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Securities and Exchange Commission Adopts Final Rules on Executive Compensation Clawbacks

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This article reviews the final rules adopted recently by the Securities and Exchange Commission regarding compensation clawbacks and identifies several significant issues that issuers should begin to focus on now and over the next year in advance of the 2024 reporting season, when the final rules are expected to first apply for most issuers.

The U.S. Securities and Exchange Commission (SEC) has adopted Rule 10D-1¹ and other rule amendments (Final Rules) as required by Section 10D of the Securities Exchange Act of 1934 (Exchange Act).² The Final Rules require national securities exchanges to adopt listing standards under which issuers must implement (and enforce) policies that require the clawback of incentive-based compensation received by any current or former executive officer during the three completed fiscal years immediately preceding the date of a required restatement of an issuer's filed financial statements due to the issuer's material noncompliance with any financial reporting requirement under the securities laws. The Final Rules also affect related disclosure items, including the disclosure of executive compensation under Item 402 of Regulation S-K.

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As SEC Chair Gary Gensler highlighted in a statement³ released on the same day as the adoption of the Final Rules, Congress's decision to require what has become the Final Rules "built upon the earlier requirements they passed as part of the Sarbanes-Oxley Act in 2002 (SOX), which requires chief executive officers and chief financial officers who commit misconduct in connection with their companies' financials to return incentive-based pay from the previous 12 months."

Indeed, the clawback provisions of the Final Rules go well beyond the SOX clawback requirements. Moreover, the Final Rules affect corporate governance, proxy statement disclosure and Form 10-K annual reporting, and boards of directors and compensation committees will need to determine how clawbacks would work under each of the issuer's incentive compensation plans. Issuers that already have clawback policies will want to carefully consider the impact of the Final Rules and evaluate whether adjustments are needed to those policies.

This article reviews the Final Rules and identifies several significant issues that issuers should begin to focus on now and over the next year in advance of the 2024 reporting season, when the Final Rules are expected to first apply for most issuers.

KEY POINTS

Clawback policies must include as trigger events both (i) "big R" restatements (where issuers must restate previously-filed financial statements to correct errors that are material to such financial statements), and (ii) "little r" restatements (which generally correct errors that would result in a material misstatement if the errors were left uncorrected in the current report or if the correction of the error was recognized in the current period).⁴

Compensation clawbacks would not be required, however, where the correction of a previous error is recorded in the current period financial statements (referred to as an out-of-period adjustment) because the error is immaterial to both the previously issued financial statements and to the current period – and, as such, there is no restatement. The SEC provided certain examples of adjustments to previously-issued financial statements that need not trigger the clawback obligation, such as the retrospective application of a change in accounting principles, retrospective revisions to segment information to reflect changes in the issuer's business, retrospective revisions for stock splits, reverse stock splits and other changes in an issuer's capital structure, and other similar retrospective changes not based on material errors in previously-issued financial statements.

The following are additional key points from the Final Rules:

- Compensation subject to clawback policies must include any incentive-based compensation (including cash and equity

awards) that is granted, earned or vested based wholly or in part upon the attainment of any “financial reporting measures.”

- Clawback policies must apply to incentive-based pay received by current and former executive officers during the three completed fiscal years immediately preceding the date that the issuer is required to prepare an accounting restatement, regardless of whether those executives were at fault with respect to any of the errors leading to the restatement. Incentive-based compensation is deemed to be “received” upon the satisfaction of the relevant performance condition, even if the compensation is not actually paid, granted or deemed vested until a later date.
- “Executive officers” are defined as the issuer’s president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division or function, and any other person who performs significant policy-making functions for the issuer. Executive officers of the issuer’s parent(s) or subsidiaries are deemed executive officers of the issuer if they perform such policy making functions for the issuer. Executive officers include, at a minimum, executive officers identified for purposes of proxy statement disclosure.
- An issuer may not indemnify any current or former executive officers against recoveries under its clawback policy and may not pay or reimburse such executives for insurance plan premiums that would allow for the retention or recovery of erroneously paid incentive-based compensation under such clawback policy.
- With very limited exceptions, most companies listed on national securities exchanges will be covered by the Final Rules.

TIMELINE FOR EFFECTIVENESS OF THE FINAL RULES

Each national securities exchange is required to file its proposed listing standards relating to the clawback policies no later than 90 days following the date of publication of Rule 10D-1 in the Federal Register. The listing standards must become effective within a year of the Federal Register publication date. Issuers subject to such listing standards are required to adopt a clawback policy no later than 60 days following the date on which the applicable listing standards become effective. Compliance with the disclosure requirements is not expected until issuers are required to have a recovery policy under the applicable exchange

listing standard. The SEC explicitly stated that there could be incentive-based compensation that is the subject of a compensation contract or arrangement that existed prior to the effective date of Rule 10D-1 which was not received until after the effective date of the applicable listing standards and, therefore, would be subject to recovery under the Final Rules.

It is anticipated that most companies will have until late 2023 or early 2024 to adopt and implement their policies, and the amendments relating to disclosure are expected to apply first to annual reports covering fiscal year 2023.

EFFECTS ON PROXY DISCLOSURE AND ANNUAL REPORTS

The Final Rules require various changes to the SEC filings and disclosures of listed issuers, including the following:

- All listed issuers must file their clawback policy adopted pursuant to the Final Rules as an exhibit to their annual reports on Form 10-K, 20-F or 40-F.
- New Item 402(w) of Regulation S-K requires issuers to make certain disclosures relating to their clawback policies. In particular, if at any time during or after an issuer's last completed fiscal year such issuer was required to prepare a restatement that triggered its clawback policy, or if there was an outstanding balance as of the end of the last completed fiscal year of erroneously awarded compensation from the application of that policy to a prior restatement, the issuer is required to disclose the following (in Inline XBRL):
 - The date on which the listed issuer was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (or, if the amount is indeterminable at the time of filing, an explanation as to why such amount has not yet been determined and related disclosures in the next filing that is subject to Item 402);
 - The aggregate amount of erroneously awarded compensation subject to the clawback policy that remains outstanding as of the end of its last completed fiscal year;
 - If the financial reporting measure related to a stock price or total shareholder return metric, the estimates used to determine the amount of erroneously awarded compensation

attributable to such restatement and an explanation of the methodology used for such estimates;

- If the issuer determines that recovery is impracticable, 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 issuer decided in each case not to pursue recovery; and
- For each current and former named executive officer, the amount of erroneously awarded compensation still owed that had been outstanding for 180 days or longer since the date the issuer determined the amount owed.⁵
- Foreign private issuers (FPIs) are required to provide the same information called for by Item 402(w) in their annual reports filed on Form 20-F, Form 10-K and Form 40-F, as applicable (in Inline XBRL). Because securities registered by these listed issuers are exempt from Section 14(a) of the Exchange Act, however, they would not be required to disclose the information in any proxy or consent solicitation materials.
- Amounts clawed back under an applicable clawback policy must be subtracted from the relevant column of the Summary Compensation Table, with any such clawback identified by footnote.
- The Final Rules add two new checkboxes to the cover of issuers' annual reports, indicating whether the financial statements filed in the annual report reflect the correction of an error to previously-issued financial statements, and whether such corrections rise to the level of restatements that require a recovery analysis of incentive-based compensation.

DETAILS OF CLAWBACK POLICY REQUIREMENTS

The following are additional details regarding the Final Rules' requirements relating to clawback policies:

- *The Final Rules apply to nearly all issuers listed on national securities exchanges, including emerging growth companies, smaller reporting companies, FPIs and controlled companies.* The SEC rejected calls to exempt such issuers, reasoning that these policies are as beneficial for small issuers and their shareholders as they are for larger ones, and as beneficial for foreign issuers and their shareholders as they are for domestic issuers.

- *Trigger Date.* The application of the clawback obligation begins on the date (i) the issuer's board of directors, a committee thereof, or an officer or officers authorized to draw such a conclusion if board action is not required, conclude or reasonably should have concluded that the issuer is required to prepare a restatement covered by the rule, or (ii) the date a court, regulator or other legally authorized body directs the issuer to prepare a restatement.⁶ The SEC rejected a bright-line or single-date test regarding the beginning of the recovery, reasoning that the adopted standard minimized incentives for issuers to delay their restatement conclusions.
- *"Incentive-based compensation" is "received" when the applicable "financial reporting measure" is attained.* The Final Rules define "incentive-based compensation" as compensation (including cash and equity awards), that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure. "Financial reporting measures" are defined as "measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, and any measures derived wholly or in part from such measures." These measures include (but are not limited to) revenues, net income, financial ratios, return measures, and explicitly includes stock price and total shareholder return. Incentive-based compensation does not include compensation paid solely upon satisfying one or more subjective standards (for example, demonstrated leadership or other similarly subjective measures) and/or completion of a specified employment period and related measures.
- The Final Rules provide that incentive-based compensation is deemed "received" in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs after the end of that period, and even if the executive officer has established only a contingent right to payment at that time. Incentive-based compensation will be subject to recovery under the clawback policy if it was received (i) while the issuer has a class of securities listed on a national securities exchange, and (ii) during the three fiscal years preceding the date on which the issuer is required to prepare a restatement⁷ (with special rules for transition periods for fiscal year-end changes during the look-back period).
- Recovery of excess incentive-based compensation received applies to 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 performance period for that incentive-based compensation. Recovery of compensation received while an individual was serving in a non-executive capacity prior to becoming an executive officer is not required.⁸ In addition, the recovery requirement does not apply to an individual who is an executive officer at the time recovery is required if that individual was not an executive officer at any time during the period for which the incentive-based compensation is subject to recovery.

- *The amount clawed back must be the excess amount received when compared with the as-restated financial statements.* To calculate the amount to be clawed back under the clawback policy, the issuer must determine the amounts by which the incentive-based compensation received by the subject executive officers exceed the amounts that would have been received based on the numbers in the restated financial statements.⁹ If the financial reporting measure was stock price or total shareholder return, reasonable estimates of the overage and thus the amount to be clawed back are permitted. The amount of the clawback must be calculated on a pre-tax basis.
- *Limited discretion regarding whether to seek recovery.* There is little room for discretion under the clawback policy mandate to seek recovery; however, the SEC has carved out three exceptions where the pursuit of recovery would be impracticable:
 - When the direct expenses paid to a third party to assist in enforcing the policy would exceed the amount to be recovered and the issuer has made a reasonable effort at recovery, documented its attempts and provided that documentation to the exchange;
 - For FPIs, recovery under the clawback policy would violate a home country law adopted prior to the date of the Final Rules' publication in the Federal Register (as verified with a legal opinion of home country counsel not unacceptable to the exchange);¹⁰ or
 - Recovery from tax-qualified retirement plans where benefits are broadly available to employees (if recovery would likely cause such plans to fail statutory requirements for tax exemption).

Any determination of impracticability would need to be made by the issuer's committee of independent directors responsible for

executive compensation decisions, or in the absence of a compensation committee, by a majority of the independent directors serving on the board.

- *Issuers are free to pursue their chosen means of recovery.* The SEC noted in the adopting release that the appropriate means of recovery may vary by issuer and by type of compensation arrangement and that issuers should pursue any recoveries mandated by their clawback policies through the means that best apply to their individual situation. The Final Rules do mandate that issuers pursue recovery “reasonably promptly” (which is not defined in the Final Rules).

KEY TAKEAWAYS

Issuers should start to focus on the establishment and implementation of new policies, or the amendment of current policies, over the coming months in advance of when the Final Rules become effective. While every situation is different, there are key takeaways to consider during this process, including:

- Issuers should commence the process of educating their Compensation Committees of the Final Rules.
- Issuers should review existing clawback policies and begin to consider whether amendments may be required to ensure compliance with the new clawback policy requirements.
- Issuers should review incentive-based compensation plans and policies, including recent incentive compensation awards, to determine the impact of the Final Rules on their executive compensation structures and whether adjustments may be needed going forward.

NOTES

1. <https://www.sec.gov/rules/final/2022/33-11126.pdf>.
2. Section 10D was added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Rule 10D-1 was originally proposed in 2015.
3. <https://www.sec.gov/news/statement/gensler-statement-clawbacks-102622>.
4. “Big R” restatements require the issuer to file an Item 4.02 Form 8-K and promptly amend its filings to restate the previously-issued financial statements, whereas “little r”

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restatements generally do not (the corrections are typically made the next time the prior year financial statements are filed).

5. An issuer that complies with its Item 402(w) disclosure requirements need not disclose any incentive-based compensation recovery pursuant to S-K Item 404(a); comparable provisions are included in Form 20-F.

6. Note that the trigger date may occur before the precise amount of the error has been determined. In addition, if an issuer is required to file an Item 4.02(a) Form 8-K, the conclusion that it is required to prepare an accounting restatement is expected to coincide with the occurrence of the event disclosed in the Form 8-K. Further, in applying a reasonableness standard to the determination of a three-year look-back period, while not dispositive, one factor would be notice from an issuer's independent auditor that previously-issued financial statements contain a material error.

7. 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.

8. Note that an award of incentive-based compensation granted to an individual before the individual becomes an executive officer will be subject to the recovery policy, so long as the incentive-based compensation was received by the individual at any time during the performance period after beginning service as an executive officer.

9. Reimbursement by an executive officer pursuant to SOX Section 304 should be credited to the extent that an issuer's recovery policy requires repayment of the same compensation by such executive officer, and recovery under the recovery policy would not preclude recovery under Section 304 to the extent applicable amounts have not been reimbursed to the issuer.

10. This exception would not be available for violations of home country law enacted after publication of the Final Rules in the Federal Register or for violations of law of other jurisdictions (e.g., the jurisdiction in which an executive officer is domiciled and employed).

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