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SEC Adopts Final Mandatory Clawback Rules

- **Requires Clawback of Excess Incentive-Based Compensation Earned by Executive Officers During the Three Fiscal Years Preceding a Required Accounting Restatement**
- **Broadens the Scope of Covered Restatements and Provides for Limited Impracticability Exceptions**

SUMMARY

On October 26, 2022, by a 3-2 vote, the U.S. Securities and Exchange Commission adopted a new rule and amendments to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The final rule directs national securities exchanges and associations to require policies mandating the recovery or "clawback" of excess incentive-based compensation earned by a current or former executive officer during the three fiscal years preceding a required accounting restatement, including to 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. The excess compensation would be based on the amount the executive officer would have received had the incentive-based compensation been determined using the restated financials, but the final rule does not appear to require the listed company to reassess discretionary award determinations (either positive or negative). The final rule applies to all listed companies without regard to the types of securities listed, other than certain listed funds, clearing agencies and unit investment trusts. The final rule requires the exchanges to propose conforming listing standards within 90 days of the final rule's publication in the Federal Register and requires the standards to become effective no later than one year after publication of the final rule. Each listed issuer would then be required to adopt a clawback policy within 60 days after its exchange's listing standard has become effective.

The SEC also adopted amendments to Item 402 of Regulation S-K, Form 40-F and Form 20-F (and for listed funds, Form N-CSR) requiring an issuer to disclose whether its financial statements reflect a correction to statements previously issued, its policy on the clawback of incentive-based compensation, whether any financial statement corrections are restatements that require analysis under such policy, and information about any actions taken pursuant to such policy.

BACKGROUND

Section 954 of the Dodd-Frank Act

In 2010, Section 954 of the Dodd-Frank Act added Section 10D to the Securities Exchange Act of 1934, which required the SEC to adopt a rule directing national securities exchanges to establish listing standards providing:

- That, in the event the listed issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, the issuer will recover from any of its current or former executive officers who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date the accounting restatement is required, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement; and
- For the disclosure of the listed issuer's policy on incentive-based compensation based on financial information required to be reported under the securities laws.

The requirements of Section 954, as implemented by the new rule and amendments, are in addition to existing provisions that relate to the clawback of executive compensation, such as Section 304 of the Sarbanes-Oxley Act of 2002 and Item 402 of SEC Regulation S-K. Section 304 requires the Chief Executive Officer and Chief Financial Officer of an issuer to reimburse the issuer for incentive-based and equity-based compensation if the issuer is required to prepare an accounting restatement due to material noncompliance, resulting from misconduct, with any financial reporting requirement under the securities laws. Item 402(b) of Regulation S-K requires an issuer's Compensation Discussion & Analysis to discuss, if material, its policies and decisions regarding the adjustment or recovery of awards to named executive officers if the relevant performance measures are restated or otherwise adjusted.

The new rule and amendments implement Section 954 by adding Rule 10D-1 under the Exchange Act, adding new compensation-related disclosure as Item 402(w) of Regulation S-K and making a number of conforming modifications to other SEC rules.[1]

Proposed Rules

On July 1, 2015, the SEC proposed a new rule, and rule and form amendments to implement the provisions of Section 10D. The SEC reopened the comment period on October 14, 2021, in light of developments since the proposal and the SEC's further consideration of the statutory mandate, including a broader interpretation of the statutory term "an accounting restatement due to material noncompliance."[2] The SEC

again reopened the comment period on June 8, 2022, having prepared a memorandum providing additional analysis on compensation recovery policies and accounting restatements.

REQUIRED CLAWBACK OF INCENTIVE-BASED COMPENSATION

The final rule requires listed issuers to adopt and comply with a written policy providing that, in the event the issuer is required to prepare an accounting restatement that corrects an error in previously issued financial statements that is material to the previously issued financial statements (commonly referred to as a "Big R" restatement) or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (commonly referred to as a "little r" restatement), the issuer will recover from its current and former executive officers the amount of erroneously awarded incentive-based compensation received during the three completed fiscal years immediately preceding the date the restatement is required. Clawback would be on a "no-fault" basis, without regard to any misconduct or responsibility of the executive for the erroneous financial statements.

The final rule takes the form of a direction that the national securities exchanges adopt listing standards to implement the clawback requirement. The SEC notes that the final rule establishes minimum standards and, accordingly, that the securities exchanges could adopt listing standards more stringent than those required by the rule. The SEC also notes that any listed issuer could adopt policies that are more extensive than those called for by the final listing standards applicable to it.

Executives Subject to Mandatory Clawback

The clawback requirement applies to a universe of "executive officers" that is modeled on the definition of "officer" under Section 16 of the Exchange Act. The Section 16 definition is potentially broader than the group of executive officers identified pursuant to Item 401(b) of Regulation S-K because it specifically includes the principal financial officer and principal accounting officer (or controller, if there is no principal accounting officer), in addition to the president, any vice-president in charge of a principal business unit, division or function, any other officer who performs policy-making functions for the issuer, or any other person who performs similar policy-making functions. Consistent with the definition under Section 16, any person identified as an executive officer under Item 401(b) would be presumed to be an executive officer for purposes of the clawback requirement.

The final rule includes both current and former executive officers. However, recovery would only apply to incentive-based compensation 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 recovery period. Accordingly, mandatory clawback would not apply to incentive-based compensation earned prior to the period that an executive officer served in that capacity.

Incentive-Based Compensation Covered

The clawback requirement applies to *any compensation* that is granted, earned, or vested *based wholly or in part* upon the attainment of *any financial reporting measure*. "Financial reporting measure" is defined as comprising measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from such financial information, stock price, and total shareholder return. These measures are encompassed by the definition of "financial reporting measure" whether or not they are included in a document filed with the SEC.

The SEC states that "in part" is included in the definition of covered incentive-based compensation to clarify that incentive-based compensation need not be based solely on the attainment of a financial reporting measure to be covered. The SEC provides as an example of covered incentive-based compensation a payment that is 60 percent earned if a certain revenue level is achieved (which is a financial reporting measure) and 40 percent earned if a certain number of new stores are opened (which is not a financial reporting measure).

On the other hand, the SEC expressly recognizes that not all forms of compensation would be subject to clawback under the new requirement and provides the following examples of compensation that would not be covered:

- Salaries (although a salary increase earned wholly or in part based on the attainment of a financial reporting measure is subject to recovery);
- Discretionary bonuses (unless paid from a "bonus pool" that is determined by reference to a financial reporting measure);
- Bonuses based solely on satisfying one or more subjective measures (*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.

Restatement Triggers

The final rule triggers clawback for both "Big R" restatements and "little r" restatements. This represents a departure from the rule as initially proposed, which focused on "Big R" restatements. The SEC explains in the adopting release that the broader construction encompassing "little r" restatements "addresses concerns that issuers could manipulate materiality and restatement determinations to avoid application of the compensation recovery policy."

The final rule does not provide separate definitions of "accounting restatement" and "material noncompliance" as initially proposed. The SEC clarifies in the adopting release that the final rule is not intended to affect existing guidance and accounting standards that already define such terms.

The SEC provides guidance to assist issuers in making materiality determinations, emphasizing that an issuer's materiality evaluation "should consider the effects of the identified unadjusted error on the applicable financial statements and related footnotes, and evaluate quantitative and qualitative factors." In Staff Accounting Bulletin No. 99 (Materiality), the SEC specifically identifies misstatements that have the effect of increasing management's compensation as one qualitative factor that should be considered by the issuer in making its materiality determination.

The SEC specifically discusses a number of changes to an issuer's financial statements as not representing error correction and therefore not triggering application of the mandatory clawback policy: (1) retrospective application of a change in accounting principle, (2) retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization, (3) retrospective reclassification due to a discontinued operation, (4) retrospective application of a change in reporting entity, such as from a reorganization of entities under common control, (5) retrospective adjustment to provisional amounts in connection with a prior business combination and (6) retrospective revision for stock splits, reverse stock splits, stock dividends or other changes in capital structure.

Three Fiscal Year Clawback Period

Clawback would be required for any excess covered compensation *received* during the *three completed fiscal years* immediately preceding *the date the issuer is required to prepare an accounting restatement*. For example, if a calendar year issuer concludes in November 2024 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2025, the recovery policy would apply to compensation received in 2021, 2022 and 2023.

The final rule deems covered compensation "received" in the fiscal period during which the relevant financial reporting measure is satisfied, 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. For example, an annual bonus award would be deemed received in the fiscal year for which the executive earns the award even if it is not actually paid until March of the following year. In addition, compensation would be deemed received even if it was subject to ongoing service-based vesting or other conditions after the financial reporting measure is satisfied. Many long-term incentive plans fit this profile.

For this purpose, "the date on which an issuer is required to prepare an accounting restatement" is the earlier of:

- 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 due to the material noncompliance of the issuer 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.

The SEC notes that, to the extent that an issuer is required to file an Item 4.02(a) Form 8-K, the conclusion that such issuer is required to prepare an accounting restatement is expected to coincide with the occurrence of the event disclosed in the Form 8-K. In addition, the SEC notes that, while not dispositive, a listed issuer should consider carefully any notice received from its independent auditor that previously issued financial statements containing a material error.

Determination of Excess Compensation

A listed issuer will be required to clawback the amount of incentive-based compensation received during the look-back period by the covered executive officer that exceeds the amount of incentive-based compensation that would have been received if it had been determined based on the accounting restatement. The recoverable amount is to be calculated on a pre-tax basis. For incentive-based compensation based on total shareholder return or stock price, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the amount must be based on a reasonable estimate of the effect of the accounting restatement on the applicable financial reporting measure and the issuer must maintain documentation of the determination of that reasonable estimate and provide it to the exchange.

The SEC states that, after an accounting restatement, an issuer would first recalculate the applicable financial reporting measure and then the amount of incentive-based compensation based on the measure as recalculated. The issuer would then determine whether the executive officer received a greater amount of incentive-based compensation than would have been received based on the recalculated measure, taking into account any positive or negative discretion that the issuer applied to the amount originally received.

The SEC provides guidance on how issuers should determine the portion of an award that constitutes 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, options, or SARs 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 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).

Effect of Discretion. A listed issuer should take into account any discretion that had been applied to increase or decrease the amount originally received in determining the recoverable amount. To illustrate this principle, the SEC provides two examples in which an award would be $3,000 based on a financial

reporting measure as originally reported and $1,800 following a restatement using the corrected financial reporting measure. In the first example, the issuer originally exercised negative discretion to pay out only $2,000. Taking into account the exercise of discretion, the SEC states that the recoverable amount would only be $200 (*i.e.*, $2,000 - $1,800). In the second example, the issuer exercised positive discretion to increase the $3,000 earned amount by $1,000, paying out a total of $4,000. The SEC concludes that the recoverable amount in this example would only be $1,200 (*i.e.*, $3,000 - $1,800) so long as, based on the revised measurement, the exercise of positive discretion to increase the amount by $1,000 was still permitted under the terms of the plan.

For discretionary cash awards paid from bonus pools determined in whole or in part by reference to a financial reporting measure, the size of the aggregate bonus pool would be reduced based on applying the restated financial reporting measure. However, boards may not pursue differential recovery among executive officers where the board may have exercised discretion as to individual grants in allocating the bonus pool. The SEC states that, in this example, the clawback should be *pro rata* based on the size of the original award and not discretionary.

In no case does the final rule require listed companies to reevaluate their discretionary decisions in light of the accounting restatement.

Performance Conditions Based on Stock Price or TSR. For compensation earned based on stock price or total shareholder return, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly, the recoverable amount must be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. As discussed below under "Clawback Policy – Related Disclosure Requirements," an issuer would be required to publicly disclose the basis for its determination. In addition, it would need to maintain documentation of its determination and provide the documentation to the relevant exchange.

Interaction with Sarbanes-Oxley Section 304. The final rule permits crediting of amounts an executive officer reimburses an issuer pursuant to Sarbanes-Oxley Section 304, but only to the extent that the final rule requires repayment of the same compensation by that executive officer.

Exceptions to the Clawback Obligation

Listed issuers would be required to clawback excess covered compensation unless it would be impracticable to do so, which is defined to include only (1) if the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered, (2) in the case of a foreign private issuer, if recovery would violate home country law and additional conditions are met or (3) recovery from certain tax-qualified retirement plans if recovery would likely cause such plans to fail to meet the statutory requirements for tax exemption.

A determination that clawback is impracticable must be made by the issuer's committee of independent compensation committee (or, in the absence of such a committee, a majority of the independent directors serving on the board), and, in any event, the issuer must first make and document a reasonable attempt to recover the covered excess compensation and provide the documentation to the relevant exchange. In addition, as described in "Clawback Policy – Related Disclosure Requirements" below, the issuer would be required to publicly disclose 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 listed registrant decided in each case not to pursue recovery.

Before a foreign private issuer may conclude that recovery would violate home country law, the issuer must provide to its securities exchange an opinion of counsel acceptable to the exchange. In addition, the exception is available only for laws adopted before the final version of Rule 10D-1 is published in the Federal Register. No exception is provided for local law (outside of an issuer's home country) that may apply to an executive and prohibit clawback.

The SEC notes that it does not view inconsistency between the final rule and existing compensation contracts, in itself, as a basis for finding recovery to be impracticable, because it states that issuers could amend those contracts to accommodate recovery.

The SEC also notes that it has declined to provide an exception or additional board discretion not to pursue clawbacks due to potential state law conflicts.

Manner of Recovery

The final rule provides issuers with some discretion as to how to clawback excess compensation, although the SEC declines to offer specific guidance on which methods may be appropriate.

The final rule does not permit boards to settle for less than the full recovery amount unless they satisfy one of the limited impracticability exceptions described in "Exceptions to the Clawback Obligation" above. Moreover, regardless of the manner of clawback, listed issuers are required to recover excess compensation reasonably promptly. A delay of more than 180 days would potentially require the issuer to publicly disclose the name of any current and former named executive officer from whom a balance is outstanding, as described in "Clawback Policy – Related Disclosure Requirements" below.

Prohibition on Indemnification or Issuer-Paid Insurance

The final rule prohibits a listed issuer from indemnifying any current or former executive officer against the loss of excess covered compensation. In addition, it is the SEC's position that Section 29(a) of the Exchange Act would render any indemnification agreement unenforceable to the extent it purported to undermine a listed issuer's obligation to recover excess compensation.

The SEC recognizes that executive officers may be able to purchase third-party insurance to fund potential recovery obligations. The prohibition on indemnification would also prohibit a listed issuer from paying or reimbursing an executive for premiums for such a policy.

CLAWBACK POLICY–RELATED DISCLOSURE REQUIREMENTS

New Item 402(w) of Regulation S-K[3] requires the following disclosure if at any time during or after an issuer's last completed fiscal year either (1) an accounting restatement requires clawback of excess compensation under the issuer's clawback policy or (2) there was an outstanding balance as of the end of the last completed fiscal year of excess compensation to be recovered from the application of the issuer's clawback policy to a prior restatement:

- The date on which the listed issuer was required to prepare an accounting restatement and the aggregate dollar amount of excess compensation attributable to such 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 disclosure of the amount and related disclosures 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 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 as described in "Exceptions to the Clawback Obligation" above, 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 listed registrant decided in each case not to pursue clawback; and
- For each current and former named executive officer, the amount of excess compensation still owed that had been outstanding for 180 days or longer since the date the issuer determined the amount owed.

Each listed issuer is required to file its clawback policy as an exhibit to its Exchange Act annual report.

In addition, the SEC has added check boxes to the cover page of Form 10-K, Form 20-F, and Form 40-F, by which the registrant will indicate (1) whether the included financial statements reflect correction of an error to previously issued financial statements and (2) whether any such corrections are restatements that required clawback analysis pursuant to the final rule during the relevant recovery period. If at any time during its last completed fiscal year a registrant prepared an accounting restatement and concluded that clawbacks were not required pursuant to the policy mandated by the final rule, the registrant must disclose why application of its policy resulted in this conclusion.

The SEC also requires specific data points included within the Item 402(w) disclosures, as well as block text tagging of those disclosures, to be provided in Inline XBRL (including the new cover page check boxes), rather than in a separate exhibit.

ISSUERS SUBJECT TO THE FINAL RULE

The final rule generally applies to all listed issuers, including emerging growth companies, smaller reporting companies, foreign private issuers (including Canadian MJDS filers) and controlled companies, without regard to the type of security issued, subject to the following limited exceptions:

- A security futures product cleared by a clearing agency that is registered pursuant to Section 17A of the Exchange Act or that is exempt from the registration requirements of Section 17A(b)(7)(A) of the Exchange Act;
- A standardized option issued by a clearing agency that is registered pursuant to Section 17A of the Exchange Act;
- Any security issued by a unit investment trust, as defined in Rule 80a-4(2) under the Investment Company Act of 1940 (the "Investment Company Act"); and
- Any security issued by a management company, as defined in Rule 80a-4(3) under the Investment Company Act, that is registered under Section 8 of the Investment Company Act, if such management company has not awarded incentive-based compensation to any executive officer of the company in any of the last three fiscal years, or in the case of a company that has been listed for less than three fiscal years, since the listing of the company.

EFFECTIVENESS

The final rule requires the exchanges to propose conforming listing standards within 90 days of the final rule's publication in the Federal Register and requires the standards to become effective no later than one year after publication of the final rule. Each listed issuer would then be required to adopt a clawback policy within 60 days after its exchange's listing standard has become effective.

Listed issuers are required to comply with the final rule regardless of whether the contracts under which incentive-based compensation is to be awarded were entered into prior to, on or after the effective date of the listing standard. However, the final rule provides that listed issuers are required to comply with the clawback policy only in respect of excess compensation received on or after the effective date of the applicable listing standard. Moreover, issuers will be required to comply with the disclosure requirements set forth above for any proxy or information statements or Exchange Act annual reports filed on or after the date on which any such issuer is required to have a policy under the applicable exchange listing standard.

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ENDNOTES

1 The adopting release, *Listing Standards for Recovery of Erroneously Awarded Compensation* (SEC Release No. 33-11126), is available at https://www.sec.gov/rules/final/2022/33-11126.pdf.

2 For more information, see Sullivan & Cromwell, SEC Reopens Comment Period for Clawbacks (October 18, 2021), *available at* https://www.sullcrom.com/files/upload/sc-publication-sec-reopens-comment-period-for-clawbacks.pdf.

3 The requirements for listed foreign private issuers and registered management investment companies subject to the rule would mirror the Item 402(w) disclosure.

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