

SEC Adopts Mandatory Rules for Clawing Back Incentive-Based Compensation: Questions and Answers for Public Companies and Best Practices

November 17, 2022

On October 26, the Securities and Exchange Commission (SEC) adopted long-delayed rules which will require companies to implement mandatory “clawback” policies with respect to incentive-based compensation if the company’s financial statements tied to achieving the relevant incentive payments are later required to be restated.

Originally introduced by Congress in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, [the final rules](#) require national securities exchanges to amend their listing standards to mandate that public companies enact clawback policies that seek to recover any incentive-based compensation (whether cash or equity) that was paid to a current or former executive officer during the three fiscal years preceding a required accounting restatement, provided 1) such incentive compensation was calculated based on a misstated financial reporting measure that was subsequently restated and (2) that non-compliance resulted in an erroneous overpayment.

The final rules require recovery on a “no-fault” basis — meaning without regard to any misconduct or responsibility of the executive for the misstated financials — and represent a significant expansion from initial proposals, which would have required clawbacks only for material accounting errors that resulted in full restatements of a prior year’s financial results.¹

12 Questions and Answers to Consider

Which issuers are covered by the new clawback rule? The clawback rule generally applies to all public companies listed on a United States stock exchange, including certain classes of issuers that are exempt from certain other SEC rules and requirements, such as smaller reporting companies, emerging growth companies, controlled companies, foreign private issuers and business development companies. The clawback rules also apply to issuers of listed debt or other non-equity securities that trade on an exchange. Limited exceptions are available for certain registered investment companies and issuers of security futures products and standardized options.

Which executive officers are subject to the clawback rule? All current and former “executive officers” are subject to the rule, whether or not they were responsible for or involved in the events that led to a restatement. The definition of “executive officer” for purposes of the rule is similar to the definition of “officer” under Section 16 of the Securities Exchange Act of 1934, as amended, and includes a company’s president, principal financial officer, principal accounting officer or controller, any vice-president of the company in charge of a principal business unit, division, or function and any other officer who performs a policy-making function.

¹ Katten’s past commentary on earlier formulations of the clawback rule is available [here](#). The SEC’s press release and fact sheet announcing the final rule are available [here](#) and [here, respectively](#).

What incentive-based compensation is subject to recovery? All incentive-based compensation that was “received” during the three-year period immediately preceding the date on which the company was “required” to issue a restatement is subject to recovery, with “received” for purposes of the rule referring to the date the performance measure that must be achieved was attained (and not for example, when the award was granted, vested or paid) and “required” for purposes of the rule meaning the earlier of (1) the date when the board of directors or management concluded, or significantly, reasonably should have concluded, that the company was required to prepare an accounting restatement or (2) a court or regulator ordering the company to prepare an accounting restatement.

What events trigger a clawback? Recovery procedures will be triggered whenever an accounting restatement occurs (1) to correct an error in previously issued financial statements that is determined to be material to those previously issued financial statements (referred to as a “Big R” restatement) or (2) that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (referred to as a “little r” restatement). Out-of-period adjustments correcting errors that are immaterial to the current period and the prior period would not trigger a recovery event. The rules provide that the materiality determination will be left to the company but should be made in consultation with the audit committee and utilizing customary accounting guidance from the Staff.

When is the deadline to implement a compliant clawback policy, and what is the earliest year incentive-based compensation may be subject to recovery? Exchanges are required to issue proposed listing standards within 90 days after publication of the final rule in the Federal Register (which is expected to occur by the end of November), with such proposed listing rules becoming effective within one year from issuance and providing issuers a 60 day period from effectiveness to adopt a compliant policy. In short, clawback policies will likely need to be in place by the second half of 2023. Note that only incentive compensation “received” after an exchange’s listing standards become effective will be subject to a clawback policy, meaning that only compensation “received” (see above for a discussion of what constitutes “received” within the context of the clawback rule) in 2023 or later will be subject to the new rules.

Which types of incentive compensation are subject to the clawback policy? Any compensation, including cash or equity (including stock options), that is granted, earned or vests wholly or in part based on any financial reporting measures used in preparing or derived from the company’s financial statements is subject to the clawback policy. Conversely, compensation that is granted, vests or is earned based solely upon the occurrence of non-financial events, such as base salary, or a bonus awarded solely at the discretion of the board and not based on the achievement of a financial performance measure, is not subject to the clawback rules.

How will the amounts to be recovered be determined? Recovered amounts will reflect the difference between what was actually paid to the executive officer and what would have been paid had the incentive compensation payout been calculated based on the restated financial information. If recoverable amounts are based on total shareholder return or stock price metrics, the excess amount will be calculated based on the company’s reasonable estimate of the effect of the restatement on the company’s stock price (with the process for arriving at the estimate of the effect being documented and disclosed).

What about awards on which the executive officer has already paid income taxes? Recovery will be based on the original amount determined to be erroneously awarded and will not be net of any income taxes paid. Note that after being subject to a clawback, executives may seek to recover taxes paid to relevant taxing authorities, but at this time, guidance from taxing authorities with respect to whether they will refund such amounts has not been released. As a result, companies may consider implementing structural protections in their incentive plans, such as mandatory deferral of a portion of incentive compensation for a period that covers some or all of the lookback period, to defer taxation and mitigate any potential clawback.

May companies waive recovery or indemnify or insure executive officers? Companies may not waive or reduce the amount of incentive compensation that is determined to have been erroneously awarded except in certain limited circumstances, such as a finding that the expense of collecting the recovery would exceed the amount recovered. However, companies are permitted to exercise discretion in terms of methods of recovery, including, for example, allowing recovery over time from future pay or cancellation of unvested equity. Companies are also not permitted to purchase insurance, pay for premiums or otherwise reimburse executive officers for the cost of any third-party insurance they choose to individually purchase to protect against potential clawbacks.

What are the ongoing disclosure obligations with respect to the clawback rule? A company will be required to file its clawback policy as an exhibit to its annual report and, in the event the policy is triggered, will be required to provide detailed disclosure regarding the circumstances of the clawback, the amounts erroneously awarded and any amounts subsequently recovered.

What are the consequences for failure to comply with the clawback rule? A listed company that does not comply with the clawback rule by either (1) failing to adopt a clawback policy, (2) failing to enforce its clawback policy or (3) failing to make the required clawback disclosures may be delisted.

What about existing clawback policies? Many large public companies (including all of the S&P 500) have already adopted some form of clawback policy. However, such policies are often triggered by a finding of misconduct as opposed to the no-fault approach of the new clawback rule, apply to broader or narrower groups of employees than the new clawback rule or include triggers unrelated to financial restatements. To ensure compliance with the new rule and avoid certain of the prescriptive and non-discretionary aspects of the new clawback rule, issuers will need to consider whether adopting a new clawback policy specifically tailored to the new rule, rather than amending an existing policy, is appropriate.

Next Steps for Public Companies and Best Practices

Before the effectiveness of these requirements following the adoption of new listing standards by national securities exchanges, companies should:

- notify their board of directors and audit and compensation committees regarding the new requirements for clawback policies;
- review existing clawback policies to determine the extent to which they comply with the SEC's final rules and the national securities exchanges and associations' listing standards. The review should include analysis of references to clawbacks in equity incentive and cash bonus plans as well as in executive employment agreements. Particular areas of focus should be the need, if any, to expand such policies to cover additional forms of compensation, a larger employee population or a longer look-back period. Issuers should monitor further developments from the exchanges and associations on their final listing standards before adopting formal revisions;
- review existing incentive-based compensation arrangements and documentation covering executives to (1) determine the scope of such arrangements captured by the final rules and listing standards and (2) add language that contemplates and allows for the recoupment of incentive-based compensation pursuant to new listing standards (private companies that are anticipating an IPO or listing on the horizon should consider consulting with their securities and executive compensation advisors about the desirability of adopting clawback policies compliant with the SEC's rule and applicable listing standards); and
- assess internal controls over disclosure and financial reporting processes, with specific emphasis on the impact of "little r" restatements and effect of recoupment pursuant to clawback policies following such restatements.

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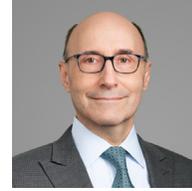
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