

Securities Regulation and Compliance Alert

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SEC Proposes Long-Awaited Mandatory Compensation Clawback Rules

On July 1, 2015, the U.S. Securities and Exchange Commission (SEC) issued long-awaited proposed rules that would implement the incentive-based compensation recovery (clawback) provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). As proposed, the rules would direct the stock exchanges to adopt listing standards requiring listed companies to develop and implement clawback policies and satisfy related disclosure obligations. The proposed clawback rules are based on the last remaining executive compensation provision in Dodd-Frank for which rules had not yet been proposed or finalized (following upon proposed rules with respect to pay ratio, pay-for-performance and hedging policies).

New Clawback Policy Requirements. All listed companies (including foreign private issuers, controlled companies, smaller reporting companies and emerging growth companies, but excluding certain registered investment companies) would be required to adopt a clawback policy providing for recovery of incentive-based compensation awarded to any current or former executive officer during the three-year period preceding the year in which the company is required to prepare an accounting restatement resulting from material noncompliance with financial reporting requirements. Noncompliance need not result from misconduct by an individual executive officer or under that individual's responsibility. Under the proposed rules, a company could be subject to delisting if it does not adopt a clawback policy that complies with the applicable listing standard, disclose the policy in accordance with SEC rules or comply with the policy's recovery provisions.

Recovery of Incentive-Based Compensation. The proposed rules would require that clawback policies provide for recovery of incentive compensation that is granted, earned or vested based wholly or in part on the attainment of any financial reporting measure, including accounting-related metrics as well as stock price and total shareholder return metrics. Awards based solely on continued employment would not need to be subject to clawback under the policy. The amount of compensation subject to recovery would be the excess of:

- such incentive-based compensation actually paid during the fiscal period when the applicable financial reporting measure is attained, over
- what would have been paid had the financial statements been correct in the first instance.

To calculate the latter, companies would be allowed to use (and, if so, be required to disclose) a reasonable estimate of the restatement's impact on the stock price or total shareholder return.

Exceptions to Recovery. The new listing standards would provide for two narrow exceptions to recovery, where the compensation committee determines that (i) pursuing such recovery would be impracticable because the direct expense of seeking recovery would exceed the recoverable amounts, or (ii) in the case of a foreign private issuer, pursuing such recovery would violate applicable home country laws.

Restrictions on Indemnification and Insurance. Listed companies would be prohibited from indemnifying or reimbursing any current or former executive officer against the loss of erroneously awarded compensation. Companies also would be prohibited from paying the premiums on an insurance policy that would cover an executive's potential clawback obligations.

New Disclosure Requirements. The proposed rules include new disclosure requirements on how the clawback policy is implemented, including a requirement to describe:

- recovery of excess incentive-based compensation due to a restatement during the last completed fiscal year;
- any outstanding balance of excess incentive-based compensation from a prior restatement; and
- any instances during the last completed fiscal year where recoverable compensation was not repaid within 180 days or the company did not pursue recoverable compensation.

Such disclosure would be required as a new component of the executive compensation disclosure provisions in Item 402 of Regulation S-K.

XBRL. The new disclosure would have to be tagged in interactive block text tag format using eXtensible Business Reporting Language (XBRL). Similar to the SEC's proposed pay-for-performance rules, if adopted, this would be the second requirement of XBRL tagging outside the financial statements.

New Exhibit Filing. The proposed rules would require the clawback policy to be filed as an exhibit to the annual report on Form 10-K or 20-F.

Effect on Existing Clawback Rules. CEOs and chief financial officers remain subject to the clawback provisions of the Sarbanes-Oxley Act of 2002 (SOX). Those provisions provide that if a company is required to prepare an accounting restatement because of "misconduct," the CEO and CFO are required to reimburse the company for any incentive or equity-based compensation and profits from selling company securities received during the year following issuance of the inaccurate financial statements. As proposed, to the extent that the clawback policy and SOX cover the same recoverable compensation, the CEO or CFO would be subject to reimbursement once. However, calculation under either scenario could result in a larger amount to be repaid by that individual.

When the Proposed Rules Take Effect. Companies would not be subject to the requirements of the proposed rules until the stock exchanges propose and adopt their new listing standards, which will occur only after the SEC adopts final rules. Based on this requirement, it is unlikely that the new clawback listing standards will be in effect before late 2016. Once the new listing standards are in effect, a listed company will be required to comply with the disclosure requirements in its first annual report or proxy or information statement, as well as meet the applicable standards within 60 days in order for its shares to continue trading on that exchange. A listed company would be required to recover all excess incentive-based compensation that is granted, earned or vested on or after the effective date of the adopted SEC rule that results from attaining a financial reporting measure based on financial information for any fiscal period ending on or after that effective date.

What Companies Should Do Now. Listed companies that would be subject to the new requirements should consider the following actions:

- Review existing clawback policies to consider what changes likely will be required;
- Consider which aspects of their compensation plan design should be reviewed and possibly changed in light of the clawback mandate;
- Review their executive officer determinations in light of the new significance of this designation; and
- Consider submitting a comment letter to the SEC to influence the final design of these crucial rules.

Please call us to discuss any of these action items.

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Comments on the proposed rules are due 60 days after their publication in the Federal Register and may be submitted on the SEC's website. A copy of the proposed rules can be found [here](#). For additional information on the proposed rules, see the [press release](#) issued by the SEC.