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SEC Adopts Final Rules Regarding Clawback Policies for Public Companies

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Overview

On October 26, 2022, the SEC adopted final compensation clawback rules (the “SEC Clawback Rules”) that direct the national securities exchanges and associations that list securities (the “exchanges”) to adopt listing standards requiring listed issuers (with limited exceptions) to (i) develop and implement a clawback policy, (ii) file the clawback policy as an exhibit to their annual report and (iii) include disclosures in their SEC filings if recovery is triggered under their clawback policy.

Below is a summary of the SEC Clawback Rules, which are [linked here](#).

Effective Dates

The SEC Clawback Rules require action by the exchanges, and issuers are not required to take any action at this time.

The SEC Clawback Rules will become effective 60 days following publication of the adopting release in the Federal Register. The exchanges must propose listing standards no later than 90 days after the publication date, and the final listing standards must be effective no later than one year after the publication date. An affected issuer will be required to adopt a compliant clawback policy no later than 60 days after the date on which the final listing standards become effective. This process could take up to 15 months to complete.

Affected Issuers

Most issuers will be required to comply with the SEC Clawback Rules.

All listed issuers (including smaller reporting companies, emerging growth companies, foreign private issuers, controlled companies, and issuers of debt and non-equity securities) other than issuers of security futures products, standardized options, unit investment trust securities and certain registered investment company securities will be subject to the SEC Clawback Rules.

Covered Persons

A compliant clawback policy must cover any current or former executive officer of the issuer who received incentive-based compensation during the applicable lookback period described below.

The definition of “executive officer” in the new rules is consistent with the definition of a Section 16 officer and includes the issuer’s president, principal financial officer, principal accounting officer (or the controller if there is no such accounting officer), any vice president of the issuer in charge of a principal business unit, division or function, and any other person who performs similar policy-making functions for the issuer.

Recovery of incentive-based compensation is only required when received by a person (i) after beginning service as an executive officer and (ii) if that person served as an executive officer at any time during the lookback period. Recovery of compensation received prior to a person becoming an executive officer will not be required, but compensation received during the lookback period by a former executive officer is covered.

Triggering Events and Covered Period

Clawback is triggered upon either a “Big R” or “little r” accounting restatement during the three-year lookback period.

A compliant clawback policy must provide for recovery of incentive-based compensation erroneously received during the lookback period, which consists of the three completed fiscal years immediately preceding the date on which the issuer is required to prepare an accounting restatement. Incentive-based compensation is

considered to be received in the fiscal period during which the applicable reporting measure is attained, even if the payment or grant occurs after the end of that period. If an award is subject to both time-based and performance-based vesting conditions, it is considered received upon satisfaction of the performance-based conditions, even if the award continues to be subject to time-based vesting conditions.

The SEC Clawback Rules require clawback of erroneously awarded compensation when an issuer is required to prepare an accounting restatement that corrects an error in previously issued financial statements that (i) is material to the previously issued financial statements (often referred to as a “Big R” restatement) or (ii) is not material to previously issued financial statements, but that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (often referred to as a “little r” restatement).

Incentive-Based Compensation

Incentive-based compensation includes any compensation granted (including pursuant to arrangements existing prior to effectiveness of the final listing standards) or earned based upon achievement of any financial reporting measure.

Incentive-based compensation includes any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measures that are determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements and any measures derived wholly or in part from such measures, as well as non-GAAP measures, stock price and total shareholder return (“TSR”).

Incentive-based compensation does *not* include: base salary; bonuses paid solely at a board or board committee’s discretion that are not paid from a “bonus pool” determined by the satisfaction of a financial reporting measure performance goal; bonuses paid upon achievement of subjective standards and/or completion of a specified employment period; non-equity incentive plan awards earned solely upon achievement of strategic or operational measures; and equity awards that are subject only to time-based vesting conditions and/or satisfying one or more subjective, strategic or operational measures that are not financial reporting measures.

Additionally, the SEC Clawback Rules provide that the clawback policy must be applied to incentive-based compensation received on or after the effective date of the final

listing standards, even if the compensation was received under plans, contracts and arrangements that were in place before the adoption of the issuer's clawback policy.

Recovery Amount

The SEC adopted a principles-based definition of "erroneously awarded compensation" and provided guidance in the adopting release on how the definition should be applied in certain circumstances. Issuers are generally required to claw back/recover the amount, calculated on a pre-tax basis, of any incentive-based compensation received that exceeds the amount that otherwise would have been received had the compensation been calculated based on the restated amounts. In instances where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement (e.g., incentive-based compensation based on TSR or stock price), the amount must be based on a reasonable estimate of the effect of the accounting restatement on the applicable measure, and the issuer must maintain documentation of the determination of that reasonable estimate and provide it to the applicable exchange.

For equity awards, if the shares, options or stock appreciation rights ("SARs") are still held at the time of recovery, the erroneously awarded compensation is the number of shares (or shares underlying the applicable award) received in excess of the number that should have been received applying the restated financial reporting measure (or the value of that excess number). If the options or SARs have been exercised, but the underlying shares have not been sold, the erroneously awarded compensation is the number of shares underlying the excess options or SARs (or the value thereof). The SEC noted in the adopting release its decision not to provide more specific guidance with respect to the determination of the recoverable amount for specific forms of incentive-based compensation, stating that "the guidance we are providing in this release coupled with the requirement in the final rule to use reasonable estimates of the effect of the accounting restatement provides appropriate direction and flexibility for issuers and exchanges to implement the rule."

Limited Exceptions to Enforcement

Issuers will have very little discretion in enforcing their clawback policies.

An affected issuer is required to recover compensation in accordance with its clawback policy unless its independent compensation committee (or, in the absence

of such a committee, a majority of the board's independent directors) determines the clawback would be impracticable based on any of the following conditions: (i) the direct cost of recovery would exceed the amount of recovery and the issuer has made a reasonable attempt to recover; (ii) the recovery would violate a home country law that existed prior to the publication of the SEC Clawback Rules in the Federal Register, and the issuer provides an opinion of counsel to that effect to the applicable exchange; or (iii) recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.

No Indemnification

The SEC Clawback Rules prohibit an issuer from providing insurance or indemnification to any executive officer or former executive officer for the loss of erroneously awarded compensation.

New Disclosure Requirements

Each issuer is required to file its clawback policy as an exhibit to its annual report, and if recovery is triggered under the clawback policy, to provide disclosure related to its clawback policy and recovery analyses.

Exhibit Requirement. An issuer is required to file its clawback policy as an exhibit to its annual report on Form 10-K, Form 20-F or Form 40-F, as applicable.

New Item 402 of Regulation S-K Requirement. An issuer is required to disclose in its annual report or proxy or information statement that requires Item 402 of Regulation S-K disclosure how it has applied its clawback policy, including:

- The date on which the issuer was required to prepare an accounting restatement;
- The aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement, including an analysis of how the recoverable amount was calculated (or if the amount has not yet been determined, an explanation of the reasons and then subsequent disclosure of the required information in the next filing that is subject to Item 402 of Regulation S-K);
- The aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of its last completed fiscal year;

- If the financial reporting measure is related to a stock price or TSR metric, the estimates used to determine the amount of erroneously awarded compensation attributable to such accounting restatement and an explanation of the methodology used for such estimates;
- If recovery would be impracticable, for each current and former named executive officer and for all other current and former executive officers as a group, the amount of recovery forgone and a brief description of the reason the issuer decided in each case not to pursue recovery; and
- As of the end of the last completed fiscal year, for each current and former named executive officer, the amount of erroneously awarded compensation still owed that had been outstanding for 180 days or longer since the date the issuer determined the amount owed.

Summary Compensation Table Disclosure. The SEC also amended Item 402 of Regulation S-K to provide that amounts recovered pursuant to an issuer's clawback policy must reduce the amount reported in the applicable Summary Compensation Table column and the "total" column for the fiscal year in which the amount recovered initially was reported and must be identified by footnote.

Consequences for Noncompliance

Failure to adopt and comply with a compliant clawback policy will result in an issuer being subject to delisting.

Recommended Actions

Review Existing Clawback Policy/Prepare New Policy. Each listed issuer should review its existing clawback policy and determine whether updates will be required to comply with the new rules or, if no clawback policy has yet been adopted, begin to consider the terms to be incorporated into such policy.

Consider Breadth of Clawback Policy. When considering its clawback policy, an issuer should consider whether it would be desirable to adopt a policy that goes further than the requirements contemplated by the SEC. For instance, recent guidance from the Department of Justice provides that in connection with criminal enforcement actions, one of the factors the Department of Justice will now consider in evaluating remediation and the effectiveness of compliance programs is whether an issuer's

compensation program includes appropriate deterrence measures (including clawback provisions), and whether the issuer has enforced those provisions. Issuers may, for this reason, find it desirable to adopt a clawback policy with a longer lookback period, one that includes a greater number of employees beyond just executive officers or one that includes additional circumstances that trigger clawback (e.g., employee misconduct, violation of company policy or breach of restrictive covenants).

Review Existing Arrangements. Issuers should review their existing compensation plans and agreements and consider incorporating language that specifically subjects incentive compensation awards to the issuer's clawback policy.

Review Internal Controls. Issuers should review their internal processes to ensure that their compensation committee clearly documents instances where it is exercising discretion and awarding incentive compensation that is not based on financial results (and thus would not be subject to the SEC Clawback Rules). If a financial restatement is required, the individuals responsible for the process of recoupment and related disclosures should be timely made aware of the need to take action.

Conclusion

The adoption of the SEC Clawback Rules is a significant development affecting the vast majority of listed issuers. Not only will issuers be responsible for ensuring that the requirements have been properly implemented, disclosed and enforced, but issuers must now also consider the additional regulatory burden and potential complications of awarding compensation tied to financial results. Issuers should start conversations now with their audit and compensation committees to make sure that there is internal alignment on when the issuer's clawback policy will be adopted (or updated) in light of the anticipated timing of the effectiveness of the final listing standards, and whether changes to existing arrangements should be made.

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Suggested Reading

- 01 September 2022 Kirkland Alert SEC Adopts Pay Versus Performance Disclosure Rules
- 06 April 2022 Kirkland Alert The SEC Proposes New Rules Regarding SPACs
- 24 March 2022 Kirkland Alert SEC Proposes New Climate Disclosure Requirements

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