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How to Navigate the SEC's New Clawback Rules

The rules direct stock exchanges to require issuers that are publicly listed in the US to adopt clawback policies for the mandatory recovery of erroneously awarded incentive compensation.

Key Points:

- **Application to substantially all issuers that are listed on a US stock exchange.** The final rules apply to nearly all listed issuers, including smaller reporting companies, emerging growth companies, and foreign private issuers.

- **Incentive compensation covered.** Clawback policies will apply to incentive compensation that is erroneously received by current or former executive officers during the three-year period preceding the date the issuer is required to prepare an accounting restatement, without regard to any misconduct.

- **All types of restatements covered.** Clawback policies will apply to "Big R" restatements, as well as "little r" restatements, as defined by the SEC.

- **Limited "impracticability" exceptions.** The final rules contain only narrow exceptions, including situations in which a clawback would cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.

- **New disclosure requirements.** The final rules require issuers to file their clawback policies with the SEC and to provide disclosure about the policies and how they are implemented, including information about any erroneously awarded incentive compensation attributable to an accounting restatement, any estimates used in determining the amount of recoverable compensation, the amount that remains to be collected, and the names of, and amounts owed by, executive officers.

- **Timing.** The New York Stock Exchange and Nasdaq have 90 days to propose listing standards that must become effective no later than one year after the publication date of the new rules. Issuers will then have 60 days following the effectiveness of the applicable listing standards to adopt compliant clawback policies. As a result, issuers will likely be required to implement clawback policies by end of 2023 or early 2024, and possibly sooner. Given this timeline, issuers have some time to consider and make changes to their existing policies or adopt new policies.

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Understanding and Applying the Clawback Rules

The written clawback policy must provide that the issuer will recover excess incentive compensation from any of the issuer's current or former executive officers that was erroneously received during the three-year period preceding the date the issuer is required to prepare an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement under the securities laws.

Below is a discussion of the significant provisions of the final rules and certain related issues and planning opportunities:

1. Issuers and Executives Subject to Clawback Policies

Which issuers are covered? The final rules generally apply to *all* issuers publicly listed on a stock exchange in the US, including smaller reporting companies, emerging growth companies, foreign private issuers, controlled companies, and companies with listed debt only. Very limited exemptions apply for issuers of security futures products and standardized options, certain registered management investment companies, and unit investment trusts.

Which executive officers are covered? Current and former executive officers are subject to the final rules regardless of any misconduct. The clawback policy must apply to an executive officer (a) after the person begins service as an executive officer, and (b) if that person served as an executive officer at any time during the recovery period. Thus, the clawback of compensation "received" by an individual before becoming an executive officer will not be required.

The SEC has modeled the definition of "executive officer" on the definition of "officer" under Section 16 of the Exchange Act, which is the same definition as the Exchange Act definition of executive officer but also captures the principal accounting officer (or if there is no such accounting officer, the controller). Thus, the definition includes the issuer's president, principal financial officer, and principal accounting officer (or if there is no such accounting officer, the controller), any vice president of the issuer 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.

Practice Pointers

- ✓ Applying mandated clawbacks against former executive officers may represent the biggest administrative burden and challenge for issuers. To ease the administrative burden of recovering compensation already received by former executive officers, issuers should (a) develop a database devoted to tracking incentive compensation received by current and former executive officers, and (b) discuss, on the date of an executive's termination, what forms of compensation received would be subject to recovery under the clawback policy (or incorporate that information into the terms of any separation agreement). As further discussed below, issuers may also want to consider adding holdback or deferral policies to incentive compensation or post-vesting "holding" or "no transfer" periods to equity awards to aid in any recovery efforts.

- ✓ The nature of a "no-fault" clawback policy triggered only by accounting restatements puts increased pressure on directors and officers who are responsible for reviewing issuer financials and the scope of any errors. Issuers may wish to reassess their financial reporting function to ensure that they are appropriately investing in sufficient personnel with the necessary expertise in GAAP or IFRS requirements and robust internal control over financial reporting, which is every company's first line of defense in avoiding financial statement errors.

Practice Pointers
Both audit committees (responsible for oversight of financial reporting) and compensation committees (responsible for implementing compensation clawbacks after a restatement) will want to ensure that management has sufficient accounting expertise and financial reporting resources to ensure effective internal control over financial reporting and maximize the likelihood of timely prevention or detection of financial statement errors to avoid financial statement errors before they occur.
✓ Foreign private issuers, which are not subject to Section 16 of the Exchange Act, will need to determine which of their executive officers are subject to the new clawback rules.

2. Form and Amount of Compensation Recoverable

Which types of incentive compensation are covered? The final rules only capture incentive compensation that is "received" during the three completed fiscal years that immediately precede the date the issuer is required to prepare an accounting restatement. In addition, only incentive compensation that is "received" after the effective date of the applicable stock exchange listing standard is subject to recovery.

Incentive compensation is compensation that is granted, earned, or vested wholly or in part upon the attainment of any "financial reporting measure." Financial reporting measures include measures determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, and measures derived wholly or in part from such financial information. The final rules specify that stock price and total shareholder return (TSR) are financial reporting measures for this purpose. Non-GAAP measures may also be financial reporting measures. The final rules also specify that a financial reporting measure need not be presented within the issuer's financial statements or included in an SEC filing to constitute a financial reporting measure for this purpose.

Equity awards that are granted without regard to achieving financial reporting measures, and whose vesting schedule is solely based on continued service or employment over time and/or on attaining non-financial reporting measures, do not qualify as incentive compensation.

Incentive compensation includes the following compensation	Incentive compensation DOES NOT include the following compensation
• Bonuses or non-equity incentive plan or other cash awards earned based on a financial reporting measure	• Salaries
• Bonuses paid from a "bonus pool," the size of which is determined based on a financial reporting measure	• Bonuses paid solely at the discretion of the compensation committee or board that are not paid from a "bonus pool" that is determined by satisfying a financial reporting measure performance goal

Incentive compensation includes the following compensation	Incentive compensation DOES NOT include the following compensation
• Restricted stock, restricted stock units, performance share units, stock options, and stock appreciation rights that are granted or become vested based on a financial reporting measure	• Bonuses or other cash awards paid solely upon satisfying one or more subjective standards and/or completion of a specified employment period
• Proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based on a financial reporting measure	• Bonuses or non-equity incentive plan or other cash awards earned solely upon satisfying one or more strategic or operational measures
• A salary increase earned based on a financial reporting measure	• Equity awards for which the grant is not contingent on any financial reporting measure and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more non-financial reporting measures

When is compensation deemed "received"? Incentive compensation is deemed "received" in the fiscal period during which the financial reporting measure is attained. If an award is subject to multiple vesting conditions, it is deemed "received" by the executive when the performance goal tied to the relevant financial reporting measure is attained, even if it is contingent upon the occurrence of other events. For example, an equity award that is subject to a time-vesting requirement following the date on which a performance goal tied to a financial reporting measure is attained is deemed "received" when the goal is attained, without regard to the additional time-vesting requirement.

Practice Pointers
✓ The final rules explicitly exclude from recovery time-based equity awards and equity awards based on non-financial reporting measures. This exclusion covers stock option awards and awards of restricted stock and restricted stock units where vesting is solely tied to service (and where the decision to grant the awards is not based on the achievement of a financial reporting measure).
✓ As non-financial reporting measures — including strategic or operational measurer — were excluded from the definition of financial reporting measure, incentive compensation programs may move away from financial measures toward objective performance metrics and targets that are non-financial, strategic or operational.
✓ The final rules would apply to incentive compensation that is granted prior to the effective date of the stock exchange listing standards if it is "received" following such effective date. Issuers should consider revising forms of incentive-based compensation plans and agreements to include a general provision that any compensation granted thereunder is subject to any clawback policy the issuer adopts to comply with the stock exchange listing standards.

How is erroneously awarded compensation subject to the clawback measured? The amount of incentive compensation that is subject to recovery is the amount the executive officer received in excess of the amount that would have been received based on the restated financial statements. Any erroneously awarded compensation is computed on a pre-tax basis. For incentive-based compensation based on TSR or stock price, the amount must be based on a reasonable estimate of the effect of the accounting restatement on the applicable financial measure. This analysis must be documented and provided to the applicable exchange.

For cash awards, the erroneously awarded compensation is 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. For cash awards paid from bonus pools, the erroneously awarded compensation is 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 or equity awards are still held at the time of recovery, the erroneously awarded compensation is the number of such securities received in excess of the number that should have been received applying the restated financial reporting measure (or the value of that excess number). If shares have been issued upon exercise or settlement of the equity awards, but the underlying shares have not been sold, the erroneously awarded compensation is the number of shares underlying the excess equity awards (or the value thereof). With respect to other circumstances, the SEC believes that issuers and their boards are in the best position to make these determinations using a principles-based application of the rules.

Practice Pointers

- ✓ The SEC recognizes that calculations necessary to assess excess compensation based on stock price and TSR may require complex analyses, significant technical expertise, and specialized knowledge. The SEC, therefore, would permit the use of "reasonable estimates" when determining the impact of an accounting restatement on stock price and TSR results. Issuers would be required to disclose such reasonable estimates, must maintain documentation of the determination and provide such documentation to the applicable stock exchange. Ambiguity remains as to (a) what forms of "reasonable estimates" will be deemed adequate without the engagement of valuation experts and other third-party advisors, and (b) the extent to which, in practice, the SEC and the investor market would ultimately demand that issuers engage outside experts to calculate proper recovery amounts based on stock price and TSR metrics. Issuers would be well advised to document all decisions and analyses, both internal and external, and monitor disclosure in connection with recoveries made by peer group members. Due to the ambiguity as to what forms of "reasonable estimates" will be deemed adequate, potential shareholder derivative litigation could arise over whether the analyses and calculations used to determine the impact of a restatement on stock price and TSR were "reasonable estimates."

3. Clawback triggers and trigger dates

What types of restatements are covered? Under the final rules, a clawback is triggered by an accounting restatement that:

- corrects an error in previously issued financial statements that is material to the previously issued financial statements — a "Big R" restatement; and
- 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.

Note that the term "little r" restatement often has been used imprecisely to refer to all forms of immaterial error correction, including out-of-period adjustments. An out-of-period adjustment is an error correction occurring when an adjustment is made in a current period to correct an immaterial prior-period error, and the correction of the error in the current period is not material to current-period financial statements. The SEC Adopting Release expressly states that an out-of-period adjustment is not a "little r" restatement that implicates the new clawback rules.

Is executive misconduct a prerequisite for recovery? No. Clawback policies will apply to incentive compensation that is erroneously received by current or former executive officers during the three-year period preceding the date the issuer is required to prepare an accounting restatement, without regard to any misconduct on the part of the executive.

On what date is the issuer "required" to prepare the restatement? The final rules apply to incentive compensation received during the three-year period preceding the date the issuer is "*required"* to prepare an accounting restatement. Under the final rules, this is the date the issuer's board of directors, committee thereof, or any of its officers concludes, or *reasonably should have concluded*, that the issuer is required to prepare an accounting restatement due to material noncompliance of the issuer with any financial reporting requirement or, if earlier, the date a court or regulator directs the issuer to restate its financial statements to correct a material misstatement.

The clawback trigger date, therefore, is not the date of the filing of the restatement itself, but instead, either the date of the issuer's decision to restate its financials or if no decision to restate was made, the date the issuer should have made a decision.

Practice Pointers
✓ The question of whether a restatement is required, and if so what flavor of restatement is involved, is a complex determination that will require substantial time and effort from an issuer's financial reporting staff, its auditors, and potentially its audit committee as well.
✓ The playbook for dealing with prior accounting errors has changed. Until now, the key distinction has been Big R versus other types of error corrections, since Big R restatements require correction via amendment to prior SEC reports, as well as the filing of an Item 4.02 Form 8-K (in the case of a US domestic registrant) to disclose that previously issued financial statements should no longer be relied upon. Now, little r restatements too can have significant impact even if prior financial statements may still be relied on.

Practice Pointers
✓ In light of the "reasonableness" standard and the lack of a clear benchmark for the standard, potential shareholder derivative litigation could arise based on allegations that an issuer reasonably should have concluded that an accounting restatement was required at an earlier date.

4. When and How to Recover or Not to Recover

Would the issuer have discretion on whether to clawback? No. The final rules only include limited impracticability exceptions whereby issuers may forego recovery if:

- the direct cost of recovery to third parties, including reasonable legal expenses and consulting fees, would exceed the amount of recovery;
- the recovery would violate home-country law that was effective prior to the date the final rules are published in the Federal Register, and only if the issuer obtained an opinion of home-country counsel establishing that recovery would result in such violation; or
- such recovery would jeopardize the qualified status of a tax-qualified retirement plan.

If relying on the first exception, the issuer must make and document a reasonable attempt to recover incentive compensation before concluding that it would be impracticable to do so and furnish such documentation to the applicable exchange. There is no exception for de minimis amounts.

When do issuers have to pursue recovery? Issuers must pursue recovery under the clawback policy "reasonably promptly." Although the SEC does not define the term, it expects issuers and their executive officers to balance cost and speed when determining the appropriate means of recovering excess compensation to safeguard the time value of any potentially recoverable compensation.

Can the issuer protect executives from the clawback? No, issuers are prohibited from insuring or indemnifying any current or former executive officer against the loss of erroneously awarded compensation. Executive officers may purchase third-party insurance policies to fund potential recovery obligations but the issuer may not directly or indirectly pay or reimburse such executive officer for premiums for the insurance policy.

Practice Pointers
✓ In practice, issuers have very limited discretion on whether to clawback. In order to show that direct costs of recovery exceeded the recoverable amounts, the issuer would still have to navigate the normal recovery process, run the calculations necessary to identify the recoverable amounts against which the enforcement costs would be measured, and ultimately attempt to enforce the recovery policy, all while monitoring and documenting the associated costs along the way to prove the recovery was a futile effort. To obtain an exemption for a home-country law violation — the second recovery exemption described above — the issuer must obtain an opinion of home-country counsel.
✓ Due to the potential enforcement costs (both direct and indirect) to recover excess incentive compensation and the requirement to recover compensation on a pre-tax basis, issuers may subject incentive compensation

Practice Pointers

payable to executive officers to holdback or deferral policies that defer payment of incentive compensation that is potentially subject to clawback until the expiration of the lookback period, which could also potentially allow for the deferral of taxation. Issuers could also consider adding post-vesting "holding" or "no transfer" periods to equity awards, so executive officers cannot dispose of the shares received for a period of time after vesting, which could ease recoupment.

✓ The SEC recognizes that active insurance markets are likely to emerge to provide executive officers with the opportunity to protect themselves against the loss of incentive compensation when they are not responsible for restatements. While the final rules explicitly prohibit issuers from reimbursing an executive for the cost of clawback-related insurance policies, the individual costs associated with such hedging policies may ultimately be borne by market-determined compensation packages.

New Disclosure Requirements

The final rules require covered issuers to file their clawback policies and to disclose certain information about those policies and their application in SEC filings.

- *Annual Reports.* Issuers will be required to file the clawback policy as an exhibit to their annual report on Form 10-K, Form 20-F, or Form 40-F. These forms have also been amended to include two new checkboxes on the cover pages. One checkbox is to notify investors when the financial statements included in the filing reflect the correction of an error to previously issued financial statements, and the second is to indicate whether any such corrections are restatements that require a recovery analysis under the issuer's clawback policy.

- *Proxy and Information Statements.* New Item 402(w) of Regulation S-K requires disclosure if, at any time during or after the issuer's last completed fiscal year, the issuer was required to prepare a restatement that required recovery of erroneously awarded compensation pursuant to its clawback policy, or there was an outstanding balance from a prior application of the clawback policy. This additional disclosure includes the following:

  - The date the issuer was required to prepare an accounting restatement.

  - If the dollar amount has been determined, the dollar amount of erroneously awarded incentive compensation attributable to the accounting restatement and an analysis of how the recoverable amount was calculated and, if the dollar amount has not yet been determined, a disclosure that explains the reasons and a disclosure in the next filing subject to Item 402 of Regulation S-K that discloses the determined amount and related disclosures.

  - The aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the issuer's last completed fiscal year.

  - If the financial reporting measure related to a stock price or TSR metric, any estimates used in determining the amount.

- If 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 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 180 days or longer since the date the issuer determined the amount owed.
- Disclosure in the Summary Compensation Table regarding the effect of any recovered amounts, which will be deducted from the table for the year in which the recovered amount was originally reported and identified in a footnote to the table.

This disclosure must be provided in XBRL format.

Practice Pointers

✓ For issuers that include a Compensation Discussion and Analysis (CD&A) in their proxy statements, the proxy statement disclosures under new Item 402(w) are not required to be included in an issuer's CD&A; however, issuers may provide disclosures in the CD&A so that all information related to the clawback policy is contained in a single location in the proxy statement. Issuers may consider including disclosure of how they have applied their clawback policies outside of the CD&A, so that it is not captured as part of the compensation committee report.

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