

# KIRKLAND ALERT

July 2015

## SEC Issues Proposed Compensation Clawback Rules

### *Overview*

On July 1, 2015, the Securities and Exchange Commission released its highly anticipated rules regarding compensation clawback policies and disclosures (the “Proposed Rules”) as required pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Proposed Rules would, once finalized, prohibit national securities exchanges from listing securities of an issuer that does not satisfy the clawback requirements under the Proposed Rules.

To ensure that their securities remain listed on national securities exchanges, issuers will need to adopt clawback policies that satisfy certain requirements set forth in the Proposed Rules, as described below. Notably, the Proposed Rules do not limit the reach of the clawback policies to financial restatements attributable to intentional inaccuracies or to executive officers who were actually involved in the preparation of the financial statements. Rather, the Proposed Rules impose a strict liability requirement pursuant to which the clawback policies must apply to all financial restatements correcting material errors on which “incentive-based” compensation was based, regardless of whether those errors were inadvertent, and to all executive officers, regardless of whether they had any involvement in preparing the financial statements.

### *Designing Clawback Policies to Comply with the Proposed Rules*

Compliant clawback policies must require issuers who restate their financial statements to recover incentive-based compensation from individuals who served as executive officers at any time during the relevant performance period, to the extent that the incentive-based compensation received by the executive officer exceeds the amount the executive officer would have received if the incentive-based compensation had been calculated based on the restated financial statements. The amount that must be clawed back is determined on a pre-tax basis and the Proposed Rules prohibit issuers from indemnifying executive officers against the loss of erroneously awarded compensation. If incentive-based compensation was based on stock price or total shareholder return (“TSR”), and the excess compensation cannot be recalculated directly from the information in the financial restatement, the clawed-back amount must be the issuer’s reasonable estimate of the effect of the financial restatement on the applicable stock price or TSR. Issuers must document how they determined this reasonable estimate and provide documentation to the applicable national stock exchange.

To comply with the Proposed Rules, clawback policies must apply to any incentive-based compensation received during the three completed fiscal years immediately

**Proposed Rules would expand scope of SEC clawback authority and may require immediate action.**

preceding the date on which the issuer is required to restate its financial statements to correct a material error, which the Proposed Rules define as the earlier to occur of: (i) the date the issuer's board of directors, a committee thereof, or the officer(s) of the issuer authorized to take such action if board action is not required, concludes or reasonably should have concluded that the issuer's previously issued financial statements contain a material error; or (ii) the date a court, regulator, or other legal body directs the issuer to restate its previously issued financial statements to correct a material error. The Proposed Rules provide that compensation is deemed "received" in the issuer's fiscal period during which the applicable financial reporting measure is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period.

Issuers must recover incentive-based compensation pursuant to the clawback policy unless it would be "impracticable" to do so. Under the Proposed Rules, recovery is only deemed impracticable if the direct expense that would be paid to a third party to assist in effecting the clawback would exceed the amount to be recovered or, for non-U.S. issuers, if the clawback would violate the laws of the issuer's home country (provided the applicable non-U.S. laws were adopted prior to the SEC's publication of the Proposed Rules).

### *What is "Incentive-Based" Compensation?*

The Proposed Rules define "incentive-based" compensation as any compensation that is granted, earned or vests based wholly or partially on the achievement of any financial reporting measure. Financial reporting measures are (i) measures that are determined and presented in accordance with the accounting principles used to prepare the issuer's financial statements, (ii) any measures derived wholly or partially from those measures, (iii) stock prices, and (iv) TSRs. The Proposed Rules require clawback policies to apply to incentive-based compensation that is based on or derived from financial information for periods that end on or after the ultimate effective date of the final clawback rules. Under this formulation, clawback policies could apply to incentive-based compensation received pursuant to a contract or arrangement that was entered into prior to the release of the Proposed Rules or during the interim period prior to the SEC's issuance of the final clawback rules.

### *Who are "Executive Officers?"*

The Proposed Rules define "executive officers" in the same manner as the definition of "officer" under Section 16 of the Exchange Act, which is substantially broader than the named executive officer definition applied for purposes of disclosing compensation in annual proxy statements.

### *Who are "Issuers?"*

The Proposed Rules apply to all issuers of listed securities, including emerging growth companies, smaller reporting companies, foreign private issuers, controlled companies and issuers of listed debt, with limited exceptions for (i) issuers of securi-

ties futures products or standardized options, (ii) unit investment trusts, and (iii) registered management investment companies that have not awarded incentive-based compensation to any executive officer in the last three fiscal years or, in the case of a registered management investment company that has been listed for fewer than three fiscal years, since the listing of the issuer.

### *New Reporting Requirements*

In addition to requiring issuers to adopt clawback policies that satisfy the standards described above, the Proposed Rules impose new reporting requirements on covered issuers. Under the Proposed Rules, issuers must include their clawback policy as an exhibit to their annual report (i.e., Form 10-K, 20-F, or 40-F). In addition, if at any time during its most recently completed fiscal year, an issuer issues a financial restatement that requires a compensation clawback under the Proposed Rules or has an outstanding amount of incentive-based compensation subject to clawback under the Proposed Rules, the issuer must include the following disclosure items in its annual report or proxy statement, as applicable:

- For each financial restatement, the date on which the issuer was required to prepare the restatement, the resulting amount of incentive-based compensation subject to clawback, the estimates used in determining the amount subject to clawback (if the applicable financial reporting measure related to a stock price or TSR metric), and the amount subject to clawback that remained outstanding as of the end of the most recently completed fiscal year.
- If, during the most recently completed fiscal year, the issuer decided not to pursue a clawback from any individual subject to clawback under the Proposed Rules, for each such individual, the name and amount forgone and a brief description of the reason the issuer decided not to pursue a clawback.
- The name of each individual for whom, as of the end of the most recently completed fiscal year, incentive-based compensation subject to a clawback under the Proposed Rules had been outstanding for 180 days or longer since the date the issuer determined the amount the individual owed, and the dollar amount of outstanding incentive-based compensation subject to clawback due from each such individual.

### *Submitting Public Comments on the Proposed Rules; Effective Date*

Public comments on the Proposed Rules are due within 60 days following the SEC's July 1, 2015, publication of the Proposed Rules in the Federal Register. We anticipate substantial comments on the Proposed Rules. Following the end of the comment period, the SEC has an unlimited amount of time to issue finalized rules, after which the national securities exchanges must propose and finalize their own listing standards. The Proposed Rules will only become effective following completion of this process. However, if finalized in their current form, the Proposed Rules could apply to incentive-based compensation payable under agreements that pre-date the effective date of the clawback rules. For example, if the Proposed Rules be-

come finalized and effective in 2015, a calendar year issuer must be able to recover incentive-based compensation in the event the December 31, 2015 financials are restated and the restatement affects currently outstanding awards.

### *Recommended Next Steps*

Issuers should review their clawback policies to determine whether those policies comply with the Proposed Rules. To the extent an issuer's clawback policies do not comply with the Proposed Rules, the issuer should review its compensation arrangements to determine whether they contractually permit it to recover compensation in compliance with the Proposed Rules and, if not, the issuer should consider revising those arrangements to permit application of compliant clawback policies once the Proposed Rules are finalized. In addition, issuers will need to review contracts with their executives (employment agreements, change of control agreements, equity award agreements and the like) to assess whether compliant clawback policies can be implemented consistently with those contracts and may need to start discussions with executives regarding amending those contracts to ensure timely compliance with the Proposed Rules upon their finalization.

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