

CLIENT ALERT

SEC Implements Final Rules Regarding Mandatory Clawback

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AUTHORS

Michael A. Katz | Jordan A. Messinger | H. Jennifer Kim | Daniel Iverson

I. **Overview.** The U.S. Securities and Exchange Commission (the “SEC”) recently released new rules (the “Rules,” available [here](#)) directing each national securities exchange and association (including NYSE and NASDAQ) (each, an “Exchange”) to establish new listing standards that will require each listed issuer to adopt and implement a policy providing for the mandatory recoupment or clawback of incentive-based compensation that is determined to have been erroneously paid to current and former executive officers of the issuer following an accounting restatement (such policy being a “Clawback Policy”).

II. **Effective Timing.** The Rules require each Exchange to propose listing standards within 90 days after the Rules are published in the Federal Register (the date of publication being the “Publication Date”) and for such listing standards to become effective no later than one year after the Publication Date. Issuers subject to the listing standards will then be required to adopt a Clawback Policy within 60 days after the applicable listing standard becomes effective.

III. **Issuers Subject to the Rules.** The Rules generally apply to most listed issuers, including smaller reporting companies, emerging growth companies, foreign private issuers, controlled companies, and issuers of debt and non-equity securities. There are limited exemptions for issuers of standardized options, security futures products, unit investment trust securities, and certain registered investment company securities.

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IV. **Mandatory Clawback of Incentive-Based Compensation.**

Triggering Events. Under the Rules, each Clawback Policy will need to require recoupment of “incentive-based compensation” that has been paid in error during the three completed fiscal years immediately preceding the date on which the issuer is required to prepare an accounting restatement that corrects (1) errors that are material to previously issued financial statements (a “Big R” restatement) or (2) errors that are not material to previously issued financial statements, but would result in a material misstatement if the errors were left uncorrected in the current report or the error correction was recognized in the current period (a “little r” restatement). The “date on which the issuer is required to prepare an accounting restatement” is defined as the earlier of (i) the date the issuer’s board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement, and (ii) the date a court, regulator, or other legally authorized body directs the issuer to prepare an accounting restatement.

Covered Executive Officers and Compensation. An issuer’s “executive officers” for purposes of the clawback requirements will be determined using the same definition as “officer” under Section 16 of the Securities Exchange Act of 1934, and includes the president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division, or function, any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. The mandatory clawback must apply to all incentive-based compensation received by a person (i) after beginning service as an executive officer, (ii) who served as an executive officer at any time during the performance period for the incentive-based compensation subject to recoupment, and (iii) while the issuer has a class of securities listed on an Exchange.

Incentive-Based Compensation. The Rules define “incentive-based compensation” as any compensation that is granted, earned, or vested based wholly or in part upon the attainment of financial reporting measures. For this purpose, “financial reporting measures” includes any 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, including non-GAAP financial measures such as stock price or total shareholder return (“TSR”).

Determination of Erroneously Awarded Compensation. The Rules require that the amount subject to recoupment in connection with any accounting restatement will be the amount of incentive-based compensation received by a current or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts. If the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement (e.g., if incentive compensation was measured based on stock price or TSR), the amount

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subject to recoupment must be based on a reasonable estimate of the effect of the accounting restatement on the measure (e.g., stock price or TSR) upon which the incentive-based compensation was received, and the issuer must maintain documentation of the determination of that reasonable estimate and provide such documentation to the applicable Exchange. In order to make the issuer whole for the entire amount erroneously paid, recoupment must be determined on a pre-tax basis.

Exceptions to Clawback Requirement. Under the Rules, issuers are permitted not to seek recoupment pursuant to a Clawback Policy only if the issuer's committee of independent directors responsible for executive compensation decisions (or in the absence of such a committee, a majority of the independent directors serving on the issuer's board of directors) has made a determination that recovery would be impracticable. For this purpose, recovery will only be deemed impracticable if (i) the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered (and only after the issuer has made a reasonable attempt to recover the erroneously awarded compensation, documented such reasonable attempts and provided such information to the applicable Exchange), (ii) recovery would violate a law in the home country of the issuer that was in effect prior to the Publication Date and only after obtaining an opinion from home country counsel acceptable to the applicable Exchange that recovery would result in such violation and such opinion is provided to the applicable Exchange, or (iii) recovery would likely cause a tax-qualified retirement plan in the United States to fail to meet certain statutory requirements for tax exemption.

Restrictions on Indemnification and Insurance. Issuers are prohibited from indemnifying or insuring any current or former executive officer against the loss of erroneously awarded compensation.

V. **Required Disclosures.** The Rules will require each listed issuer to file its Clawback Policy as an exhibit to its annual report on Form 10-K, 20-F or 40-F, as applicable. The SEC will also amend the cover page of Form 10-K, 20-F and 40-F to add new check boxes requiring issuers to indicate separately (i) whether the financial statements included in the filing reflect correction of an error to previously issued financial statements and (ii) whether such corrections are restatements that required a recovery analysis of incentive-based compensation received by the issuer's executive officers during the relevant recovery period. In addition, the Rules will add a new Item 402(w) to Regulation S-K that will require an issuer to disclose the manner in which it has applied its Clawback Policy if, at any time during or after such issuer's last completed fiscal year, the issuer was required to prepare an accounting restatement that required recovery of erroneously awarded compensation pursuant to its Clawback Policy, and if there is an outstanding balance at the end of the last completed fiscal year of erroneously awarded compensation to be recovered from the application of the Clawback Policy to a prior accounting restatement. An issuer that triggers the Item 402(w) disclosure requirement must disclose:

- the date on which the issuer was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (including an analysis of the calculation of the recoverable amount) or, if the amount has not yet been determined, an explanation of the

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reasons and disclosure of the amount and related disclosures in the next filing that contains compensation disclosure pursuant to Item 402 of Regulation S-K;

- the aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the issuer's 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 pursuant to the impracticability exception, 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
- for each current and former named executive officer, the amount of erroneously awarded compensation still owed that has been outstanding for 180 days or longer since the date the issuer determined the amount owed.

VI. **Next Steps and Other Considerations.** Note that the Rules establish the minimum standards and permit the Exchanges to adopt their own listing standards which may be more extensive than those contemplated by the Rules. Issuers should stay informed on further developments, including on the applicable Exchange's release of its listing standards, begin evaluating any existing clawback policies and comparing them against the various standards under the Rules (such as those applying to the scope of the covered group, covered compensation, and the degree of discretion given to the board in the enforcement of the policy) and, in the absence of an existing clawback policy, begin designing the Clawback Policy, in each case, subject to further assessment upon the applicable Exchange's adoption of listing standards.

To aid with enforcement, it is recommended that issuers (i) create binding obligations on the part of each executive officer to promptly repay amounts that the issuer is required to recoup pursuant to its Clawback Policy (which can be done in the Clawback Policy itself or in separate agreements with each executive officer), and (ii) require each executive officer to reimburse the issuer for any costs and expenses incurred by the issuer in recouping incentive compensation from the executive officer after the issuer has formally requested repayment.

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If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Michael A. Katz

212 728 8204

mkatz@willkie.com

Jordan A. Messinger

212 728 8799

jmessinger@willkie.com

H. Jennifer Kim

212 728 8152

jkim1@willkie.com

Daniel Iverson

212 728 3480

diverson@willkie.com

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