



sec proposes rules to broaden executive compensation "clawback" policies required by dodd-frank

MSK Client Alert

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In an effort to increase executive accountability and promote higher quality financial reporting, the Securities and Exchange Commission (the "SEC") issued proposed Rule 10D-1 for comment on July 1, 2015. The SEC issued the proposed rule to implement the provisions of Section 954 of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which 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 associations to prohibit the listing of securities of an issuer that is not in compliance with the requirements of Section 10D(b). Section 10D(b) requires each listed issuer to develop, implement and disclose an executive compensation clawback policy providing for recovery of excess incentive-based compensation received by a current or former executive officer based on erroneous financial information that resulted in an accounting restatement by the issuer during the three year period preceding the date on which the issuer was required to prepare the accounting restatement.

The concept of clawing back executive compensation is not new and while the adoption of a policy has not previously been required, some public companies have chosen to adopt such policies primarily in response to the clawback provision of The Sarbanes-Oxley Act of 2002 ("SOX") or in an effort to deter wrongdoing or misconduct. Section 304 of SOX requires that in the event of a financial restatement due to material noncompliance with any financial reporting requirement under the securities laws as a result of misconduct, the Chief Executive Officer and the Chief Financial Officer must reimburse the issuer for all incentive-based compensation paid to such officers during the 12 month period following the earlier of the date on which the financial statements requiring restatement were first made publicly available or were filed with the SEC. In addition, the issuer can recover from the officer subject to a clawback policy any gains realized from the sale of issuer securities during that 12 month period.

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Proposed Rule 10D-1 differs from the incentive-based compensation recovery required by SOX in several ways, including the following:

- The policy for recovery of incentive-based compensation required by Rule 10D-1 will be triggered by any accounting restatement of an issuer listed on any national securities exchange or association that results from material noncompliance with reporting requirements under securities laws, without regard to fault or misconduct. Section 304 of SOX is triggered by an accounting restatement due to the material noncompliance of the issuer as a result of misconduct. SOX defines an "issuer" as an issuer the securities of which are registered under Section 12 of the Exchange Act or that is required to file reports under Section 15 (d) or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933.
- Rule 10D-1 requires that all current and former "executive officers" of the issuer during the three-year period preceding the date the issuer is required to prepare the accounting restatement be subject to the terms of the clawback policy. Section 304 of SOX applies only to the CEO and CFO and only if the accounting restatement results from misconduct.
- While Section 304 of SOX requires recovery of *all* incentive-based compensation, Rule 10D-1 only requires reimbursement of the amounts overpaid after taking the restatement into account.
- Listed issuers will be required to recover incentive-based compensation, although they will have some discretion not to pursue recovery to the extent that the direct expense paid to a third party to assist in enforcing the policy would likely exceed the amount to be recovered or, for foreign private issuers, where recovery would violate home country laws. Section 304 of SOX is enforceable only by the SEC and requires the CEO and the CFO to reimburse the issuer for incentive-based compensation. Private plaintiffs, such as the issuer or a stockholder, do not have standing to recover the incentive-based compensation.

In addition, Rule 10D-1 would require each listed issuer to file its compensation recovery policy as an exhibit to its Annual Report on Form 10-K. In the event of an accounting restatement, listed issuers would also be required to provide, in their Form 10-Ks and proxy and information statements, information regarding any compensation recovery efforts undertaken during the last completed fiscal year, including (1) the aggregate amount of excess incentive-based compensation attributable to the accounting restatement and the aggregate amount of excess incentive-based compensation that remains outstanding at the end of the issuer's last completed fiscal year, including any estimates used for valuing the excess amount, if the financial reporting measure is related to a stock price or total shareholder return metric; (2) the name of each current or former officer subject to recovery but from whom the listed issuer decided during the last completed fiscal year not to pursue recovery, the amount forgone for each such person, and a brief description of the reason in each case the decision was made not to pursue recovery; and (3) the name of each current or former executive officer with excess compensation due to the issuer and outstanding for more than 180 days as of the end of the most recent fiscal year.

State Wage and Labor Law Implications

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In preparation for compliance with the proposed rules and adopting clawback policies, listed issuers will have to ensure their policies are consistent with the wage and labor laws of the states in which they operate, to the extent that any form of compensation recoverable in accordance with such policies is deemed to be "wages". Rule 10D-1 does not specify a method for recovery of wages and the laws surrounding recovery of wages vary from state to state, in some cases allowing recoupment only if specified conditions are satisfied. For example, in the State of California, the recovery of amounts deemed to be wages might be permitted if there is a written agreement in effect pursuant to which the employee consents to such recovery, the total amount recovered does not exceed the total amount originally agreed upon, there is no balloon payment at the time of termination, and the recovery does not reduce total amounts paid below minimum wage. In comparison, New York will allow recovery of wages resulting from inadvertent overpayments and advances without consent from the employee; provided that the employer provides sufficient notice to the employee before making the deduction(s) and specifies a procedure by which the employee may contest the recovery. It remains an open question how the mandatory no fault provisions of Rule 10D-1 requiring recovery of excess compensation may be implemented or otherwise addressed by the courts in states with more restrictive recovery regulations.

Tax and Accounting Implications

The tax and accounting implications applicable to adopted clawback policies must also be very closely examined. Employee compensation is subject to income tax and various payroll taxes. In addition, employers are generally entitled to a deduction for compensation paid. While an employee subject to a compensation clawback policy may be able to recover taxes paid, such recovery may be limited or vary depending on the form of compensation as well as when such compensation was originally paid. In addition, employers who have taken a deduction for compensation paid in prior years may have to recognize income upon repayment and/or adjust their prior years' tax returns to reflect the return of such compensation. Listed issuers required to adopt a clawback policy and the executive officers who are subject to such policies should consult with their tax counsel, accountants and auditors for a clear understanding of the tax and accounting implications resulting from the adoption and implementation of an incentive-based compensation recovery policy.