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Securities and Exchange Commission Adopts Executive Compensation Clawback Rules

By Kerry T. Wenzel

In this article, the author reviews the new rules adopted by the Securities and Exchange Commission requiring companies to claw back erroneously awarded compensation.

The Securities and Exchange Commission (SEC) has adopted final rules¹ that require each listed issuer to adopt a compensation clawback policy pursuant to Section 954 of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act. The SEC first proposed compensation clawback rules in 2015 and reopened the comment period in October 2021 and again in June 2022.

The final rules direct the national securities exchanges to establish listing standards requiring that any registrant that has a class of securities (whether equity or debt) listed on a national securities exchange adopt and disclose a clawback policy. If a company is required to prepare an accounting restatement, the clawback policy must require the company to recover incentive-based compensation received by any current or former executive officer if such compensation was based on erroneously reported financial information. The compensation

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clawback policy must mandate recovery regardless of fault or responsibility for the error or resulting restatement, with limited exceptions.

The SEC adopted the proposed rules substantially as proposed, with certain modifications noted below (the most significant modification arguably being broadening the scope of covered restatements).

This article takes stock of the new rule and what companies must do to comply, explaining:

- How the clawback policy is triggered;
- The compensation subject to the policy; and
- The disclosures that are required.

COVERED ISSUERS

All listed issuers – including emerging growth companies, smaller reporting companies, foreign private issuers, controlled companies, and debt-only issuers – are required to comply with the final rules, with limited exemptions for the listing of certain securities futures products, standardized options, securities issued by unit investment trusts, and securities issued by certain registered investment companies.

RESTATEMENTS TRIGGERING APPLICATION OF CLAWBACK POLICY

The final rules provide that the clawback policy must be triggered when the issuer is required to prepare an accounting restatement that corrects an error in previously issued financial statements that is material to those 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. This is a significant change from the proposed rule, which limited the triggering event to restatements for errors that are material to the issuer's previously issued financial statements.

The final rules provide that the statutory language of Dodd–Frank can be read to include both “Big R” and “little r” restatements, noting that both are considered “accounting restatements” under U.S. GAAP and IFRS because both result in revisions of previously issued financial statements for a correction of an error in those financial statements and that both types of restatements address material noncompliance with financial reporting requirements.

COVERED EXECUTIVE OFFICERS

“Executive officers” covered by the policy must include the issuer’s president, principal financial officer, principal accounting officer (or if there is no accounting officer, the controller), any vice president 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 for the issuer, or any other person who performs similar policymaking functions for the issuer. Executive officers of the issuer’s parents or subsidiaries would be deemed executive officers of the issuer if they perform policymaking functions for the issuer. This group should mirror the issuer’s Section 16 officer group.

While the policy must apply to current or former executive officers, the final rule only requires recovery of incentive-based compensation received by a person after beginning service as an executive officer and if that person served as an executive officer at any time during the recovery period.

This is a welcome change from the proposed rule, which would have required recovery from individuals for incentive-based compensation received before they became an executive officer.

THREE-YEAR LOOKBACK MEASUREMENT PERIOD

The applicable three-year lookback period covers the three completed fiscal years immediately preceding the date on which the issuer is required to prepare an accounting restatement. That date is considered to occur on the earlier of (1) the date the board or committee concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement, or (2) the date a court, regulator, or other legally authorized body directs the issuer to prepare an accounting restatement.

Incentive-based compensation will be deemed to have been “received” by the executives in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award was attained, even if the payment or grant occurred after the end of that period.

COMPENSATION SUBJECT TO THE CLAWBACK POLICY

The clawback policy must apply to “incentive-based compensation,” which is defined to include any compensation (including options and other equity awards) that is granted, earned, or vested based wholly or in part upon the attainment of any “financial reporting measure.”

“Financial reporting measures” include any measures that are determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements (including non-U.S. GAAP financial measures), any measures derived wholly or in part from such financial information, and stock price and total shareholder return.

The final rules specifically provide that options and other similar equity awards whose grant or vesting is based wholly or in part upon the attainment of financial reporting measures are incentive-based compensation. They also provide the following examples of incentive-based compensation:

- Non-equity incentive plan awards earned based wholly or in part on satisfying a financial reporting measure performance goal;
- Bonuses paid from a “bonus pool,” the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal;
- Other cash awards based on satisfaction of a financial reporting measure performance goal;
- Restricted stock, restricted stock units, performance share units, stock options, and stock appreciation rights that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal; and
- Proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal.

Examples of compensation that are *not* considered incentive-based include:

- Salaries;
- Bonuses paid solely at the discretion of the compensation committee or board that are not paid from a bonus pool, the size of which is determined based wholly or in part on 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, or 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 non-financial reporting measures.

DETERMINATION OF THE RECOVERABLE AMOUNT

The recoverable amount, or the erroneously awarded compensation, is 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. Recoverable amounts related to incentive-based compensation that was based on stock price or total shareholder return must be determined by the issuer based upon a reasonable estimate of the effect of the accounting restatement on the issuer's stock price or total shareholder return.

While the final rules note that the determination of erroneously awarded compensation is a principles-based determination, the final rules also offer limited guidance, providing that erroneously awarded compensation is, in the case of cash awards, 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 and in the case of cash awards paid from bonus pools, 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 stock appreciation rights (SARs) are still held at the time of recovery, the erroneously awarded compensation is the number of such securities received exceeding 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).

ISSUER DISCRETION

Recovery of erroneously awarded compensation is mandatory, unless the issuer's compensation committee (or, in the absence of a compensation committee, a majority of the independent directors serving on the board) determines that recovery would be impracticable because of one of the following:

- After making a reasonable attempt at recovery, the issuer determines that further pursuit of recovery would be impracticable because it would impose undue costs on the issuer or its shareholders (i.e., the cost of recovery would exceed the clawback amount);
- The issuer determines that recovery would violate home country law, provided certain conditions are met; or
- Recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the applicable requirements under the tax code. Erroneously awarded incentive-based compensation contributed to SERPs and other nonqualified plans would continue to be subject to recovery.

REQUIRED DISCLOSURE

The clawback policy must be filed as an exhibit to an issuer's Annual Report on Form 10-K or 20-F. In addition, the final rules amend the executive compensation disclosure rules by adding a new Item 402(w) of Regulation S-K, which requires disclosure of the issuer's enforcement of the policy.

Specifically, if at any time during its last completed fiscal year the issuer triggered its clawback policy, or there was an outstanding balance subject to recoupment related to a prior enforcement of the policy, the issuer is required to disclose:

- The date on which the issuer was required to prepare an accounting restatement; the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement or, if the amount has not been determined, an explanation of the reasons; and disclosure of the amount and related disclosures in the next applicable filing.
- The aggregate dollar amount of erroneously awarded compensation that remained outstanding at the end of its last completed fiscal year.

- If the financial reporting measure is related to a stock price or total-shareholder-return metric, the estimates used to determine the amount of erroneously awarded compensation attributable to the accounting restatement and an explanation of the methodology used for the estimates.
- If recovery would be impracticable as contemplated by the final rules, for each current and former named executive officer and for all other current and former executive officers as a group, the amounts of recovery forgone and a brief description of the reason the issuer decided not to pursue recovery.
- For each current and former named executive officer, the amount of erroneously awarded compensation still owed that had been outstanding for more than 180 days.

In addition, in a modification to the proposed rules, if at any time during or after its last completed fiscal year the registrant was required to prepare an accounting restatement, and the registrant concluded that recovery was not required, the registrant must include a brief explanation of its conclusion.

The information provided under Item 402(w) will not be deemed to be incorporated by reference into any filing under the Securities Act.

In addition, a new instruction to the Summary Compensation Table requires that any amounts recovered pursuant to an issuer's compensation recovery policy reduce the amount reported in the applicable column, as well as the "total" column, for the fiscal year in which the amount recovered was initially reported, and be identified by footnote.

Listed companies are required to block-text tag the disclosure in an interactive data format using eXtensible Business Reporting Language (XBRL). The final rules also amend the cover pages of Form 10-K, Form 20-F, and Form 40-F to add check boxes that indicate separately (1) whether the financial statement of the registrant included in the filing reflects correction of an error to previously issued financial statements, and (2) whether any of those error corrections are restatements that required a recovery analysis of incentive-based compensation received by any of the registrant's executive officers during the relevant recovery period.

CONSEQUENCES OF NONCOMPLIANCE

An issuer would be subject to delisting if it does not adopt a clawback policy that complies with the applicable listing standard, disclose the policy in accordance with SEC rules, and comply with the policy's recovery provisions.

EFFECTIVE DATE

The final rules will be effective 60 days following publication in the Federal Register, and each exchange is required to file its proposed listing standards no later than 90 days following publication. The listing standards must become effective no later than one year following that publication date. Each issuer subject to these listing standards will be required to adopt a recovery policy no later than 60 days following the date on which the applicable listing standards become effective. Given these requirements, the rules are expected to become effective in early 2024.

In a modification from the proposal, the final rules will not be retroactive (i.e., the mandated recovery policy will not be applicable to compensation that was granted before the effective date of the rules). Instead, the final rules provide that each listed issuer is required to comply with the recovery policy for all incentive-based compensation received by current or former executive officers on or after the effective date of the applicable listing standard.

NEXT STEPS

Whether or not issuers have clawback policies currently in place, there is significant work to be done. Issuers will need to revise their existing clawback policies, in some cases significantly, to comply with the final rules, and issuers without policies should begin thinking about what a compliant policy looks like for them.

In both cases, issuers will also need to review the impact of the new rules on their existing incentive arrangements and disclosure and what impact the rules may have on new compensation arrangements going forward.

While there is time before the exchanges issue their listing standards, issuers should begin to educate their compensation committees, management, and others that are involved in implementing compensation programs regarding the new requirements and what the final rules mean for the issuer's compensation program.

NOTE

1. <https://www.sec.gov/rules/proposed/2015/33-9861.pdf>.

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