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The Dodd-Frank Wall Street Reform and Consumer Protection Act (“**Dodd-Frank**”) contains numerous corporate governance provisions with important implications for publicly-traded companies. One such significant provision is Section 954, which compels companies to “clawback” erroneously paid executive compensation after restating financial statements.

The language of the provision is sparse and awaits rulemaking by the Securities and Exchange Commission (“**SEC**”), the securities exchanges, and NASDAQ. The SEC predicts that it will propose rules during December 2011, and adopt the rules during January-June 2012, after which the corresponding exchange/NASDAQ rules will be enacted.¹ The timing suggests that the exchange rules will not be in place until after the 2012 proxy season. In the meantime, companies should familiarize themselves with the clawback provision and begin preparing for the impending adoption of the rules.

This alert provides an overview of the Dodd-Frank clawback, compares it to the existing Sarbanes-Oxley Act of 2002 (“**SOX**”) clawback, lists currently open questions raised by the new law, and suggests steps public companies should consider to comply with the requirements.

Dodd-Frank Clawback

Section 954 instructs the SEC to adopt rules requiring every listed public company to:

- disclose its policies on incentive-based compensation; and
- develop and implement a policy that, in the event the company is required to restate its financials for material noncompliance, the company will recoup from current or former executive officers any incentive-based compensation, including stock option awards, that has been (i) received within a 3-year period preceding the required restatement; (ii) is based on erroneous data; and (iii) is in excess of what otherwise would have been paid.

Section 954 also requires the SEC to direct exchanges and NASDAQ to delist companies that have not developed and implemented policies that adhere to these standards.

Comparison with SOX Clawback, Section 304

As the table below demonstrates, Dodd-Frank substantially broadens the existing SOX clawback system by (i) removing the “misconduct” requirement as a trigger for the clawback; (ii) increasing the look-back period to 3 years; and (iii) expanding the parties subject to the clawback beyond the CEO and CFO. However, Dodd-Frank does not apply to *all* compensation paid within the relevant period, only “erroneous” and “excess” compensation.

	SOX	Dodd-Frank
Trigger	Company is required to prepare an accounting restatement due to material noncompliance, as a <i>result of misconduct</i> , with any financial reporting requirement under the securities laws	Company is required to prepare an accounting restatement due to the material noncompliance with any financial reporting requirement under the securities laws
Parties subject to clawback	CEO and CFO	All current and former executive officers (to be defined)
Amount	Any bonus or other incentive-based or equity-based compensation; profits realized from the sale of securities	Incentive-based compensation, including stock option awards, that was based on erroneous data and in excess of what would have been paid under the restated financials
Time period	Applies to compensation received during the 12-month period following the first public issuance or filing of the misstated financials	Applies to compensation received during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement
Enforcement	CEO and CFO to reimburse the company; SEC may bring an enforcement action if there is a violation	Company is required to develop and implement the clawback policy; exchanges and NASDAQ required to delist a non-compliant company

Significantly, Dodd-Frank provides for a stricter enforcement mechanism than SOX. Under SOX, companies are not responsible for recouping compensation, the CEO or CFO must voluntarily reimburse the company. If the CEO or CFO does not comply, the SEC may take action against the executive, but it has done so only rarely. In fact, the SEC waited five years after the adoption of SOX to bring the first clawback action.² In addition, the SEC has focused mostly on executives involved in the misconduct that led to the restatement. Recently, however, the SEC has taken a more aggressive stance and brought an action against a CEO who was not involved in such misconduct.³ Nevertheless, SEC enforcement has been infrequent. Under Dodd-Frank, on the other hand, companies are required to police their executives and the exchanges are tasked with applying the harsh penalties, up to and including delisting.

Open Issues

While the rules are pending, commentators have tried to make predictions on how the Dodd-Frank clawback will develop. The language of the statute raises numerous questions, most of which will likely be addressed by the SEC rulemaking.

- **Definition of “executive officers.”** Dodd-Frank requires the company to recoup compensation from current or former executive officers. It is unclear which employees this will cover, but it will likely include more individuals than SOX’s CEO and CFO formulation. One possibility is that the SEC will use the definition in Rule 3b-7 of the Securities Exchange Act of 1934 (“**Exchange Act**”), which includes:
 - the president
 - vice presidents (division or function); and
 - others who perform similar policy-making functions and executives of subsidiaries who also perform policy-making functions.

Another possibility is that the definition will include the persons covered by Item 402 of Regulation S-K, that is, the “named executive officers” (the principal executive officer (PEO), principal financial officer (PFO), and the company’s three most highly compensated executive officers other than the POE and PFO).

However, the SEC may draw from other sources, or develop a new definition entirely.

- **What constitutes “material noncompliance”?** Generally, a public company must restate its financial statements if they do not comply with GAAP or violate federal securities laws.⁴ Under SOX, material noncompliance with these laws is limited to noncompliance as a result of misconduct. Under Dodd-Frank, it remains to be seen what statements the SEC will view as materially noncompliant, but the type of restatements that would trigger clawback has certainly expanded.
- **Calculation of erroneous and excess compensation.** Unlike SOX, Dodd-Frank limits the clawback to “erroneous” and “excess” compensation. For now, it is unclear how the applicable compensation is to be calculated, especially in the context of compensation based on non-financial, subjective data.
- **Is there room for company discretion?** The Dodd-Frank requirement to recoup erroneous and excess compensation is mandatory, thus there is no room on the face of the statute for the company to exercise its discretion. For instance, it may have to clawback even *de minimus* amounts, where costs would outweigh the benefits, unless the SEC provides otherwise.
- **Is the law retroactive?** It remains to be seen whether companies will have to adjust already existing policies and contracts.

Next Steps

In anticipation of the SEC and exchange/NASDAQ rules, publicly-traded companies should consider taking the following steps:

- Carefully monitor SEC rulemaking and exchange/NASDAQ responses.
- Review existing clawback policy. If no such policy exists, begin devising a

policy that complies with Dodd-Frank (as presently understood) and SOX.

- Include anticipatory provisions in new plans, such as “subject to any rule promulgated under Section 954 of the Dodd-Frank Act.”
- Identify any contractual obstacles to clawback in executive employment and separation agreements.
- Assess the process by which incentive-based compensation is determined and what factors are included in the calculation. The less straightforward the policy, the more difficult it will be to comply with the clawback requirements.

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¹ Securities and Exchange Commission, Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act — Upcoming Activity, *available at* <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml>

² See *SEC v. Mercury Interactive, LLC*, Case No. 07-2822 (RS) (N.D. Cal., filed May 31, 2007), *available at* <http://www.sec.gov/litigation/complaints/2007/comp20136.pdf>

³ See *SEC v. Jenkins*, 718 F.Supp.2d 1070 (D. Ariz 2010).

⁴ Regulation S-X provides that financial statements filed with the SEC that are not prepared in accordance with GAAP are presumed inaccurate and misleading. 17 C.F.R. §210.4-01(a)(1); Sections 17(a), 10(b), 13(a)-(b) of the Exchange Act and accompanying rules set out reporting requirements.

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