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BLOG

SEC Adopts Final Compensation Clawback Rules; Companies Should Begin Preparing for New Requirements

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On October 26, 2022, the Securities and Exchange Commission ("SEC") adopted the long-awaited new Rule 10D-1 (the "Final Rule"), implementing the incentive-compensation clawback rules mandated by Section 10D of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), originally added to the Exchange Act by Section 954 of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd–Frank Act"). The Final Rule is separate and distinct from the clawback mandates set forth in the Sarbanes–Oxley Act. The SEC initially released proposed rules in 2015 and reopened the comment period on the proposal in October 2021 and again in June 2022.

The Final Rule directs national securities exchanges to adopt listing standards that require issuers[1] to:

- adopt—and comply with—a clawback policy providing for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers following an accounting restatement;
- disclose the issuer's clawback policy as an exhibit to its annual report filed with the SEC; and
- annually disclose any activity to recover such erroneously awarded compensation during its last completed fiscal year.

Issuers that do not comply with the Final Rule will be subject to delisting by their national securities exchange.

Specifics of the Final Rule

Overview

The Final Rule requires national securities exchanges to adopt listing standards that will subject an issuer to delisting if it does not adopt a clawback policy with the following requirements:

- in the event the issuer is required to prepare an accounting restatement, the policy should provide that the issuer will recover incentive-based compensation paid to current or former "executive officers" (defined below) based on any misstated financial-reporting measure;

- the policy should cover affected compensation received during the three completed fiscal years immediately preceding the date the company concludes, or reasonably should have concluded, that an accounting restatement was necessary; and
- the amount of affected compensation recoverable under the policy by the issuer is calculated on a pretax basis and equals the excess over the amount that would have been paid to the executive officer if it had been determined based on the accounting restatement.

Key Points

Recovery Triggered by Big "R" and Little "r" Accounting Restatements

Under the Final Rule, a clawback policy must require recovery when "accounting restatements" correct an error in the issuer's previously issued financial statements that either is material to those previous financial statements (a "Big 'R' Restatement") or would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (a "Little 'r' Restatement"). Little "r" Restatements can be understood as anything a company deems material enough to correct, but not significant enough to announce formally.

The Final Rule expands the clawback triggers announced under the 2015 proposed rules, which included only Big "R" (*not* Little "r") Restatements.

Applies to Current and Former Section 16 Officers; No Indemnification Permitted

The definition of "executive officers" under the Final Rule mirrors the definition of "officer" under Section 16 of the Exchange Act.[2] The Final Rule applies to all current and former Section 16 officers who received incentive-based compensation based on misstated financial-reporting measures, regardless of whether an officer was directly responsible for the accounting error requiring correction. The SEC acknowledged that the broad definition of "executive officer" may "result in recovery from officers who did not play a direct role in an accounting error or who did not help to set a 'tone at the top' that affects financial reporting accuracy[,]" but has insisted that such outcomes are consistent with the statutory purpose of recovering compensation *erroneously* paid to such officers.

In addition, issuers are prohibited from insuring or indemnifying any current or former Section 16 officers against the loss of erroneously awarded compensation.

Incentive-Based Compensation Includes Compensation Based on Financial-Reporting Measures

Under the Final Rule, "incentive-based compensation" includes any compensation (e.g., equity awards, bonus payments, stock awards, or cash awards) granted, earned, or vested based wholly or in part on the attainment of a "financial reporting measure," which generally refers to any measure used to prepare an issuer's financial statements. Financial-reporting measures may include both GAAP and non-GAAP measures (such as revenues, operating income, net assets, EBITDA, and financial ratios), as well as stock price and total shareholder return ("TSR"), regardless of whether the measure appears in an issuer's financial statements or SEC filings.

For illustrative purposes, the chart below sets forth a nonexhaustive list distinguishing between forms of compensation that are incentive based and forms of compensation that are not incentive based:

EXAMPLES OF COMPENSATION THAT IS	
"INCENTIVE-BASED COMPENSATION"	***NOT*** **"INCENTIVE-BASED COMPENSATION"**

EXAMPLES OF COMPENSATION THAT IS

- nonequity incentive plan or other cash award earned wholly or in part on satisfying an FRM* performance goal;
- equity awards that become vested wholly or in part on satisfying an FRM performance goal;
- equity awards where the number of shares underlying the award at the time of grant is determined by satisfying an FRM 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 an FRM performance goal.

- salary (*except* for certain increases based on satisfying an FRM performance goal);
- bonuses paid solely upon satisfying subjective standards (e.g., demonstrated leadership and/or completion of an employment period);
- nonequity incentive plan awards paid solely upon satisfying strategic measures (e.g., change in control) or operational measures (e.g., project completion); and
- equity awards for which the award is not contingent upon achieving any FRM performance goal and vesting is contingent solely upon continued service and/or attaining a non-FRM measure (e.g., most time-vested restricted stock units).

**Stands for "financial reporting measure"*

Challenges of Treating Stock Price and TSR as Financial-Reporting Measures

Despite concerns from commenters regarding the costs, uncertainty, and subjectivity of calculating amounts of recoverable compensation with respect to the calculation of stock price and TSR, the SEC explicitly included these measures in the final definition of "financial reporting measures." The Final Rule does permit issuers to use reasonable estimates to assess the effect of an accounting restatement on stock price and TSR when determining the amount of erroneously awarded compensation that is recoverable. In such instances, issuers are required to maintain documentation of the reasonable estimate determination and provide a copy to the issuer's national securities exchange.

Primary Disclosure Implications

An issuer must include its clawback policy as an exhibit to its annual report on Form 10-K, Form 20-F or Form 40-F,[3] as applicable, and indicate by checkboxes on the annual report's cover page (i) if errors to previously issued financial statements required correction and (ii) whether such errors required a recovery under the policy. An issuer must disclose in its annual report and any proxy or information statements that require disclosure pursuant to Item 402 of Regulation S-K how it applied its clawback policy, including, as relevant:

- the date of the required accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable thereto, including estimates used in calculating the amount in the case of awards based on stock price or TSR;
- the aggregate amount still outstanding and any outstanding amounts due from any current or former named executive officer (NEO) for 180 days or more; and
- details regarding reliance on any recovery exceptions (described below).

Any clawback recovery disclosures are required to be tagged using Inline XBRL.

Exceptions to Recovery; Issuer Discretion Over "Reasonably Prompt" Recovery Method

Limited exceptions to enforcement apply and involve situations where (1) the direct costs paid to a third party to enforce the clawback policy would exceed the amount of the compensation recovery, (2) recovery would violate a foreign private issuer's home-country law (only if that law was in place before the Final Rule is published in the Federal Register), or (3) recovery would jeopardize the tax qualification of a retirement plan (so long as benefits under the plan may not be assigned or alienated). The SEC did leave the method of recovery (e.g., lump-sum repayment, forfeiture of future equity awards, structured payment plan) up to the discretion of the issuer; provided that the ultimate recovery is "reasonably prompt"—a standard the SEC purposefully left undefined.

Timing Considerations

Issuer Adoption

The Final Rule will be effective 60 days after being published in the Federal Register. The national securities exchanges are required to file proposed listing standards within 90 days of the date the Final Rule is published in the Federal Register. The proposed listing standards must become final and effective no later than the first anniversary of the date the Final Rule is first published in the Federal Register, and the standards must require issuers to adopt clawback policies no later than 60 days following such effective date. Generally, issuers must begin to comply with the Final Rule's disclosure requirements in the issuer's proxy or information statement and annual report filed on or after the date the issuer adopts its clawback policy.

Application to Compensation Awarded before Final Rule Is Effective

The Final Rule provides that an issuer must apply its clawback policy to any incentive-based compensation "received" by a current or former executive officer on or after the effective date of the applicable listing standard, as opposed to the effective date of the Final Rule. Incentive-based compensation is deemed received in the issuer's fiscal period during which the financial-reporting measure specified in the award is attained, even if the payment or grant of the incentive-based compensation occurs after the end of such period.[4] As a result, executive officers could have incentive-based compensation that is the subject of a compensation contract or arrangement that existed prior to the effective date of the Final Rule that would not be deemed to have been received until after the effective date of the applicable listing standards—and therefore would be subject to an issuer's clawback policy under the Final Rule.

Takeaways

The Final Rule represents a broad interpretation of the SEC's mandate under the Dodd–Frank Act as reflected in Section 10D of the Exchange Act.

Public companies impacted by the Final Rule, and their compensation committees, should begin preparing for compliance with the new clawback requirements and consider taking the following steps:

- **Review Existing Clawback Policies.** Issuers should review their existing clawback policies against the Final Rule and the listing standards implementing the rule. Since the exhibit requirements of the Final Rule only require disclosure of an issuer's clawback policy as it relates to the listing standards of its national securities exchange, issuers should assess whether it makes sense to amend existing policies to comply with the Final Rule—subjecting such policies to public disclosure—or whether adoption of a new policy covering the listing standards is preferable.
- **Review Existing Incentive-Compensation Plans and Award Agreements.** Issuers should (i) identify and evaluate existing incentive-based-compensation plans or agreements, (ii) make any amendments necessary to subject future awards under such plans to the issuer's Rule 10D-1–compliant clawback policies, and (iii) determine the extent to which the Rule 10D-1–compliant policies would apply to arrangements entered into before the effective date of the Final Rule. Issuers should consider whether additional consideration is necessary to allow for the enforcement of a new policy that could apply retroactively to incentive-based compensation "received" after the effective date of the national securities exchanges' listing standards.
- **Review Existing Indemnification, Insurance, and Attorneys'-Fees Provisions.** Issuers should review any existing arrangements, including incentive-based-compensation arrangements, in which current or former Section

16 officers participate to identify any provisions that would require indemnification, insurance, or increased compensation to cover a compensation clawback and revise them if necessary to comply with the Final Rule. Additionally, issuers should assess the impact of the Final Rule on provisions requiring advancement or reimbursement of attorneys' fees to such officers.

- **Going Beyond the Final Rule.** For some issuers, the Final Rule may be a floor and not a ceiling on their clawback policies; a broader policy may provide desired deterrent effects that are worth the cost of administration. Many public companies have adopted policies that cover situations unrelated to financial-reporting measures, including breach of restrictive covenants and misconduct resulting in financial or reputational harm. For example, the "MeToo" movement encouraged many companies to voluntarily incorporate sexual harassment and other reputational-harm considerations as a clawback trigger on the grounds that inappropriate behavior by an executive can have an impact on an issuer's reputation and share price. In addition, proxy advisory organizations such as ISS and Glass Lewis incorporate assessments of the quality of an issuer's clawback policy into their recommendation metrics, and a stronger clawback policy could potentially result in stronger overall ratings.
- **Impact on Design of Incentive-Compensation Programs.** It is too early to tell whether the cost of compliance with the Final Rule, in particular with respect to Little "r" Restatements, will have any appreciable impact on the design of public companies' incentive-compensation programs, particularly with respect to section 16 officers whose compensation is not publicly reported and thus would not impact an issuer's ability to receive a "for" recommendation from ISS or Glass Lewis on the issuer's say-on-pay vote. Issuers should continue to consult with their compensation consultants and other advisors regarding the impact the Final Rule may have on the design of their incentive-compensation programs, including assessing how companies that the issuer benchmarks against for compensation purposes are responding.

Please contact any member of the Winston & Strawn Employee Benefits and Executive Compensation Practice Group or your regular Winston contacts for further information.

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[1] The Final Rule generally applies to any company with securities listed on a U.S. national securities exchange that is registered under section 6 of the Exchange Act, other than certain registered investment companies and management companies. This means that foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies, and issuers of nonequity securities are all subject to the rule.

[2] For purposes of Section 16 of the Exchange Act, an "executive officer" includes 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; or any other person who performs similar policy-making functions for the issuer, including if the individual is employed by the issuer's parent or subsidiary.

[3] Foreign private issuers and Canadian filers who qualify under the multijurisdictional disclosure system file annual reports on Form 20-F and Form 40-F, respectively. Like the Form 10-K, the Form 20-F and Form 40-F will be amended to reflect the Final Rule's disclosure requirements.

[4] For example, a performance stock unit where the number of units earnable is determined following a three-year performance period but the units remain subject to forfeiture over an additional two-year service period is deemed "received" for purposes of the Final Rule at the end of the three-year performance period as opposed to two years later, when the award is finally settled.

10 Min Read

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