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SEC Adopts Executive Compensation Clawback Rules

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On October 26, 2022, the Securities and Exchange Commission (the "Commission") adopted final rules implementing its Section 10D of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), mandate of directing national securities exchanges and associations to establish listing standards providing for issuers to adopt and adhere to an incentive-based compensation clawback policy. Section 10D stems from the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[1] The Commission initially proposed rules in accordance with Section 10D in 2015, and reopened the comment period on the proposal in October 2021 and again in June 2022. The final rules, though largely tracking the proposed rules, are broader in scope.

At the heart of the new rules is the overarching idea that it is "unfair to shareholders for corporations to allow executive officers to retain compensation that they were awarded erroneously."[2] Accordingly, pursuant to the final rules, an issuer's clawback policy must provide for the issuer's recovery of "erroneously awarded incentive compensation" paid to executive officers if the issuer is required to restate its financials—whether a "big R" restatement or a "little r" restatement—during a three-fiscal year look-back period, regardless of fault. The final rules also impose disclosure obligations regarding an issuer's clawback policy, including information if a recovery analysis under the policy is triggered, and require filing the policy with the issuer's Annual Report on Form 10-K. The rules are broadly applicable and there are no exemptions for smaller reporting companies, emerging growth companies, or foreign private issuers.[3] Issuers who fail to comply will be subject to delisting.[4]

When viewed in conjunction with the recently adopted pay v. performance rules, the final rules signal a shift in the current paradigm of executive compensation disclosure, and will likely spur downstream effects in the structuring of listed companies' executive compensation programs. Certainly, compensation committees and boards alike should plan for ample discussion to work through the rules and their implications.

Effective Date

The final rules will become effective 60 days after they are published in the Federal Register.[5] Exchanges will then have 90 days to file proposed listing standards, which must be effective within one year following the publication of the final rules in the Federal Register.[6] Subject issuers will need to adopt a clawback policy within 60 days of the applicable listing standard's effectiveness.[7]

Overview of the Final Rules

What Triggers the Clawback Policy?

Under the final rules, clawback policies are required to be triggered if the issuer must restate its financials due to *material* noncompliance with the financial reporting requirements set forth in the securities laws, including restatements that "correct an error in previously issued financial statements that is material to the previously issued financial statements" (i.e., a "big R" restatement), and restatements to correct errors that "would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period" (i.e., a "little r" statement).[8] Out-of-period adjustments (or corrections of immaterial errors) are not considered accounting restatements and therefore are not covered by the rules.[9]/[10] The Commission elected to include "little r" restatements within the purview of the final rules in an effort to combat questionable materiality determinations driven by a reluctance to implicate an issuer's clawback policy.[11]

Who is Covered and for How Long?

The final rules call for recovery from an issuer's current or former executive officers. The final rules include a broad definition of "executive officer" that tracks the definition of "officer" under Rule 16a-1(f) (often referred to as a "Section 16 officer") and includes 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 policymaking functions for the company. As a result, executive officers who do not participate in the preparation of an issuer's financial statements will nonetheless be subject to clawback policies. Moreover, a clawback policy must be triggered even if there is no misconduct or oversight failure by an executive officer.

However, the rules do place some guardrails on applicability—recovery is only required if incentive-based compensation was "received" by an individual (a) while the issuer was listed, (b) after becoming an executive officer, and (c) who served as an executive officer during the applicable performance period.[12] In addition, only compensation "received" during the three-year lookback period is required to be recoverable. The three-year lookback period includes the three most recently completed fiscal years prior to the earlier of the date (i) an issuer's board, a committee, or authorized officer(s) determines or reasonably should have determined the restatement to be required or (ii) a court or other authorized body requires an issuer to prepare a restatement. For example, if a board of directors for a calendar year reporting issuer determines in 2024 that previously issued financial statements must be restated, the policy would cover compensation deemed received in 2021-2023. Transition periods caused by a change in fiscal year end are also included.[13] The structure of the rules renders the filing date of the restatement is irrelevant for lookback purposes.[14] Under the rules, compensation is deemed "received" in the fiscal year the financial reporting measure is met, despite the payment or grant date. For example, if a bonus is paid by a calendar year reporting issuer to an executive officer in February 2024 for the executive officer's performance in 2023, the bonus would be deemed received by the executive officer in 2023 for purposes of the clawback rules.

What Compensation is Considered Recoverable?

In line with the goal of recouping erroneously paid incentive-based compensation, the final rules generally provide for the recovery of any incentive-based compensation over and above what should have been paid to an executive officer under the restated figures. The rules broadly define "incentive-based compensation" to encompass "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure."[15] Incentive-based compensation is not limited to equity incentive awards like stock options, restricted stock units, or restricted stock, but

also includes bonuses paid out of a bonus pool "the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal" as well as similarly tied cash awards.[16] The term "financial reporting measures" is also broadly defined and includes stock price and total shareholder returns and both GAAP and non-GAAP measures.[17]

In some circumstances, calculating the excess erroneously received compensation will be a simple rote mathematical determination. In other cases, for example, where the incentive-based compensation was attributable only in part on the restated financial reporting measure, the issuer will need to first make a determination as to what portion of the initial compensation was tied to the restated financial reporting measure. The issuer's calculation of excess compensation will likely be the most complicated if the applicable financial reporting measure is total stockholder return or stock price. In those instances, the Commission calls on issuers to reasonably estimate (and document) the impact of the accounting error on its stock price or total shareholder return.[18] Finally, issuers are required to calculate erroneously awarded compensation on a pre-tax basis and without regard to particular tax circumstances of the individual executives.[19]

It bears repeating that issuers must pursue recovery from executives, regardless of fault for the accounting errors or an individual's involvement in the preparation of financials.[20] Issuers cannot indemnify any current or former executive officer for the loss of erroneously awarded compensation and do not have discretion as to when to seek recovery.[21]

What Compensation is not Recoverable?

The final rules expressly provide that the following compensation does not meet the definition of incentive-based compensation:

- Base salaries;
- Pure time-based equity awards, where vesting is contingent upon the passage of time;
- Equity awards where vesting is contingent upon another nonfinancial reporting measure;
- Non-equity awards tied to strategic measures or operational measures;[22]
- Bonuses paid based on subjective individual performance or the passage of time; and
- Discretionary bonuses that are not paid out of a bonus pool tied to a financial reporting measure.[23]

Are There Any Exceptions?

Issuers are required to recover erroneously awarded compensation except in three limited situations where recovery is impracticable, as determined by the issuer's compensation committee comprised of solely independent members or, absent a committee, a majority of the independent members serving on the board: (a) the direct third-party cost of recovery exceeds the amount of recovery (subject to documented reasonable attempt requirements); (b) recovery would violate a pre-existing law in the issuer's home country; or (c) recovery would likely cause a tax-qualified employee retirement plan to fail to meet the applicable statutory requirements for exemption.[24] If an issuer relies on an exception, it must document its attempts to recover the erroneously awarded compensation and provide that documentation to the securities exchange on which its shares are listed.

What Does Recovery Look Like?

One aspect of the final rules where the Commission is particularly generous and particularly quiet is with respect to required methods of recovery; instead, boards are afforded a measure of discretion. Here, the Commission simply guides issuers to "act in a manner that effectuates the purpose of the statute: to prevent current or former executive officers from retaining compensation that they received and to which they were not entitled under the issuer's restated financials" and to seek recovery "reasonably promptly."[25] The Commission notes an acceptable method of recovery could involve a deferred payment plan in lieu of a lump sum in order to reduce the economic impact on the executive officer.[26] However, the exchanges may adopt a more structured approach when formulating their listing standards.

Disclosure Requirements

The final rules contain a number of new disclosure requirements, including inline XBRL tagging aspects. Significantly, an issuer will be compelled to file its compensation clawback policy as an exhibit to its annual report on Form 10-K or 20-F, and the cover pages of such forms are amended to include check boxes indicating whether the financial statements included therein have been restated and whether those restatements required a recovery analysis.

Additionally, new Item 402(w) of Regulation S-K requires an issuer to disclose actions taken pursuant to its clawback policy if a recovery is triggered. Generally, issuers will need to describe how they applied their policy, amounts of erroneously awarded compensation, any estimates utilized in the recovery analysis, outstanding amounts to be recovered, and any impracticability determinations. Notably, clawback disclosure will be required in Annual Report on Form 10-K filings and proxy or information statements calling for Item 402 disclosure, and not in other filings otherwise implicating Item 402 disclosure. Disclosures will not be deemed incorporated by reference into Securities Act of 1933, as amended, filings unless expressly incorporated at the issuer's discretion.[27] Finally, a new instruction will be added to the Summary Compensation Table regarding disclosure of any amount of erroneously paid compensation recovered.[28]

Recommendations

While the exchanges work on their respective listing standards, we recommend issuers get a head start on digesting the new rules and dialoguing with their executive officers. In-house legal teams should be reviewing the final rules and including an overview in board materials for upcoming meetings. Boards should communicate with their executive officers regarding the new rules, and be prepared to work through any resulting concerns. Compensation committees should consider engaging with their compensation consultants to review existing compensation structures and whether any changes thereto are appropriate in light of the new rules or executive officers' feedback. Issuers might find themselves walking the tightrope of pay v. performance / proxy advisory recommendations and pushback from executives on levels of incentive-based compensation, and should be prepared to work through these challenges well in advance of annual compensation determinations.

In addition, issuers should conduct a review of their existing clawback policies, as applicable, and any indemnification agreements with executive officers for compliance with the new rules. Existing indemnification agreements may need to be amended to ensure that executive officers do not have a contractual right to reclaim amounts required to be clawed back under the new rules. Finally, foreign private issuers and others with executive officers located outside of the U.S. should seek to understand existing local regulations with respect to clawing back compensation and any potential future restrictions thereon. While the new rules provide that only local laws put in place prior to the date the final rules

are published in the Federal Register can serve as a basis for not clawing back compensation, issuers should be aware of pending conflict of laws issues.[29]

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If you have any questions concerning these developing issues, please do not hesitate to contact the following Paul Hastings Palo Alto lawyer:

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1 *Listing Standards for Recovery of Erroneously Awarded Compensation*, Release No. 33-11126 (adopted October 26, 2022) [hereinafter the *"Adopting Release"*], at p. 5, https://www.sec.gov/rules/final/2022/33-11126.pdf.

2 *Id.* at p. 6.

3 There are limited exceptions for listed funds that meet certain criteria, unit investment trusts, and certain security futures products and standardized options issued by a clearing agency. (Exchange Act Rule 10D-1(c)).

4 *Adopting Release*, *supra* note 1 at p. 17.

5 *Id.* at p. 123.

6 *Id.*

7 *Id.*

8 Exchange Act Rule 10D-1(b)(1).

9 *Adopting Release*, *supra* note 1 at p. 33.

10 The Commission included a list of adjustments to an issuer's financial statements that would not be considered restatement for the purposes of the rule, including "[r]etrospective application of a change in accounting principle; [r]etrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization; [r]etrospective reclassification due to a discontinued operation; [r]etrospective application of a change in reporting entity, such as from a reorganization of entities under common control; [r]etrospective adjustment to provisional amounts in connection with a prior business combination (IFRS filers only); and [r]etrospective revision for stock splits, reverse stock splits, stock dividends or other changes in capital structure." *Id.*

11 *Id.* at p. 35.

12 Exchange Act Rule 10D-1(b)(1)(i).

13 Exchange Act Rule 10D-1(b)(1)(i)(D).

14 *Adopting Release*, *supra* note 1 at p. 43.

15 Exchange Act Rule 10D-1(d).

16 *Adopting Release*, *supra* note 1 at p. 64.

17 Examples include revenue, net income, operating income, profitability of one or more reportable segments, financial ratios, net assets or net asset value per share, EBITDA, liquidity measures, return measures, earnings measures, etc. A financial reporting measure is not required to be set forth in the issuer's financial statements itself. *Id.* at p. 59.

18 Exchange Act Rule 10D-1(D)(iii)(A)-(B).

19 *Adopting Release*, *supra* note 1 at p. 77.

20 *Id.* at p. 85.

21 *Id.* at p. 118.

22 The Commission lists the consummation of a merger or divestiture as a potential strategic measure and the opening of a specified number of stores or completion of a project as a potential operational measure, all of which would fall outside the clawback rules. *Id.* at p. 64.

[23] *Id.*

[24] Exchange Act Rule 10D-1(D)(iv).

[25] *Adopting Release*, *supra* note 1 at p. 99.

[26] *Id.* at p. 100.

[27] *Id.* at p. 112.

[28] *Id.* at p. 108.

[29] Exchange Act Rule 10D-1(b)(1)(iv).