



▶ The Big Payback?

Part One

What the Dodd-Frank proposed clawback rules mean for your company now.

In this two-part series, we examine the impact that recent rulemaking under the 2010 Dodd-Frank legislation (Dodd-Frank) will have on public companies and their boards. As legislation that heralded the most significant changes to financial regulation in the US since those following the Great Depression of 1929, it is imperative that boards steering companies listed in the US understand the ramifications on how they manage their executive reward.

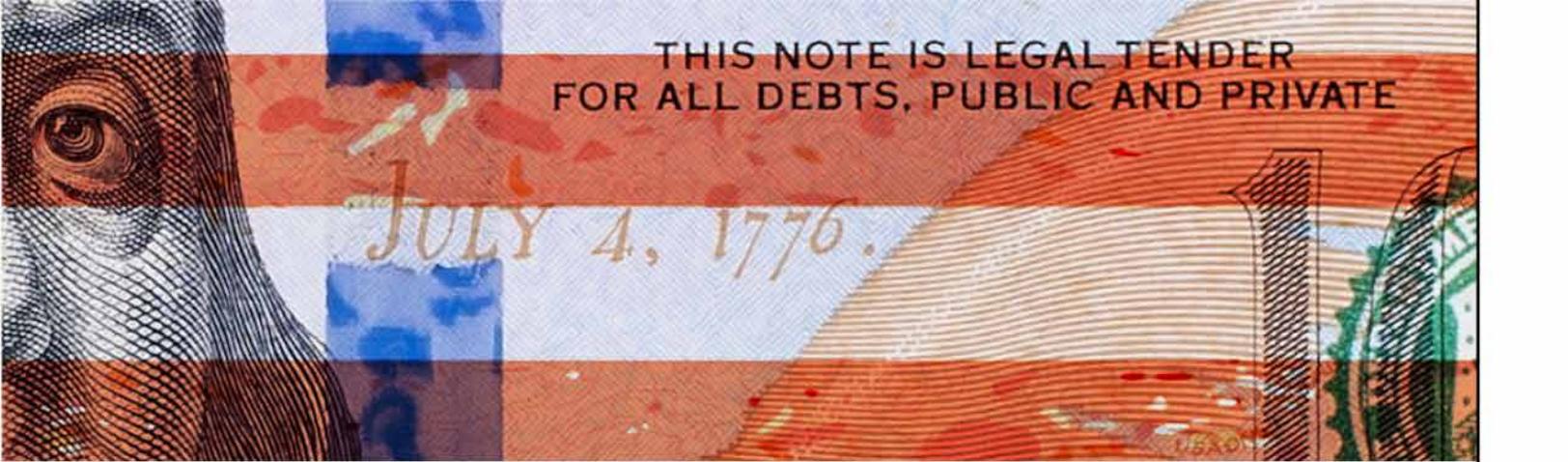
In this first article, we focus on the impact of clawback policies and what actions you should consider this year; and in part two we will address the effects of the rules on determining and disclosing the CEO pay ratio.

“Clawbacks”

The recovery of erroneously awarded compensation

Currently the SEC is proposing new rules that will mandate US securities exchanges to require that their listed companies develop policies for recovering any erroneously awarded incentive-based compensation received during the three-year look-back period preceding any year in which the company is required to prepare an accounting restatement to correct a material error. Mandated recoveries would apply to any current or former executive officer during a look-back period, regardless of whether the individual had engaged in misconduct or was responsible for an accounting error causing the restatement. Certain disclosures related to any clawback also would be required.

The term “executive officer” in the proposed rule applies to the company’s president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division or function, and any other employee who performs a similar policy-making function.



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What situations will clawback policies apply to?

Answer: Under the proposed rules, clawback policies would apply to any incentive-based compensation received by an executive officer that is granted, earned or vested based on the attainment of any “financial reporting measure” (any measure based on the accounting principles used in preparing the financial statements, as well as stock price and total shareholder return).

Notably, stock options and other equity awards that vest exclusively due to continued employment, as well as bonus awards that are discretionary based on subjective goals or goals unrelated to financial reporting measures, do not have to be covered by the clawback policy.

How much compensation is subject to recovery?

Answer: This amount equals the extra incentive-based compensation received that exceeds the amount that would have been received had the compensation been determined based on the accounting restatement. Where compensation is based on stock price goals or total shareholder return, the recoverable amount may be determined using a reasonable, documented estimate of the effect of the accounting restatement on the financial reporting measure.

What are the exceptions to recovery? Are there restrictions on indemnification and insurance?

Answer: Only two limited exceptions are proposed, stating that recovery is not required if the compensation committee determines that (i) pursuing such recovery would be impractical 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. To use the “impractical” exception, a reasonable attempt at clawback is required, while for a foreign private issuer, home country legal counsel is needed.

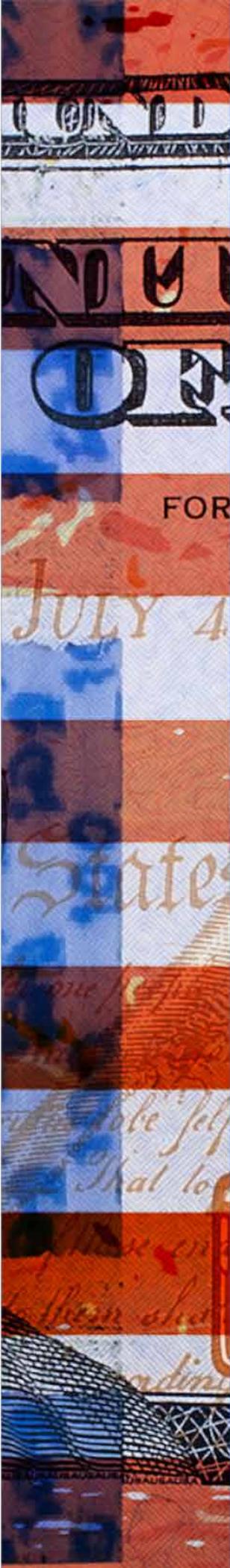
The proposed rules prohibit companies from indemnifying or reimbursing an executive officer against the loss of erroneously awarded compensation and from paying the premiums on an insurance policy covering an executive’s potential clawback obligations.

What are the new disclosure requirements?

Answer: The proposed rule would require that the reporting company file its clawback policy as an exhibit to its annual report on Form 10-K or 20-F. In addition, certain disclosures may be required in its annual proxy statement.

When must companies comply?

Answer: Once the SEC publishes final rules, each exchange will have 90 days to file proposed listing standards that must become effective within one year following the rule publication date. Companies must adopt a compliant recovery policy no later than 60 days following the effective date of the applicable listing standards and to recover excess incentive-based compensation received on or after the date on which the final rules are published.



How should boards respond?

While it is uncertain when any clawback rules will be adopted by the SEC, public companies will need to modify or replace existing policies when they are. If there is no clawback policy, one then must be established. To ease the transition, we suggest the following steps:

- **Compare any existing clawback policy to the proposals and identify what changes would be needed. A simple chart that lists each key point, notes whether and how the current policy addresses that issue, considers whether and how the point is handled under the proposed SEC rules, and examines any other implications for the company can be useful. A company without an existing clawback policy should consider how the required policy will impact its executive pay arrangements.**
- **Since the clawback proposals apply to a company's executive officers (including former ones), this group should be identified; this can be particularly useful if compensation exempt from clawback is to be provided to executive officers. Update this list at least annually.**
- **Review existing contractual entitlements: they won't be exempt from the new rules.**

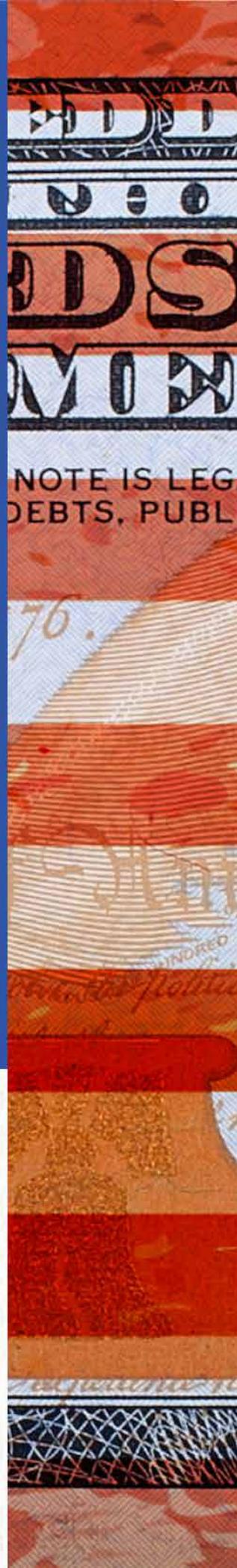
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- **Examine current performance measures to determine whether and how they would be impacted by a clawback.** The complications attendant to the clawback of compensation based on total shareholder return may affect the use of that measure in incentive award design.
- **Consider altering the compensation mix—some types of compensation are not subject to clawback.** For example, awards vesting solely on service are excluded from required clawbacks, so consider using service-vested restricted stock units.
- **Consider whether clawback policies might adversely affect the accounting treatment of any compensation program.**
- **Overall, while the clawback proposals may be revised in any final rulemaking, now is the time to consider the reach of the proposed rules when reviewing or designing incentive pay programs.**

NEXT we will look at what the Dodd-Frank pay ratio means for your company now.

NEXT ARTICLE



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FEDERAL RESERVE NOTE
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