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Executive Compensation and Employee Benefits Group Client Alert: SEC Proposed Rules to Implement Clawback Provisions of the Dodd-Frank Act

The SEC has proposed new rules to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which relates to clawbacks of incentive compensation.

The proposed rules direct the exchanges to establish listing standards that require listed issuers to adopt and comply with written policies for the recovery of incentive-based compensation in connection with the restatement of financial information required to be reported under applicable securities laws and to disclose the issuer's recovery policies in accordance with the Commission's rules. The proposed rules would require listed issuers to file their written recovery policies as an exhibit to their annual reports and to also disclose any actions taken under such policies.

TIMING

We expect that the rules will likely become effective in the latter half of 2016. The proposed rules would require each exchange to file its proposed listing rules no more than 90 days following the publication of the final rule, and such rules must be effective no later than one year following such publication date. Each listed issuer must adopt its recovery policy no later than 60 days following the date on which the applicable exchange's rules become effective.

SCOPE OF PROPOSED RULES

The proposed rule would apply the requirements to nearly all listed issuers, including emerging growth companies, smaller reporting companies, foreign private issuers, and controlled companies. Limited exceptions would apply to the listing of security futures products, standardized options, and the securities of certain registered investment companies.

INDIVIDUALS SUBJECT TO PROPOSED RULES

The rules apply to any current or former executive officer of the issuer who received incentive-based compensation during the three completed fiscal years prior to the date the issuer is required to prepare an accounting restatement. Executive officers would include the issuer's president, principal financial officer, principal accounting officer (or controller), vice-presidents in charge of principal business units, divisions, or functions, and any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the issuer, including officers of parents or subsidiaries of the issuer if they perform such policy making functions for the issuer.

COMPENSATION SUBJECT TO PROPOSED RULES

Incentive-based compensation would include any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. This broad definition includes measures that are (i) determined and presented in accordance with accounting principles used in preparing the financial statements, (ii) derived from such financial information, or (iii) determined based on stock price and total shareholder return. This would encompass nearly all performance-based bonus programs or equity grants which have some objective, company-wide performance criteria (e.g., RSUs or stock options which vest upon the achievement of objective, company-wide performance criteria).

The recovery policies would require recovery only of the incentive-based compensation in excess of what would have been paid to the executive officer under the accounting restatement. Following an accounting restatement, an issuer must determine what the executive officer would have received had the accounts properly been stated and recover any amounts received by the executive officer in excess of the proper amounts. In circumstances where such a mathematical recalculation is impossible, the recoverable amount may be determined based upon a reasonable estimate of the effect of the restatement.

ACCOUNTING RESTATEMENTS TRIGGERING APPLICATION OF PROPOSED RULES

An accounting restatement includes any revision to previously issued financial statements to correct one or more errors that are, in the aggregate, material to those financial statements. Restatements do not include retroactive application of a change in accounting principles, retrospective revisions to reflect a change in the internal organization, retrospective reclassification due to a discontinued operation, retrospective application of a change in reporting entity, retrospective adjustment to provisional amounts in connection with a prior business combination, or retrospective revision for stock splits.

The issuer is required to prepare an accounting restatement on the earlier of (i) the date the board, a committee of the board, or officers authorized to take such action, conclude(s), or reasonably should have concluded, that the issuer's prior financial statements contain a material error and (ii) the date a court, regulator, or other legally authorized body directs the issuer to restate its previous financial statements to correct a material error.

HOW TO RECOVER

The proposed rules provide that the issuer must recover any excess compensation in compliance with its recovery policies, except to the extent that (i) recovery would be impracticable because the direct costs of recovery exceed the amount to be recovered or (ii) recovery would violate home country laws. Inconsistencies between compensation contracts and the proposed rules is not sufficient reason to find that recovery would be impracticable, as the proposed rules contemplate that contracts may be amended to accommodate recovery. The proposed rules do not directly address the precise means of recovery but allow discretion in determining the best way to affect a recovery.

DISCLOSURE

Issuers will be required to file their recovery policy as an exhibit to their Forms 10-K and will be required to disclose how they have applied their recovery policy. Any amounts recovered must also be reflected in the summary compensation table.

INDEMNIFICATION

Issuers are prohibited from indemnifying any executive officer or former executive officer against the loss of any excess incentive-based compensation. Executive officers may purchase insurance from a third-party protecting against such loss, but issuers are prohibited from paying the premiums on such an insurance policy.

PENALTY FOR FAILURE

Under the proposed rules, failure to adopt and comply with a compensation recovery policy would result in delisting. The exchanges have discretion to determine if an issuer is complying with its recovery policy and must take into account whether an issuer is making a good-faith effort to promptly pursue recovery.

PRACTICAL STEPS

Because inconsistency of the recovery policies with any existing compensation contract is not sufficient reason to withhold application of the recovery policy, issuers should review their clawback policies in connection with any future incentive compensation grants and should include a clause reserving the right to claw back compensation as

may be required by the Dodd-Frank Act or by any applicable listing standard. This will prevent any contract claim from executives upon application of any recovery policy. Further, as the rules become final and exchanges issue their listing rules, issuers should work with their advisors in developing a written recovery policy and implementing such policy upon any financial restatement.

**EXECUTIVE COMPENSATION
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