts in connection with a prior business combination; and (vi) revisions for stock splits.



## ***When is the Restatement Required to be Prepared (Triggering Event)?***

The three-year look-back period begins on the date the company is required to prepare a restatement (the Triggering Event), which is not the date the restatement is actually filed. The Proposed Rules define the Triggering Event as the earlier of:

- The date the company's Board (or Committee) concludes, or reasonably should have concluded, that the company's previously issued financial statements contain a material error; or
- The date a court, regulator, or other legally authorized body directs the company to restate its previously issued financial statements to correct a material error.

## **Incentive-Based Compensation**

### ***What Type of Compensation is Subject to the Clawback Policy?***

Only "incentive-based compensation" is subject to the clawback policy, with the Proposal defining it as any compensation ***granted, earned or vested***, wholly or in part, upon the attainment of either:

- Any financial reporting measures which are based on accounting principles using the company's financial statements, and any measures derived from these measures (revenues, net income, operating income, profitability, net assets, etc.); or
- Stock price and TSR.

The Proposal contains examples of incentive-based compensation, including:

- Non-equity incentive plan awards earned, wholly or in part, on financial reporting measure performance goals, stock price or TSR (each referred to as a Financial Goal);
- Bonuses paid from a bonus pool, the size of which is based, wholly or in part, on satisfying Financial Goals;
- Restricted stock, restricted stock units, performance stock units, stock options and stock appreciation rights granted or vested, wholly or in part, on satisfying Financial Goals; and
- Proceeds received from the sale of stock acquired through an incentive plan granted or vested, wholly or in part, on satisfying Financial Goals.

The Proposal also contains examples of those types of compensation not covered:

- Salary;
- Discretionary bonuses (except those paid from a pool, the size of which is based, wholly or in part, on satisfying Financial Goals);
- Bonuses based on subjective standards (e.g., leadership);
- Retention bonuses;
- Non-equity incentive awards based only on satisfying non-Financial Goals; and
- Equity awards that are either time-based or earned based on attaining one or more non-Financial Goals. Significantly, this provision excludes from the clawback policy any stock option or restricted stock award which vests based on the passage of time, even though their value fluctuates with the value of the company's stock (but only to the extent the grant of such option or restricted stock was not itself contingent on attainment of a Financial Goal).



**Pearl Meyer Observation:** *The DFA’s say-on-pay provisions initiated a movement towards increased pay-for-performance, a trend expected to be reinforced by the DFA’s proposed pay-for-performance provisions released in late April 2015. The proposed clawback provisions may have the opposite effect, with companies placing a greater emphasis on restricted stock and stock options, which commonly vest solely on the passage of time, to mitigate risk of recoupment. Note that the classification of stock options is controversial in this regard, with Institutional Shareholder Services (ISS), Glass Lewis, and, apparently, the SEC, considering them not to be “incentive-based”, in contrast to general opinion.*

### **How Long is Incentive-Based Compensation At Risk Under the Clawback Rules?**

The policy generally applies to incentive-based compensation received in the three completed **fiscal years** immediately preceding the Triggering Event (i.e., not the 36 months preceding the Triggering Event), with certain exceptions for companies that have changed fiscal years.

### **What is “Received” Incentive-Based Compensation?**

Compensation is deemed received under the Proposed Rules in the fiscal period in which the financial reporting measure is attained, even if the compensation is not actually paid until a later date and/or the compensation is subject to additional service-based or non-Financial Goal-based vesting conditions after the period ends. Notably, administrative acts and conditions necessary for payment (e.g., calculating the amount or Board approval) will not delay when the compensation is deemed received under the Act. Incentive-based compensation received after a company goes public is subject to the policy even if the compensation was granted before the company listed.

### **Recovery Process**

#### **How Much Compensation is Subject to Recovery?**

Companies must recoup the amount of incentive-based compensation received by the executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement. Such amounts are to be determined on a pre-tax basis, and companies do not have the discretion to settle for less than the full recovery amount unless impracticable from a cost standpoint (discussed below).

The Proposal provides guidance on determining excess amounts in several specific situations:

Situation	Guidance
<b>Incentive Compensation Based on Stock Price or TSR</b>	<ul style="list-style-type: none"> <li>• Amount is determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure</li> <li>• The company must maintain documentation of how it determined its reasonable estimate and provide the documentation to the relevant exchange</li> </ul>



<b>Incentive Compensation Partially Based on Financial Goals</b>	<ul style="list-style-type: none"> <li>• Determine the portion of the original incentive-based compensation based on the Financial Goal</li> <li>• Recalculate the incentive compensation based on the restatement</li> <li>• Recover the difference between the amount based on the original financial statements and the lesser amount based on the restatement</li> </ul>
<b>Bonus Pools Based on Financial Goals</b>	<p>For discretionary individual awards made from a bonus pool funded based on Financial Goals:</p> <ul style="list-style-type: none"> <li>• Reduce the size of the aggregate bonus pool from which individual bonuses are paid based on the restatement</li> <li>• If the reduced pool is less than the aggregate amount of individual bonuses received from it, the excess amount of an individual bonus is the pro-rata portion of the deficiency</li> <li>• If the aggregate reduced bonus pool would have been sufficient to cover the individual bonuses received from it, then no recovery is required</li> </ul>
<b>Shares/Options/SARs Unexercised/Still Held at Recovery Date</b>	<p>Recoverable amount is equal to the number of shares received in excess of the number that should have been received after applying the restatement</p>
<b>Options/SARs Exercised but Shares Still Held</b>	<p>Recoverable amount is equal to the number of shares underlying the excess options or SARs after applying the restatement</p>
<b>Options/SARs Exercised and Shares Sold</b>	<p>Recoverable amount is sale proceeds received with respect to excess number of shares after applying the restatement</p>
<b>Retirement Plans</b>	<ul style="list-style-type: none"> <li>• Where erroneously awarded compensation is deferred into a nonqualified plan, the account balance or distributions attributable to the erroneously awarded compensation should be reduced</li> <li>• Where erroneously awarded compensation has been used to calculate an executive officer's accrued benefit under a pension plan, the accrued benefit should be reduced or distributions recovered</li> </ul>



***Pearl Meyer Observation:*** *In our view, the most troubling aspect of the Proposal is the requirement that companies make “reasonable estimates” as to how a restatement would have impacted stock price or TSR. There are countless assumptions that go into the “but for” price of the stock (i.e., the stock price that would have been if financial statements originally had been presented as later restated) and stock price may be simultaneously impacted by information other than the announcement of a restatement (e.g., corporate actions, macro-economic events, etc.). The SEC itself recognized the complexity of this calculation in an extensive eight page discussion of possible methodologies and costs to obtain reasonable estimates. It notes that an “event study” may need to be conducted, and that outside experts may be necessary to give an estimate deemed “reasonable”, as well as the possibility that an executive officer could challenge the estimate. If adopted as proposed, this provision will be a windfall for the plaintiffs’ bar as any “reasonable estimate” will be fair game for challenge.*

### ***Is There a Specific Process for Recovery?***

This is one of the rare areas of the Proposal that allows for company discretion. Companies may recover excess compensation by recovering compensation all at once by direct payment from the recipient, by recovering compensation over time, or by reducing future pay so long as it happens in a way to achieve the purpose of the statute in a reasonably prompt manner without undue delay. While deadlines are not prescribed, an exchange may delist a company if it determines it was not making a good faith effort to promptly pursue recovery.

### ***Are There any Exceptions to the Mandatory Recovery Rules?***

The Proposed Rules do not provide issuers with the discretion to seek or not seek recovery of covered incentive compensation, but do provide for two narrow exceptions to recovery:

#### ***Impracticality***

Recovery is not mandated where the company’s Compensation Committee determines recovery would be impracticable because the direct expense payable to a third party (e.g., legal costs), but not indirect costs (e.g., reputational harm), of seeking recovery would exceed the recoverable amounts. Before concluding it would be impracticable to recover the amounts, the company must make a reasonable attempt to recover the compensation, must document its attempt to recover, and must provide the documentation of this attempt to the relevant stock exchange. The company would also be required to disclose in the proxy statement why it chose not to pursue recovery.

#### ***Violation of Foreign Law***

Recovery is not mandated where the Committee determines, in the case of a foreign private issuer, pursuing such recovery would violate applicable home country laws. In this case, a company would have to obtain an opinion of home country counsel that the recovery was prohibited by home country law, and the opinion would need to be accepted by the listing exchange. The home country law must have been adopted in the home country prior to the date the Proposed Rules were published in the Federal Register.





## ***Can Companies Protect Executive Officers from Clawback Risks?***

The Proposed Rules prohibit companies from indemnifying an executive officer for the loss of erroneously awarded compensation the officer is required to pay back under the clawback policy, whether directly or indirectly by paying insurance premiums on an officer's purchase of third-party indemnification insurance.

## ***How Does the New Clawback Impact Existing Rules and Contracts?***

CEOs and CFOs will remain subject to clawback provisions under the Sarbanes-Oxley Act of 2002 (SOX), whereby following an accounting restatement caused by "misconduct", the CEO and CFO must reimburse the company for any incentive or equity-based compensation and profits they obtained from selling company securities received during the year following issuance of inaccurate financial statements. However the Proposed Rules would not require double recoupment under both SOX and DFA – any compensation recouped under SOX would be credited against the clawback policy.

The SEC rejected the idea of existing contractual commitments trumping the clawback policy. The Proposed Rules apply the clawback policies to any incentive compensation received with respect to a fiscal year ending on or after the effective date of the final rule and include compensation payable pursuant to pre-existing arrangements. Further, pre-existing contractual arrangements do not result in compensation being "impracticable" to recover. The SEC seems to expect companies to amend the terms of these agreements to accommodate recovery.

***Pearl Meyer Observation:*** *As a practical matter, most new and amended employment agreements since 2010 have contained specific provisions that all compensation payable under contract are subject to the requirements under the company's clawback policy as amended for final guidance under the DFA. To the extent existing contracts do not contain such a provision, companies should consider an amendment, now that clawback implementation is on the horizon.*

## ***What are the Consequences of Non-Compliance?***

Companies are subject to delisting from their stock exchange if they do not adopt a clawback policy in compliance with the applicable listing standard, disclose the policy under the SEC rules, and comply with the policy's recovery provisions.

## **Disclosure**

### ***What are the Clawback Disclosure Requirements?***

Companies will have up to three additional disclosure items under the Proposal.

#### *Clawback Policy*

The Company is required to file its clawback policy as an exhibit to its annual report on Form 10K.



## *Proxy Statement Disclosure*

Disclosure is required in the proxy statement if a restatement requiring recovery under the policy was completed in the past fiscal year or if there was an outstanding balance of excess compensation due under the policy with respect to a prior restatement. This disclosure must include the following information:

- Current Year Restatement Information: The date when the restatement was required to be prepared, the amount of erroneously awarded compensation recoverable under the policy with respect to the restatement, any estimates used in calculating the erroneously awarded compensation, and any unrecovered compensation as of the end of the fiscal year;
- Information if Recovery was Foregone: The names of the executive officers and amounts of any erroneously awarded compensation to such executive officers which the company decided not to recover and the reasons why; and
- Dated Balances: The names of the executive officers and amounts of any erroneously awarded compensation that had been outstanding for more than 6 months as of the end of the last completed fiscal year.

***Pearl Meyer Observation:*** *The new disclosure items appear to provide a handy road map for plaintiffs' attorneys to use in initiating cases against any company that has a restatement and subsequent need to clawback incentive-based compensation. Clearly, disclosure and related discussion about decisions not to pursue recovery will be excellent material for questioning the Committee/Board's judgment.*

## *Summary Compensation Table (SCT)*

Instructions to the SCT would be amended to allow any recovered amount to reduce the amount reported in the applicable column of the SCT for the fiscal year in which the recovered amount was initially reported, with an explanation and the value of the excess/recouped amount reported in the footnotes.

## ***Tag, You're It?***

The new clawback proxy disclosure requirements must be tagged in interactive block text tag format using eXtensible Business Reporting Language (XBRL). This is only the second time XBRL will be required outside of the financial statements, with its use also being prescribed under the pay-for-performance disclosure rules proposed in April 2015.

## **Effectiveness and Next Steps**

### ***When Will the Proposed Rules Take Effect?***

Required implementation is not immediate:

- The comment period on the Proposal ends in September of 2015, and from there the SEC has an unspecified period of time to file final rules;
- After the effective date of the final rules, incentive-based compensation will be subject to clawback so long as the fiscal period the financial information is based on has not been completed before this date;

- After the final rules have been filed, the exchanges have 90 days to file their rules (which must be effective within a year of the SEC's final rules); and
- Once the new listing standards are in effect, companies will be required to adopt a compliant recovery policy within 60 days of the effective date of the relevant exchange's rules. Companies will also be required to comply with the disclosure requirements in their first annual report or proxy statement after their clawback policy is adopted.

Assuming the most aggressive adoption schedule, if SEC final rules were published by December 2015, exchange rules would be effective by December 2016 at the latest, with policies first being filed and subject to disclosure in 2017.

### ***Is There a Phase-In Period?***

Under the Proposal, beginning on the date of the SEC's final rule, all compensation granted, earned or vested based on financial information for any fiscal period ending on or after that date will be subject to clawback. In other words, any incentive compensation based on financial information for any period which includes or comes after the effective date of the SEC's final rule will be subject to clawback, even if it was granted before the SEC final rule is adopted.

### ***What Should You be Doing Now?***

In our experience, many public companies have already adopted clawback policies to cover compensation in situations where the Board or Committee, *in its judgment*, has determined it is appropriate to recoup improperly awarded compensation. The Proposal imposes new burdens on companies by requiring them to adopt and disclose relatively rigid compensation policies, discarding any hope of a principles-based approach and the possibility of Board discretion. The Proposal is particularly troubling in its expectation that companies make "reasonable estimates" of the impact of accounting restatements on stock price or TSR, which are extremely common measures in long-term incentive design. We encourage all of our clients to submit comment letters to the SEC to influence the final design of these rules.

We recommend some specific action items to our clients to prepare for adoption of final rules, including:

- Review your current Section 16 executive officers and make a list of those executives who will likely be subject to the policy. Re-consider your definition of executive officers if you have a fairly liberal definition to reduce the number of officers subject to the new provisions. Consider communicating with these individuals to explain the new rules.
- Review your existing clawback policy to consider changes needed to be made assuming the final rules are similar to the Proposal. If your company does not have a clawback policy that goes beyond the basic SOX clawbacks, consider preparing such a policy based on the Proposal.
- Review all existing employment agreements to assess whether provisions have been made in the event a recoupment is warranted or whether amendments will need to be made to the agreements.
- Ensure all future contracts and plans for executive officers contain provisions for recoupment requirements.
- Review all incentive plans and outstanding awards to determine those subject to the clawback plan, with a focus on those related to stock price or TSR which will be subject to the "reasonable estimate" regime in the event of recoupment.



- If any executive officers are subject to foreign laws, research whether such jurisdictions currently prohibit recoupment.
- Review indemnity plans and insurance coverage to ensure the company is not protecting against the risk of recoupment.
- Review Committee charters to document the responsibility for drafting, implementing, and maintaining the clawback requirements.

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# Pearl Meyer

## **NEW YORK**

570 Lexington Avenue, 7th Floor  
New York, NY 10022  
(212) 644-2300  
newyork@pearlmeyer.com

## **ATLANTA**

One Alliance Center  
3500 Lenox Road, NE, Suite 1708  
Atlanta, GA 30326  
(770) 261-4080  
atlanta@pearlmeyer.com

## **BOSTON**

93 Worcester Street, Suite 100  
Wellesley, MA 02481  
(508) 460-9600  
boston@pearlmeyer.com

## **CHARLOTTE**

3326 Siskey Parkway, Suite 330  
Matthews, NC 28105  
(704) 844-6626  
charlotte@pearlmeyer.com

## **CHICAGO**

123 N. Wacker Drive, Suite 860  
Chicago, IL 60606  
(312) 242-3050  
chicago@pearlmeyer.com

## **HOUSTON**

Three Riverway, Suite 1575  
Houston, TX 77056  
(713) 568-2200  
houston@pearlmeyer.com

## **LONDON**

3rd Floor  
58 Grosvenor Street  
London W1K 3JA  
+44 (0)20 3384 6711  
london@pearlmeyer.com

## **LOS ANGELES**

550 S. Hope Street, Suite 1600  
Los Angeles, CA 90071  
(213) 438-6500  
losangeles@pearlmeyer.com

## **SAN FRANCISCO**

595 Market Street, Suite 1340  
San Francisco, CA 94105  
(415) 651-4560  
sanfrancisco@pearlmeyer.com