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Client Alert

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SEC Releases Final Rule on Clawback of Incentive Compensation

On October 26, 2022, the SEC adopted final incentive compensation clawback rules requiring U.S. listed issuers to:

- develop and implement a policy for the recovery of incentive-based compensation that is erroneously "received" by current and former executive officers during the three completed fiscal years immediately preceding the date that the issuer is required to prepare an accounting restatement; and
- file that policy as an annual report exhibit and satisfy related disclosure obligations in accordance with SEC rules.

The rule, known as Rule 10D-1, directs national securities exchanges to establish listing standards in line with the final rule. Companies that fail to comply with the rule may be delisted.

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Which Issuers are Subject to the Clawback Rule?

The rule generally applies to **all** listed issuers including emerging growth companies, foreign private issuers, smaller reporting companies, controlled companies and companies listing non-equity securities. Only certain issuers of security futures products, standardized options and registered unit investment trusts are exempt, as well as registered management investment companies that have not awarded incentive-based compensation to any current or former executive officer in the last three fiscal years.

What Type of Accounting Restatements will Trigger a Clawback Analysis?

The clawback policy must be applied in the event an issuer is required to prepare an accounting restatement to either:

- correct an error in previously issued financial statements that is material to the previously issued financial statements (commonly called a "Big R" restatement), **or**

- correct an error that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (commonly called a "little R" restatement).

However, an out-of-period adjustment (i.e., a correction of an error recorded in the current financial statements that is immaterial to both the prior and current financial statements) should not trigger a clawback.

Which Executive Officers are Subject to the Clawback?

Rule 10D-1 applies to both current and former executive officers, which is defined to mean the issuer's president, principal financial officer, principal accounting officer (or, if there is no such 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 (including an officer of a parent or subsidiary) - aligning with the officers subject to Section 16 of the Exchange Act. As foreign private issuers are not subject to Section 16 of the Exchange Act, such issuers will need to determine which of their officers will be subject to the new clawback rules.

The rule is not limited to executive officers who were directly involved with the accounting error and applies even if the executive officer engaged in no misconduct. However, in a change from the proposed rules, recovery applies only with respect to compensation "received" (as explained below) during the period an individual served as an executive officer.

What Type of Incentive-Based Compensation is Subject to the Clawback?

"Incentive-based compensation" subject to clawback includes any compensation that is granted, earned, or vested wholly or in part upon the attainment of any financial reporting measure. In turn, "financial reporting measures" are measures that are determined and presented in accordance with the accounting principles used in preparing the financial statements, and any measures that are derived wholly or in part from such measures, such as non-GAAP financial measures. However, consistent with the proposed rule, the final rule includes stock price and total shareholder return (TSR) as financial reporting measures. Although the SEC recognized that it can be difficult and costly to isolate and quantify the effect that an accounting restatement has on company stock price or TSR, the SEC concluded that such additional costs were justified in light of the purpose of the statute.

Examples of "incentive-based compensation" include stock options and other equity awards whose grant or vesting is based wholly or in part on the attainment of a financial reporting measure (including proceeds from the sale of shares from such awards), as well as non-equity incentive plan awards, bonuses paid from a bonus pool and other cash awards where, in each case, the awards or payments are based wholly or partly on satisfying a financial reporting measure performance goal.

Incentive-based compensation excludes salary, discretionary bonuses and equity awards or other compensation that is based **solely** on satisfying subjective standards, time-based vesting periods and/or strategic or operational goals and not based on a financial reporting measure. In other words, these types of compensation are not subject to clawback under the rule.

What is the Recovery Period?

The recovery period is the three completed fiscal years immediately preceding the date the issuer was required to prepare an accounting restatement. The date that the issuer is "required to prepare the restatement" is the **earlier** to occur of:

- the date the issuer's board of directors (or other authorized party) concludes or **reasonably should have concluded** that the issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, or
- the date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.

When is Incentive-Based Compensation "Received"?

Incentive-based compensation is deemed received in the fiscal period during which the relevant financial reporting measure is attained, even if payment or grant occurs after the end of that period and even if the executive officer has established only a contingent right to payment as of goal attainment. For an award that is subject to multiple conditions, the executive need not satisfy all conditions in order for that award to be deemed received.

How is the "Erroneously Awarded Compensation" Subject to Recovery Calculated?

Where incentive-based compensation received during the recovery period was based wholly or partly on achievement of a financial reporting measure, the issuer must first determine the portion of the compensation based on such measure, and then

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determine whether any current or former executive officer received greater compensation than would have been received if the corrected measure had been applied (taking into account any discretion the board applied to reduce the amount originally received).

If the incentive-based compensation was based on stock price or TSR and therefore is not subject to mathematical recalculation directly from the accounting restatement, the amount subject to recovery must be based on a reasonable estimate and the issuer must maintain documentation of the estimate and provide it to the exchange on which it is listed.

Importantly, the amount subject to recovery is calculated on a **pre-tax** basis, regardless of any tax hardship that this may cause an executive who may be unable to obtain a deduction to offset the taxes paid on prior year compensation that was later subject to clawback.

The rule includes the following guidance for computing the erroneously awarded compensation:

- For cash awards, the erroneously awarded compensation is the difference between the amount of the cash award (whether payable as a lump sum or over time) that was received and the amount that should have been received applying the restated financial reporting measure.
- For cash awards paid from bonus pools, the erroneously awarded compensation is the pro-rata portion of any deficiency that results from the aggregate bonus pool that is reduced based on applying the restated financial reporting measure.
- For equity awards, if the shares, stock options, or stock appreciation rights are still held at the time of recovery, the erroneously awarded compensation is the number of such securities 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 stock appreciation rights 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 stock appreciation rights (or the value thereof). The rule does **not** provide guidance on the recovery amount in the case where the relevant equity award shares have been sold, leaving issuers to determine the appropriate date of valuation of such shares (e.g., the date the issuer is required to prepare the restatement, the date the shares were "received" under the rule, or the date the erroneously awarded compensation amount is determined, etc.).

In What Circumstances Does the Board Have Discretion Not to Pursue a Clawback?

The rule provides for limited exceptions to pursuing recovery where it would be impracticable:

- First, if the direct costs of recovery paid to a third party (such as reasonable legal expenses and consulting fees) would exceed the amount of recovery;
- Second, if recovery would violate the issuer's (not the executive's) home country law, as adopted in such home country prior to publication of the final rule and the issuer obtains the opinion of home country counsel (acceptable to the exchange) to this effect;
- Third, amounts need not be recovered from broad-based tax-qualified retirement plans, as such recovery could risk disqualifying the plans for all participants (however, plans limited to executive officers, supplemental executive retirement plans, and other non-qualified plans are still subject to recovery).

An issuer must make a reasonable attempt to recover any "erroneously paid" compensation before concluding it would be impracticable to do so, and must document its attempts to recover and provide such documentation to the relevant exchange. Any impracticability determination must be made by independent directors responsible for executive compensation decisions (or, if there is no compensation committee, by the majority of independent directors on a board), and such determination is subject to review by the exchange.

Full recovery is generally required, and must be accomplished reasonably promptly, but an issuer's board of directors has discretion to determine the manner and means of recovery based on the facts and circumstances of each executive officer.

What Disclosure is Required?

- First, issuers must file their clawback policy as an exhibit to their annual report on Form 10-K, Form 20-F, or Form 40-F, as applicable.
- Second, new Item 402(w) under Regulation S-K will require disclosure in the relevant proxy statement, annual report or registration statement of how the clawback policy has been applied in a case where the clawback was triggered or when there

is an outstanding balance of erroneously paid compensation due to a previous restatement at the end of the issuer's fiscal year. The new disclosure must include the following:

  - The date the issuer was required to prepare the accounting restatement and the amount of compensation awarded in error (including how the amount was calculated), or if such amount has not yet been determined, an explanation for that, plus disclosure of the amount in the next filing requiring Item 402 disclosure;
  - The aggregate dollar amount of erroneously awarded incentive-based compensation that remains outstanding at the end of the issuer's last completed fiscal year;
  - If the compensation was based on stock price or TSR, the estimates used to determine the amount of erroneously awarded compensation and an explanation regarding how these estimates were calculated;
  - If any amount cannot be recovered due to one of the "impracticability" exceptions, disclosure of the amount of recovery forgone for each current and former **named** executive officer and for all other executive officers as a group, along with an explanation of why the issuer decided not to pursue recovery; and
  - The amount of erroneously awarded incentive-based compensation outstanding for 180 days or more since the issuer determined it must be repaid.

- Third, the amount reported in the applicable column of the Summary Compensation Table must be reduced by any amounts recovered pursuant to the clawback policy, as well as the "total" column for the fiscal year in which the amount recovered initially was reported and be identified by footnote.
- Fourth, issuers will be required to clearly identify in check boxes on the cover page of their annual reports (i) when the financial statements therein contain restatements and (ii) when such restatements triggered a clawback analysis. This should provide additional transparency regarding such restatements and their impact on executive compensation.

Information related to the recovery of compensation under the rule must be tagged using Inline XBRL.

Can a Company Provide Clawback-Related Indemnification or Insurance?

The final rules prohibit issuers from indemnifying impacted executives or providing insurance in an effort to protect executives from personal liability or loss regarding amounts deemed erroneously awarded and recovered under the issuer's policies.

When is the Rule Effective?

Based on the timeline below, it is likely that the listing standards to implement the final rule will become effective, and compliance by issuers will be required, by early 2024, with new disclosures required in annual reports and information and proxy statements that are filed after such time.

- The final rule will become effective 60 days following its publication in the Federal Register ("Publication").
- The stock exchanges have 90 days after Publication to propose listing standards to implement the final rule.
- The listing standards must become effective no later than one year after Publication.
- Each listed issuer will be required to adopt a clawback policy no later than 60 days after the effective date of the listing standards and will be required to comply with that policy for all incentive-based compensation "received" (as explained above) on or after such effective date and during the three-year recovery period described above.

Next Steps

U.S. listed issuers who do not already have a clawback policy in place should begin preparations to design, adopt and implement a policy that complies with the listing standards once established by the applicable national securities exchange. Issuers that have already adopted a clawback policy should review their existing policy and consider whether any changes may be necessary to comply with the new requirements once the listing rules are adopted. In addition, issuers should consider any impact the new requirements will have on their current incentive-based compensation plans, programs, agreements and arrangements and those going forward.

As the final rule will apply retroactively to compensation under arrangements entered into prior to the effective date but "received" thereafter, issuers should ensure that their equity plans, award agreements, bonus plans and other incentive-based

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compensation plans and agreements provide for recoupment of such awards and any compensation received therefrom to the extent required by applicable law, including new Rule 10D-1.

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