SEYFARTH SHAW

Management Alert

Dodd-Frank and Executive Compensation — Where Are We Now?

By M. John Burgess, Jake R. Downing, Michael T. Dunn, Jennifer Neilsson and Kelly R. Rourke

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") became federal law on July 21, 2010 to provide safeguards for consumers and increase transparency in the U.S. capital markets in response to public outcry over a lack of oversight in these areas that came to light during the financial crisis that began in 2007. Certain provisions of Dodd-Frank require enhanced disclosure of executive compensation by public companies, and the act further requires exchange listed companies to adopt policies to recoup executive compensation in certain circumstances.

While Dodd-Frank provided a framework for these new executive compensation policies and disclosures, the Securities and Exchange Commission (the "SEC") was tasked with the job of adopting definitive rules and regulations to implement them. Recently, the SEC has adopted final rules requiring pay ratio disclosures, as well as proposing rules mandating "clawbacks" of incentive compensation from executives at exchange listed companies in the event of a restatement in certain circumstances. The purpose of this Client Alert is to provide a summary of these final and proposed rules and the steps that companies should consider taking to prepare to comply with the new rules.

Additionally, because Dodd-Frank was enacted more than five years ago and implementation has been slow, we include a summary of the Dodd-Frank provisions relating to executive compensation and their current status in the Appendix to this Client Alert.

Clawback Rules

Section 954 of Dodd-Frank added a new Section 10D to the Securities Exchange Act of 1934 (the "Exchange Act"), to require clawbacks of executive incentive compensation in circumstances to be established by the SEC. On July 1, 2015, the SEC proposed the executive compensation clawback rules under proposed Rule 10D-1, which would require national securities exchanges such as the NYSE and NASDAQ to adopt listing standards requiring each listed company to develop a compensation recovery policy related to the clawback of incentive-based compensation of executive officers when the company's financial statements are found to have material errors. The proposed rule is summarized below.

Who is required to establish a Recovery Policy?

Exchanges must apply the rules to all listed companies, with limited exceptions such as security futures products, standardized options and securities of certain investment companies. In deciding not to exempt emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies from the proposed rules, the SEC noted that the objective of recovering excess incentive-based compensation is as relevant for these categories of listed companies as any other.

©2015 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.

What is required in a Recovery Policy?

The proposed rules mandate that exchanges adopt listing standards to require a listed company to adopt and implement a written recovery policy regarding the recovery of incentive-based compensation of executive officers who served during the performance period related to the material errors. Under the proposed rules, companies may not indemnify any executive officer or former executive officer against the loss.

Executive officer. The proposed rules include a definition of "executive officer" that is modeled on the definition of "officer" under Section 16 of the Exchange Act, and would include a company's president, principal executive, financial and accounting officers, controller, vice-presidents in charge of a principal business unit, division or function, and other officers performing policy-making functions for the company. Notably, this would not be limited to the named executive officers for whom compensation disclosures are required under Item 402 of Regulation S-K in a company's annual report or proxy, but would apply to all executive officers.

Material Error in Financial Statements. The recovery policy is triggered when a registrant is required to restate its financial statements to correct an error that is material. Materiality under the proposed rules would be assessed using the same materiality standards under the Exchange Act for other purposes, which generally require an assessment of the likelihood that the error would be viewed by a reasonable investor as having significantly altered the total mix of information available. The proposed rules provide that restatements made for the following reasons will not trigger the application of the recovery policy:

- a change in accounting rules;
- revisions to reportable segment information due to a change in the structure of the registrant's internal organization;
- reclassification due to a discontinued operation;
- change in reporting entity;
- adjustment to provisional amounts in connection with a prior business combination; and
- revisions for stock splits.

Recovery of Compensation. The recovery includes compensation the executive officer would not have received had the financial statements been prepared properly. Specifically, under the proposed rules, recovery includes any excess compensation granted, earned or vested "based wholly or in part upon the attainment of any financial reporting measure" during the three fiscal years preceding the date the registrant is required to prepare a revised financial statement. This date would be the date the board of directors or authorized officer concludes, or reasonably should have concluded, that the previously issued financial statements contain a material error, or the date a court, regulator or other authorized body directs the registrant to restate its financial statements. The excess is calculated based on the revised financial reporting measure. The proposed rules provide guidance on how to determine excess for incentive-based compensation based on something other than a financial reporting measure, including making a "reasonable estimate" of the amount to be recovered. The SEC recognizes that there may be different levels of complexity in making estimations and would require documentation of how the estimate was determined to be provided to the applicable exchange.

Exceptions to Recovery. Generally, a registrant would not be required to clawback compensation when (a) the costs of recovery exceed the amount of incentive-based compensation to be recovered, or (b) a foreign corporation's home country prohibits recovery.

Where is the Recovery Policy disclosed?

The proposed rules will require a company listed on an Exchange to file its recovery policy as an exhibit to its annual report on Form 10-K or Form 20-F. The proposed rules would create a new paragraph (w) of Item 402 of Regulation S-K and a new Item 6.F of Form 20-F that will require additional disclosure if (a) revised financial statements trigger recovery pursuant to a recovery policy or (b) there is an outstanding balance of excess incentive-based compensation from a previously triggered

©2015 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.

recovery policy. In such cases, the company must disclose how it applied the recovery policy in its annual report or proxy statement, as applicable.

How is the rule enforced?

The proposed rules provide that a company may be de-listed from an Exchange if it does not adopt and comply with its recovery policy and/or adhere to the disclosure requirement. The proposed rules do not specify the time by which a company must recover excess compensation under its recovery policy, but the SEC expressly sought comments in the proposing release for the rules as to whether a maximum recovery period should be established. As proposed, the rules note that recover should be "reasonably prompt," and the exchanges will have authority to determine whether a registrant is making a good faith effort to "promptly pursue recovery" when applicable. The challenge for exchanges will be to provide guidance to listed companies as to what may constitute prompt recovery efforts. Moreover, listed companies will need to assess whether it will be necessary to withhold or defer all or a portion of incentive-based compensation to ensure immediate recovery in the event of a restatement.

When would the new rule take effect?

After final rules become effective, exchanges will have 90 days to submit proposed listing standards requiring recovery policies, and such listing standards must become effective no later than one year after they are approved by the SEC. An issuer on a given exchange would then be required to establish and adopt a recovery policy within 60 days of the effective date of the exchange listing standards. Notwithstanding the potential for delayed adoption and implementation of listing standards by exchanges up to one year after the SEC adopts final rules, the proposed rules state that a listed company with a Recover Policy must recover any amount required under its policy for any fiscal period ending on or after the effective date of the SEC final rules, regardless of when exchange listing standards become effective.

A company must include the applicable disclosure of its recovery policy in its SEC filings on or after the date the exchange listing standards becomes effective, or at the latest, one year after the SEC final rule is published.

How do the proposed rules differ from the existing statutory clawback under Sarbanes-Oxley?

Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX") established a 12-month clawback of bonuses and incentive-based compensation from a chief executive officer ("CEO") and chief financial officer ("CFO") in the event of an accounting restatement due to material noncompliance with SEC reporting rules resulting from misconduct. The proposed rules significantly expand the SOX clawback provisions by:

- expanding the class of covered persons from the CEO and CFO to all executive officers;
- increasing the clawback period from 12 months to three years; and
- eliminating misconduct as a prerequisite to the application of a clawback.

Pay Ratio Rules

On August 5, 2015, the SEC adopted final pay ratio rules, which are designed to provide investors with information regarding the compensation of a company's CEO as compared to the median compensation of that company's employees. The pay ratio rules satisfy the SEC's mandate to provide regulations with respect to Section 953(b) of Dodd-Frank by adding new paragraph (u) to Item 402 of Regulations S-K. The final rule is similar to the proposed rule with certain important modifications. The final rules are summarized below.

Who is required to make the pay ratio disclosure?

The pay ratio disclosure must be made by all SEC registrants with the exception of smaller reporting companies, foreign private issuers, U.S.-Canadian Multijurisdictional Disclosure System filers and emerging growth companies.

©2015 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.

What is the "pay ratio" rule/disclosure?

The pay ratio rule requires covered registrants to disclose the median of the annual total compensation of all employees of a registrant, excluding the CEO, the annual total compensation of that registrant's CEO, and ratio of the median of the annual total compensation of all employees to the annual total compensation of the CEO.

Definition of Employee. Generally, for purposes of the rule, an employee includes all employees of the registrant's consolidated subsidiaries, whether part-time, full-time, seasonal, temporary, U.S. or non-U.S.[1] (Note, the proposed rules required the inclusion of all of the registrant's subsidiaries, not just the consolidated subsidiaries.) Unlike the proposed rule which provided that employees were counted as of the last day of the last completed fiscal year, the registrant may choose any date within three months prior to the last day of the last completed fiscal year. Registrants must disclose the date chosen for counting employees, as well as any changes to this date in future years along with an explanation about the reasons for the change.

Non-U.S. Employees. As describe above, non-U.S. employees are included as employees. The final rule provides two exemptions to this requirement.

- **Data Privacy.** The final rule provides an exemption for circumstances where foreign data privacy laws make registrants unable to comply. In such cases, the registrant must (a) use reasonable efforts to seek relief under the applicable data privacy law and (b) receive an opinion from counsel that it cannot comply. If a registrant excludes any non-U.S. employees in a particular jurisdiction under this exemption, it must exclude all the employees in that jurisdiction, identify the data privacy law, explain how compliance with the rule violates the data privacy law and provide the approximate number of employees exempted.
- **De Minimis.** The final rule also provides a de minimis exemption for non-U.S. employees. If a registrant's non-U.S. employees are less than 5% of its total employees, it may exclude all of those employees from the pay ratio calculation. If the registrant excludes any non-U.S. employees under this exemption, it must exclude all non-U.S. employees. If, however, the registrant's non-U.S. employees exceed 5% of its total employees, it may exclude up to 5% of foreign employees. The data privacy exemption counts toward this limit. Also, if the registrant excludes any non-U.S. employees in a particular jurisdiction, it must exclude all employees in that jurisdiction.

Total Annual Compensation. The final rules require total compensation to be defined with respect to existing rules under Item 402(c)(2)(x) of Regulation S-K. For calculating the compensation of employees other than the CEO, a registrant may use total compensation or any other compensation measure that is consistently applied to all employees included in the calculation. This information might be gathered from the registrant's tax or payroll records. Additionally, the final rule, a change from the proposed rules, allows registrants to make cost-of-living adjustments to compensation in jurisdictions other than where the registrant's CEO resides. Any cost-of-living adjustments must be disclosed. When calculating the total annual compensation of all employees, however, a company is not allowed to make any adjustment or to annualize for part-time or seasonal workers.

Median Calculation. In determining the employees from whom the median employee is identified (an actual employee), a registrant may use its employee population or statistical sample, reasonable estimates, and/or other reasonable methods. Unlike the proposed rule, which required registrants to identify the median employee every year, the final rule allows registrants to identify the median employee every three years unless there has been a change in the employee population or employee compensation arrangements that would significantly change the pay ratio disclosure. If during that three year period it is no longer appropriate to use the median employee identified, a similar positioned employee can be used for purposes of the disclosure.

Narrative Disclosure. The registrant is required to describe the methodology used to identify the median employee and any material assumptions. See above for some of the items that require specific disclosure.

---

[1] Currently, practitioners are debating as to whether independent contractors and/or leased employees should be included as employees.

©2015 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.

Where is pay ratio information disclosed?

A covered registrant must include pay ratio disclosure in registration statements, proxy and information statements and annual reports that require Item 402 executive compensation disclosure.

When does the new rule take effect?

A covered registrant is required to include pay ratio disclosure beginning in its first full fiscal year commencing on or after January 1, 2017. For example, the reporting period for a company with a fiscal year that ends on December 31 will begin on January 1, 2017. Generally, this means that pay ratio disclosure will first be included in 2018 proxy statements.

If you have any questions, please contact your Seyfarth attorney, John Burgess at *jburgess@seyfarth.com*, Jake Downing at *jdowning@seyfarth.com*, Michael Dunn at *mdunn@seyfarth.com*, Jennifer Neilsson at *jneilsson@seyfarth.com*, or Kelly Rourke at *krourke@seyfarth.com*.

Appendix

The table below summarizes the status of the SEC's rulemaking with respect to each executive compensation-related Dodd-Frank provision.

Dodd-Frank Section	Purpose	Status	Link to Seyfarth Alerts
951	Shareholder approval of executive compensation	Finalized 1/25/2011	SEC Adopts Final Rules on Shareholder Advisory Votes
952	Compensation committee independence	Finalized 6/20/2012	SEC Adopts Final Rules on Listing Standards and Disclosure Requirements
953(a)	Pay v. performance disclosure	Proposed 4/29/2015	
953(b)	Pay ratio disclosure	Finalized 8/5/215	See above for summary of Final Rules
954	Executive compensation claw backs	Proposed 7/1/2015	See above for summary of Proposed Rules
955	Disclosure of employee and director hedging	Proposed	SEC Proposes Rules Requiring Disclosure of Hedging by Employees, Officers and Directors
972	Chairman/CEO pay structure disclosure in proxy	Finalized 6/20/2012	

Attorney Advertising. This Management Alert is a periodical publication of Seyfarth Shaw LLP and should not be construed as legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have. Any tax information or written tax advice contained herein (including any attachments) is not intended to be and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. (The foregoing legend has been affixed pursuant to U.S. Treasury Regulations governing tax practice.)

©2015 Seyfarth Shaw LLP. All rights reserved. "Seyfarth Shaw" refers to Seyfarth Shaw LLP (an Illinois limited liability partnership). Prior results do not guarantee a similar outcome.