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SEC APPROVES EXECUTIVE OFFICER INCENTIVE COMPENSATION CLAWBACK RULES

- APPLY TO BOTH “BIG R” AND “LITTLE R” RESTATEMENTS
- NO BOARD DISCRETION; RECOVERY TRIGGERED WITHOUT REGARD TO FAULT OR RESPONSIBILITY

Oct 27, 2022

On October 26, 2022, the SEC – by a 3-2 vote – approved final rules directing the NYSE, Nasdaq and other stock exchanges to adopt requirements for listed companies to develop and implement clawback, or recovery, policies that provide for the recovery of incentive-based compensation erroneously awarded to current or former executive officers based on a misstated financial reporting measure. A company will need to file the policy with the SEC as an exhibit to its annual report and provide detailed disclosures related to the policy and a recovery analysis where a recovery is triggered.

Background

By adopting the Dodd-Frank Act in 2009, Congress required the SEC to adopt clawback rules. The SEC initially proposed rules in 2015 and subsequently re-opened comment periods in October 2021 and again earlier this year.

Timing of effectiveness of new requirements

The rules will become effective 60 days following publication of the adopting release in the Federal Register. Exchanges must file proposed listing standards no later than 90 days following that publication date, and the listing standards must be effective no later than one year following such publication. Listed companies will be required to adopt a recovery policy no later than 60 days following the date on which listing standards become effective. The SEC does not expect compliance with the disclosure requirements until companies are required to have a policy under the applicable exchange listing standard.

Discussion of requirements

New Exchange Act Rule 10D-1 will require securities exchanges to adopt listing standards that apply the disclosure and compensation recovery policy requirements to all listed issuers, with only limited exceptions. Each listed issuer will be required to adopt a compensation recovery policy, comply with that policy, and provide the required compensation recovery policy disclosures. A company will be subject to delisting if it does not adopt and comply with a compensation recovery policy that meets the requirements of the listing standards.

Covered companies

Any company with securities listed on a national securities exchange – other than security futures products and standardized options – will be required to adopt a clawback policy. The SEC considered but declined to exempt emerging growth companies (EGCs), smaller reporting companies (SRCs) and foreign private issuers (FPIs), among others.

Inclusion of both "Big R" and "little r" restatements

As previously signalled by the SEC, the rule covers both types of restatements:

- Those that correct errors that are material to previously issued financials ("Big R" restatements); and
- Those that correct errors that are not material to previously issued financials, but would result in a material misstatement if (a) the errors were left uncorrected in the current period or (b) the error correction were recognized in the current period ("little r" restatements).

A "Big R" restatement requires a company to file an Item 4.02 Form 8-K and amend its filings to restate the previously issued financials. By contrast, a "little r" restatement generally does not trigger an 8-K, and a company may make any corrections the next time it files the earlier financials. The SEC believes inclusion of "little r" restatements reduces the ability of companies to "manipulate materiality and restatement determinations to avoid the application of" clawback policies.

The SEC acknowledged that an "out-of-period adjustment" – i.e., the correction of an error that is recorded in the current financials where the error is immaterial to both the previous and current financials – would not constitute an accounting restatement.

Starting date for three-year incentive compensation look-back

The three-year look-back will be measured from the earlier of:

- The date the board or committee, or an authorized officer, concludes, or reasonably should have concluded, that the company is required to prepare an accounting restatement due to the company's material noncompliance with any financial reporting requirement under securities laws; or

- The date a court, regulator or other legally authorized body directs the company to prepare an accounting restatement.

The SEC added the "reasonably should have concluded" element to address the potential for manipulation of the recovery date by delaying the restatement determination. It believes the increased risk of litigation over the board's conclusion is "acceptable" in order to deter such manipulation.

The SEC noted that the look-back is triggered merely by concluding a restatement is required, even if the precise amount of the error has not been determined.

Covered officers

The individuals subject to recoupment include any current or former executive officers for purposes of Form 10-K disclosure, in order to encompass officers "with policy making functions," and expressly includes Section 16 officers, in order to encompass officers "with an important role in financial reporting." The rule will only require recovery of 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. The rule excludes compensation received in a non-executive capacity before becoming an executive officer.

The SEC declined to limit recoupment to more limited categories of individuals such as NEOs or officers with financial reporting responsibilities, viewing that as inconsistent with the Dodd-Frank Act's specific reference to executive officers. Moreover, the SEC believes senior officers "play an important managerial role and help set the tone at the top," and thus can help "reduce the likelihood of inadvertent misreporting."

Definition of "incentive-based compensation" subject to clawback

As defined in the final rule, "incentive-based compensation" means "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure." The adopting release at pages 64-65 lists examples of incentive-based and non-incentive-based compensation for purposes of the rule.

Definition of "financial reporting measures"

Financial reporting measures include:

- Both GAAP and non-GAAP financial reporting measures, as well other measures, metrics and ratios that are not non-GAAP, such as same-store sales, whether or not included in an SEC filing; and
- Stock price and total shareholder return (TSR), even though not accounting-based because, according to the SEC, "improper accounting affects such measures and in turn results in

excess compensation."

The SEC acknowledges that companies "may need to engage in complex analyses that require technical expertise and specialized knowledge and may involve substantial exercise of judgment in order to determine the stock price impact of [an accounting] error," but believes the additional costs are justified in light of the objectives of the statute. The rule permits companies to use reasonable estimates when assessing the impact of a restatement on stock price and TSR.

When compensation is "received" and time period covered

Incentive-based compensation will be deemed received in the fiscal period during which the financial reporting measure specified in the award is attained, even if the payment or grant occurs after the end of that period.

The time period covered for the recovery policy will be the three completed fiscal years immediately preceding the date the company is required to prepare an accounting restatement. The rule addresses situations where a company changes its fiscal year during the look-back period.

Calculation of erroneously awarded compensation

The new rule defines the amount of incentive-based compensation subject to a company's recovery policy ("erroneously awarded compensation") as "the amount of incentive-based compensation received by the executive officer 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 accounting restatement," computed without regard to taxes paid.

When compensation is based on TSR or stock price and 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 measure. Further, the company must maintain documentation of the determination of the estimate and provide it to the exchange.

The SEC declined to address specific forms of incentive-based compensation in the rule, instead setting forth general guidance to calculate recoverable amounts on pages 78-80 of the adopting release.

The calculation of recoverable amounts does not take into account any taxes incurred or paid by the executive. The SEC believes that "any resulting tax burden should be borne by executive officers, not the issuer and its shareholders."

The SEC believes that any amounts recovered pursuant to SOX Section 304 can be credited to the required recovery under a company's clawback policy. However, it believes that recovery under the new rules would not prevent recovery under SOX Section 304, to the extent any applicable amounts have not been reimbursed to the company.

No board discretion whether to seek recovery; three exceptions for impracticability

The new rule will require companies to recover erroneously awarded compensation in compliance with their recovery policies except in three instances due to impracticability. The SEC believes the Dodd-Frank Act does not permit conditioning recovery based on the board's discretion or on a determination of an individual's fault or responsibility.

The three impracticability exceptions are:

- Where the direct cost of recovery payable to a third party, such as legal expenses and consulting fees, would exceed the amount of recovery; the company has made a reasonable attempt to recover; and the company provides documentation of its attempts to the exchange;
- Recovery would violate home country law that was adopted before the date of publication in the Federal Register, and the company provides an opinion of home country counsel acceptable to the exchange that recovery would violate such law; or
- Recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.

Any determination of impracticability is required to be made by the compensation committee (or, if none, a majority of independent directors), subject to review by the stock exchange.

The SEC acknowledged that the requirement may conflict with existing compensation arrangements. However, it notes that companies have been on notice of the statutory mandate for a number of years and, further, companies have more than a year from the date of publication in the Federal Register to implement any necessary amendments.

Prohibition on indemnification and insurance

The new rules prohibit companies from insuring or indemnifying covered individuals against the loss of erroneously awarded compensation, including de facto indemnification by modification of compensation arrangements. Further, the SEC believes the Exchange Act would render any indemnification agreement void and unenforceable, to the extent it purports to relieve the company from its recovery obligations.

Board discretion regarding means of recovery

The SEC provides guidance at pages 98-100 of the adopting release to assist boards in exercising discretion regarding the means of recovery, as permitted under the rule. The SEC emphasized that boards may not settle for less than the full recovery amount, unless one of the impracticability exceptions applies. Further, the rule requires companies to seek recovery "reasonably promptly," which "may depend on the additional cost incident to recovery efforts."

Additional disclosure requirements for listed companies

The new rule requires and/or includes the following:

- Disclosure of the policy related to recovery of erroneously awarded compensation;
- Filing the policy as an exhibit to annual reports on Form 10-K pursuant to amended S-K Item 601(b)(97) or corresponding requirements for listed FPIs; and
- Disclosure on how companies have applied their recovery policies, pursuant to new S-K Item 402(w), including:
  - The date a company was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such restatement (including an analysis of how the recoverable amount was calculated) or, if not yet determined, an explanation of the reasons, with updated disclosure in the next filing;
  - The aggregate dollar amount that remains outstanding at the end of the fiscal year and any outstanding amounts due from any current or former named executive officer for 180 days or more;
  - For TSR or stock-price based compensation, the estimates used to determine the amount of erroneously awarded compensation and an explanation of the methodology used; and
  - Details regarding any reliance on the impracticability exceptions, with aggregated disclosure permitted except with respect to current and former named executive officers.
- Additionally, if at any time during the last fiscal year a company prepared an accounting restatement and concluded that recovery of erroneously awarded compensation was not required pursuant to its policy, the company must briefly explain why application of the policy resulted in such conclusion.
- Such disclosure is only required for proxy or information statements that include Item 402 disclosure and annual reports such as Form 10-K; such information will not be incorporated into Securities Act filings unless a company specifically acts to do so. Initial disclosure will be required in the first proxy and information statement, and annual report, filed after the issuer adopts its recovery policy.
- New instructions for the Summary Compensation Table to address adjustments for any recovered amounts.
- Tagging of the compensation recovery disclosures in Inline XBRL.
- Additional check box disclosure on the cover of Forms 10-K, 20-F, and 40-F as to:

- Whether the financials included in the filing reflect correction of an error to previously issued financials; and
- Whether any of those error corrections are restatements that required a recovery analysis of incentive-based compensation received by any of the company's executive officers during the relevant recovery period.

Concerns of dissenting Commissioners

Commissioner Peirce viewed the new rules as too broad, inflexible and impractical.

- Too broad, by including "little r" restatements that involve immaterial errors; too many employees covered; by applying to all listed companies without accommodation for EGCs or SRCs; and by applying to non-accounting based incentive compensation;
- Too inflexible, by not providing discretion to stock exchanges or boards to determine the scope and triggers for policies or an alternative for companies to disclose policies and recoupments on websites instead of annual reports; and
- Impractical, by not providing for a de minimis threshold, by subjecting lower level officers to recoupment, regardless of amounts involved, and by covering "little r" restatements that would require recoupment analysis and efforts, despite lower potential dollar amounts due to their immateriality. Further, litigation risk arises out of the inclusion of trigger dates based on when the board "reasonably should have concluded" a restatement was required and the requirement for companies to act "reasonably promptly," which may also discourage cost mitigation practices such as netting or setting-off.

Commissioner Uyeda criticized the SEC's failure to update the economic analysis conducted in 2015 when it re-opened the comment period on the clawback proposal in 2021 and 2022. He believes the inclusion of "little r" restatements is inconsistent with the Dodd-Frank mandate and unsupported by underlying data. He also views the 30-day comment periods in 2021 and 2022 as unduly short.

Recommendations for listed companies

- Begin preparation of required clawback policies; consider whether the scope of any existing policy conforms to SEC requirements and/or whether to extend new or existing policies beyond covered employees and/or the mandated recovery period;
- Review existing employment and compensation agreements, awards and other arrangements with covered officers to determine if any amendments may be needed in view of the new clawback rules and policies; and

- Evaluate the impact of the clawback rules and company policies and their effect on executive motivation; whether to adjust performance metrics or the mix of incentive and non-incentive based compensation.

DOJ's recent focus on compensation clawbacks as a remedial measure

The SEC is not alone in its focus on compensation clawbacks. On September 15, 2022, DOJ released the Monaco Memo, which instructs prosecutors to evaluate the remediation a company has taken to address corporate misconduct. DOJ highlights compensation clawbacks as a remedial measure to align the interests of the C-Suite and the compliance department. Yet, unlike the SEC, the DOJ does not suggest limiting clawbacks to incentive-based compensation. Instead, DOJ notes that a factor for prosecutors to consider in their assessment of a compliance program is "whether the corporation's compensation agreements, arrangements, and packages (the "compensation systems") incorporate elements such as compensation clawback provisions that enable penalties to be levied against current or former employees, executives, or directors whose direct or supervisory actions or omissions contributed to criminal conduct." DOJ implies that the clawback provision itself is not enough, and "prosecutors should consider whether, following the corporation's discovery of misconduct, a corporation has, to the extent possible, taken affirmative steps to execute on such agreements and clawback compensation previously paid." By year end, further guidance is expected from DOJ to specifically address how it will reward corporations that develop and apply the compensation clawback policies when misconduct is discovered.

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