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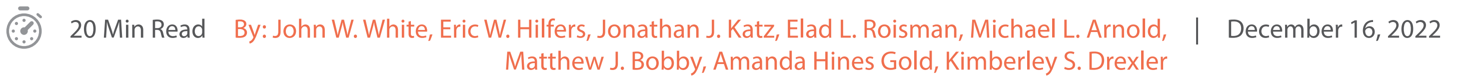

Securities Law

SEC Adopts Rules for Mandatory Clawback Policies

20 Min Read By: John W. White, Eric W. Hilfers, Jonathan J. Katz, Elad L. Roisman, Michael L. Arnold, Matthew J. Bobby, Amanda Hines Gold, Kimberley S. Drexler | December 16, 2022

On October 26, 2022, the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") adopted final rules (the "Final Rules")[1] implementing the clawback provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). In particular, the Final Rules require:

- national securities exchanges ("exchanges") and national securities associations to establish listing standards that require listed companies to develop and implement policies providing for the recovery of "erroneously awarded" incentive-based compensation received by current or former executive officers where such compensation is based on erroneously reported financial information and an accounting restatement is required (a "clawback policy"); and
- listed companies to provide disclosures about their clawback policies and how they are being implemented.

HISTORICAL BACKGROUND AND COMMISSIONERS' VIEWS

Section 954 of the Dodd-Frank Act added Section 10D to the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Section 10D directed the SEC to adopt a rule requiring companies to develop, implement, and disclose clawback policies designed to recover "erroneously awarded" incentive-based compensation from current or former executive officers during the three-year period preceding the date on which the company was required to prepare an accounting restatement due to the company's material noncompliance with any financial reporting requirement under the securities laws.

The SEC first proposed clawback rules on July 1, 2015, and received significant public comment. After the proposal languished for years, and in light of regulatory and market developments since 2015, the Commission reopened the comment period for these rules on October 14, 2021. On June 8, 2022, the Commission released a memo prepared by the staff in its Division of Economic and Risk Analysis that contained additional analyses and data relevant to the proposed clawback rules and reopened the comment period again. The SEC adopted the Final Rules on October 26, 2022, in a 3-2 vote.

SEC Chair Gary Gensler and Commissioners Caroline Crenshaw and Jaime Lizárraga voted in favor of the Final Rules. Their statements indicated that they supported the Final Rules largely because they believe the Final Rules will benefit investors and promote accountability, including by, among other things, "strengthen[ing] the transparency and quality of corporate financial statements, investor confidence in those statements, and the accountability of corporate executives to investors."[2]

Commissioners Hester Peirce and Mark Uyeda dissented from the adoption of the Final Rules. Their statements included concerns that the Final Rules are overly broad by, among other things, applying to so-called "little r" restatements (rather than only "Big R" restatements),[3] covering too broad a swath of company executives (rather than only individuals involved in the events leading to the restatement), applying to all listed companies (rather than excluding or providing exemptions for emerging growth companies ["EGCs"], smaller reporting companies ["SRCs"], and foreign private issuers ["FPIs"]), and defining "incentive-based compensation" too broadly (rather than limiting it to compensation based on accounting-based metrics). Commissioner Uyeda also expressed his concern that the Final Rules may misalign the interests of shareholders and corporate executives, as companies may restructure executive compensation arrangements to decrease incentive pay vulnerable under clawback policies in favor of increasing discretionary bonuses.[4]

IMPORTANT THINGS TO KNOW

The Final Rules will require companies to adopt clawback policies and provide related disclosures. Below are questions highlighting issues of note for companies, directors, and advisors about the Final Rules, which are separated into sections discussing the Final Rules generally, clawback policies, and disclosure requirements.

General Information

1. Which companies are affected?

All listed issuers—including EGCs, SRCs, FPIs, Canadian companies reporting under the multijurisdictional disclosure system, and controlled companies—will be subject to the Final Rules.

2. When will this new regime go into effect?

The Final Rules, which, as noted, are structured to direct the exchanges to adopt new listing standards, will become effective on January 27, 2023. Exchanges will need to file proposed listing standards no later than February 26, 2023, and these listing standards must then be effective no later November 28, 2023. A listed company must adopt a clawback policy no later than sixty days following the date on which the applicable listing standard becomes effective and must begin to comply with the Final Rules' disclosure requirements in proxy and information statements and annual reports filed on or after the effective date of the applicable listing standard.

3. May companies indemnify or otherwise assist their executive officers in mitigating the impact of the clawback policy?

No. Companies are prohibited from insuring or indemnifying their executive officers with respect to recoverable amounts, including from paying or reimbursing the executive officer for premiums on an insurance policy covering recoverable amounts.

Clawback Policies

4. What must be included in a company's clawback policy?

A listed company will be required to adopt and comply with a written policy providing that the company:

> will recover ***reasonably promptly*** the amount of ***erroneously awarded incentive-based compensation*** in the event that the issuer is required to prepare an ***accounting restatement*** due to the material noncompliance of the issuer with any ***financial reporting requirement*** under the securities laws, including any required accounting restatement to correct an error in previously issued financial statements ***that is material*** to the previously issued financial statements, or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period. (Final Rules; ***emphasis*** added to highlight defined terms.)

5. Which employees need to be covered by the clawback policy?

A company's current and former executive officers will be subject to the clawback policy.

"Executive officers" in the new Rule 10D-1(d) are the same as officers as defined by Rule 16a-1(f) for Section 16 purposes and therefore broader than the definition of "executive officer" provided in Rule 3b-7 under the Exchange Act. So, for domestic issuers, the group covered will include any executives subject to Form 4 reporting. The group includes a company's president; principal financial officer; principal accounting officer (or if there is no such accounting officer, the controller); any vice president of the company in charge of a principal business unit, division, or function (such as sales administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for the company.

Importantly, the definition of executive officer is broader than the definition of "named executive officer" (NEO) and the group of executives subject to clawback under the Sarbanes-Oxley Act of 2002. The company's principal accounting officer (or controller if the listed company does not have a principal accounting officer) is covered by the Final Rules even if the company does not otherwise consider that person to be among its executive officers.

Note that the definition of executive officer is not limited to executive officers who may be "at fault" for, or have knowledge of, errors that led to a restatement or those who are directly responsible for the preparation of the financial statements. Recovery of compensation received while an individual was serving in a non-executive capacity prior to becoming an executive officer will not be required, but for an employee who served as an executive officer and then returned to employee status, recovery for compensation following service as an executive officer would be required.

The Final Rules do not apply to non-employee directors.

6. What is incentive-based compensation?

The Final Rules define incentive-based compensation broadly as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure" and includes cash awards, bonuses from a "pool" the size of which is determined based on financial reporting measures, equity awards, and proceeds from shares acquired pursuant to such equity awards. Notably, however, incentive-based compensation excludes equity awards that were not granted based on the attainment of any financial reporting measure and vest solely based on continued service.[5]

Note that compensation contracts or arrangements that existed at or prior to the Final Rules' effective date must be subject to clawback policies if any incentive-based compensation is *received* on or after the effective date of the listing standards (e.g., a performance-based equity award granted in 2021 with a performance period that ends in 2025). In other words, currently existing compensation contracts are subject to potential clawback if any applicable compensation will be received on or after the effective date of the exchanges' standards.

7. What are financial reporting measures?

Financial reporting measures are:

- measures that are determined in accordance with the accounting principles used in the company's financial statements, whether presented in or outside of the company's financial statements,
- any measures derived wholly or in part from such measures (including non-GAAP measures and other measures, metrics, and ratios that are not non-GAAP measures, e.g., same-store sales), and
- other performance measures—including stock price, Total Shareholder Return ("TSR"), and relative TSR—that are affected by accounting-related information.[6]

8. When is incentive-based compensation deemed to have been erroneously awarded?

Incentive-based compensation will be deemed erroneously awarded and subject to a company's clawback policy if the compensation was tied to financial performance measures and the issuer is required to restate or correct the financial statements upon which the payouts were based (i.e., the payout was a higher amount than it would have been had the corrected financial statements been the ones initially prepared).[7]

This means that clawback policies must cover both "Big R" and "little r" restatements. The Final Rules do not provide a separate definition for

either "materiality" or "accounting restatements"; instead, the Final Rules look to existing accounting standards and guidance to define such terms in order to help ensure standards are consistently applied across companies and over time.[8]

9. What time period must the clawback policy cover?

The clawback policy must provide for a three-year look-back period, which comprises the three completed fiscal years (rather than the preceding thirty-six months) immediately preceding the date when the company is required, or should have reasonably concluded that it was required, to prepare an accounting restatement for a given reporting period.[9]

This means that if a company with a December 31 fiscal year-end determines in November 2024 that a restatement is required going back to 2021 and files restated financial statements in January 2025, the clawback policy would apply to incentive-based compensation received in 2023, 2022, and 2021 (see next section for the definition of "received"). If a company changed its fiscal year-end during the three-year look-back period, it must recover incentive-based compensation received during the transition period occurring during, or immediately following, that three-year period in addition to during the three-year look-back period (i.e., a total of four periods).

Notwithstanding the three-year lookback, the Final Rules apply only to (i) incentive-based compensation received after a person began service as an executive officer and served as an executive officer at any time during the performance period for that incentive-based compensation, and (ii) incentive-based compensation received while the company's securities are listed.

10. When is incentive-based compensation "received" for purposes of the three-year lookback?

Incentive-based compensation is deemed to be "received" in the fiscal year during which the financial reporting measure included in the incentive-based compensation award is attained or satisfied, regardless of whether the payment or grant occurs after the end of that period or if the executive officer has established only a contingent right to payment at that time. The Adopting Release notes that ministerial acts or other conditions necessary to effect issuance or payment (e.g., calculating the amount earned or obtaining the board of directors' approval of payment) do not extend the date of receipt.

11. What portion of erroneously awarded compensation must be recovered?

"[T]he amount of incentive-based compensation received that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts"[10] is subject to recovery.

The Adopting Release provides the following, non-comprehensive, guidance for calculating the amount of erroneously awarded compensation:

- For equity awards, if the equity award or shares are still held at the time of recovery, the number of such securities received in excess of the number that should have been received based on the accounting restatement (or the value of that excess number), *provided* that if 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 did not clarify if by "the value thereof" it intends to capture the value at the time of grant or at the time of clawback.
- For cash awards paid from bonus pools, the erroneously awarded compensation is the pro rata portion of any deficiency that results from the reduction in the aggregate bonus pool based on applying the restated financial reporting measure.
- For incentive-based compensation attained only partially based on the achievement of financial reporting measures, recalculate only the portion of such compensation based on or derived from the financial reporting measure that was restated.
- If the erroneously awarded compensation is not able to be calculated from information in an accounting restatement (e.g., TSR, relative TSR,[11] or stock price measures), a reasonable estimate of the effect of the accounting restatement on such measure should be used (with documentation of such determination provided to the relevant exchange).

All amounts of erroneously awarded compensation would be calculated on a pre-tax basis (i.e., without respect to any tax liabilities that may have been incurred or paid by the executive).

12. How and when must recovery occur?

As noted above, the Final Rules mandate recovery on a no-fault basis, without regard to any "scienter" on the part of relevant executive officers and with very limited discretion by the board of directors to forgo recovery. The Final Rules provide that recovery need not be pursued if the compensation committee (or in the absence of a compensation committee, a majority of the board's independent directors) determines recovery is impracticable in light of one of the following three conditions:

- the direct cost paid to a third party to assist in enforcing recovery would exceed the amount of recovery, *provided* that the company has first made a reasonable attempt to recover such erroneously awarded compensation, has documented such reasonable attempt(s) to recover, and has provided that documentation to its listing exchange;
- the recovery would violate a home country law that was adopted prior to November 28, 2022, *provided* that the company has obtained an opinion of home country counsel acceptable to the company's listing exchange that recovery would result in such a violation and the company has provided such opinion to its listing exchange; or
- the recovery would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees of the registrant, to fail to meet the requirements of 26 U.S.C. 401(a)(13) or 26 U.S.C. 411(a) and regulations thereunder.

Absent a finding of impracticability, companies are permitted to exercise discretion in what specific means to use to accomplish recovery, but generally must pursue recovery and should endeavor to prevent executive officers from retaining the full amount of compensation to which they were not entitled under the company's restated financials. Partial recovery can only be sufficient with a showing of impracticability, as described above.

Recovery must occur "reasonably promptly." The Final Rules do not define "reasonably promptly," but the Adopting Release notes that companies may consider costs related to recovery efforts when determining what is "reasonable." For example, it may be reasonable, depending on the facts and circumstances, to establish a deferred payment plan allowing an executive officer to repay erroneously awarded compensation as soon as possible without unreasonable economic hardship or to establish compensation practices that account for the possibility of the need for future recovery (e.g., holdbacks).

There are no de minimis exceptions for small amounts of recovery (except to the extent it may implicate the impracticability analysis described above).

13. What happens if a company does not adopt a clawback policy?

A company will be subject to delisting if it does not adopt and comply with a clawback policy that meets the requirements of its exchange's listing standards, and no exchange will be able to list the company's shares until it has adopted a compliant policy.

Disclosure Requirements

14. Where do clawback policies and related information need to be disclosed?

Disclosures will need to be provided in proxy and information statements, as well as in companies' annual reports.

15. What disclosures does a company need to make regarding its clawback policy?

The Final Rules require companies to provide a number of new disclosures related to their clawback policies. A listed company will be required to:

- file its clawback policy as an exhibit to its annual report; and
- include check boxes on the cover of its Form 10-K, 20-F, or 40-F, as applicable, disclosing whether the financial statements included in the report reflect the correction of an error to previously issued financial statements and whether any such error corrections are restatements that required a compensation recovery analysis pursuant to the company's clawback policy.

A listed company that has prepared an accounting restatement that triggered its clawback policy, along with any company that has an outstanding balance of excess incentive-based compensation relating to a prior restatement, will also be required to provide the following disclosures in its proxy or information statement or annual report containing executive compensation disclosures pursuant to Item 402 of Regulation S-K:

- the date the accounting restatement was required to be prepared, the aggregate amount of any related erroneously awarded compensation, and a description of how the recoverable amount was calculated or why the amount has not yet been determined;
- the aggregate amount of the erroneously awarded compensation outstanding at the end of the last fiscal year;
- if the erroneously awarded incentive compensation was determined based on stock price or TSR metrics, the estimates used to determine the amount of erroneously awarded compensation attributable to an accounting restatement and an explanation of the methodology used for those estimates;
- the amount of recovery forgone and a description of the reasons recovery was not pursued if recovery would be impracticable; and
- for each covered current or former executive, the amount of any erroneously awarded compensation that is owed and has been outstanding for 180 days or longer after the company determined the amount owed.

Disclosure would also be required if an accounting restatement occurred and the registrant concluded recovery of erroneously awarded compensation was not required under the clawback policy.

Next Steps

16. What steps should be taken now to ensure compliance with the Final Rules?

Companies should work with counsel to update existing clawback policies or adopt new clawback policies to comply with the Final Rules. Companies should also review existing contracts and forms (e.g., employment agreements, separation agreements, bonus plans, and equity award agreements) and consider updates addressing the company's clawback policy. Members of management should expect to engage with both their nominating and governance committees as well as compensation committees on efforts to comply with the Final Rules. Members of these committees should make appropriate inquiries of management to understand the timing and nature of any changes that might be required in a company's clawback policies.

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1. The text of the final rule and the Commission's related adopting release (the "Adopting Release") can be found on the SEC's website.

2. *See* Chair Gary Gensler, "Statement on Final Rules Regarding Clawbacks of Erroneously Awarded Compensation"; Commissioner Caroline A. Crenshaw, "Statement on Listing Standards for Recovery of Erroneously Awarded Compensation"; and Commissioner Jaime Lizárraga, "Statement on Listing Standards for Recovery of Erroneously Awarded Compensation."

3. "Big R" restatements are restatements where historical financial statements are restated to correct errors material to previously issued financial statements. "Little r" restatements are restatements that correct errors that are not material to previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period.

4. *See* Commissioner Hester M. Peirce, "Erroneous Clawbacking: Statement at Open Meeting to Consider Listing Standards for Recovery of Erroneously Awarded Compensation," and Commissioner Mark T. Uyeda, "Statement on the Final Rule Related to Listing Standards for Recovery of Erroneously Awarded Compensation."

5. The Adopting Release provides non-exhaustive examples of compensation that is *not* incentive-based compensation, including salaries; bonuses paid solely at the discretion of the compensation committee or board that are not paid from a bonus pool determined by satisfying a financial reporting measure performance goal; bonuses paid solely upon satisfying one or more subjective standards (e.g., demonstrated leadership) and/or completion of a specified employment period; non-equity incentive plan awards earned solely upon satisfying one or more strategic measures (e.g., consummating a merger or divestiture) or operational measures (e.g., opening a specified number of stores, completion of a project, increase in market share); and equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more nonfinancial reporting measures.

6. The Adopting Release provides a non-exhaustive list of financial reporting measures, including revenue; net income; operating income; profitability of one or more reportable segments; financial ratios; net assets or net asset value per share; earnings before interest, taxes, depreciation and amortization; liquidity measures; return measures; earnings measures; sales per square foot or same-store sales, where sales are subject to an accounting restatement;

revenue per user, or average revenue per user, where revenue is subject to an accounting restatement; cost per employee, where cost is subject to an accounting restatement; any of such financial reporting measures relative to a peer group where the company's financial reporting measure is subject to an accounting restatement; and tax basis income.

7. When errors are both immaterial to previously issued financial statements and immaterial to the current period, they are often corrected in the current period in so-called "out-of-period" adjustments. The Adopting Release explains that an out-of-period adjustment should not trigger a compensation recovery analysis under the Final Rules, because it is not an "accounting restatement."

8. The Adopting Release does, however, provide a list of changes to a company's financial statements that do not represent error corrections, and therefore do not trigger application of its clawback policy, including retrospective application of a change in accounting principle; retrospective revision to reportable segment information due to a change in the structure of a company's internal organization; retrospective reclassification due to a discontinued operation; retrospective application of a change in reporting entity, such as from a reorganization of entities under common control; retrospective adjustment to provisional amounts in connection with a prior business combination (for international financial reporting standards only); and retrospective revision for stock splits, reverse stock splits, stock dividends, or other changes in capital structure.

9. Accounting restatements are required to be prepared on the earlier of (1) the date the board of directors, a committee of the board of directors, or the officer(s) of the company authorized to take such action concludes, or reasonably should have concluded, that the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws, or (2) the date a court, regulator, or other legally authorized body directs the company to prepare an accounting restatement.

10. Rule 10D-1(b)(1)(iii).

11. Note that with respect to relative TSR, only an accounting restatement by the issuer, not accounting restatements by other issuers in the peer group, would result in application of the Final Rule and potential recovery.

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