Hughes Hubbard & Reed

Beware the Claw! SEC Finalizes Dodd-Frank Clawback Rules

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October 31, 2022 – Just in time for Halloween, on October 26, 2022, the Securities and Exchange Commission (SEC) finalized long-awaited rules implementing the clawback provision mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The SEC describes the clawback provision as a sort of "scared straight" program, designed to "maintain investor confidence in markets and improve liquidity by incentivizing executive officers to provide more accurate financial reporting." Under the new rules, the national securities exchanges (including Nasdaq and the NYSE) must establish listing standards that will, with very limited exceptions, require all listed companies, including emerging growth companies, smaller reporting companies, foreign private issuers, and controlled companies, as well as companies whose only listed securities are debt securities, to:

- establish and implement a clawback policy providing for the recovery of incentive compensation "erroneously paid" to current and former executive officers during the three completed fiscal years immediately preceding the date the company is required to prepare an accounting restatement, and
- file the clawback policy with the company's annual reports (including on Form 10-K and 20-F) and disclose in its proxy statement information regarding the clawback policy and its implementation.

According to the SEC, the rule stands for "a simple proposition: executive officers of exchange-listed issuers should not be entitled to retain incentive-based compensation that was erroneously awarded on the basis of materially misreported financial information that requires an accounting restatement. The statute thus mandates that exchange-listed issuers maintain policies to recover such compensation for the benefit of the issuers' owners—their shareholders." Accordingly, a listed company must apply the clawback policy to all of its current and former executive officers who benefited from the misstated figures, regardless of whether the executive officer may be "at fault" for the accounting errors that led to a restatement or bear any responsibility for the preparation of the financial statements.

Transition Period

The national securities exchanges must complete their new listing standards no later than 90 days following publication of the final rules in the Federal Register, and the listing standards must become effective no later than

one year following that same publication date. Each listed company will be required to adopt a compliant clawback policy no later than 60 days following the date on which the listing rules to which it is subject become effective. As noted by the SEC, listed companies will therefore "have more than a year from the date the final rules are published in the Federal Register to prepare and adopt compliant recovery policies."

In addition, each listed company must (a) comply with the clawback policy for all incentive compensation "received" by current or former executive officers on or after the effective date of the applicable listing standard and (b) provide the disclosures required by the rules on or after the date on which the exchange's listing standard becomes effective.

Based on the announced time periods, and assuming the listing standard is effective in or about a year from the date the rule is published in the Federal Register, each listed company will need to adopt compliant clawback policies during the latter part of 2023 or the beginning of 2024. For companies with fiscal years ending December 31, required recoveries under the clawback policy will first apply in respect of an accounting restatement (if any) in 2024, and incentive compensation "received" by the company's current and former executive officers during the latter part of 2023, even if such compensation arrangement is covered by an agreement or plan that was in effect prior to that time. Assuming that the listing standards do not become effective until 2023, the new rules would not apply to incentive compensation that is earned during or prior to 2022.

What should you do now?

- We enclose with this alert important questions and answers regarding the new rules. Please read these Q&As for more color on the new requirements.
- If you currently have a clawback policy, it's time to review it and determine what changes you will need to make to it bring it into compliance with the new rules.
- If you do not currently have a clawback policy, it's time to prepare one that complies with these new rules.
- In addition to the SEC's rules, consider other desirable, but not mandated, provisions to include in your clawback policy. For example, consider implementing a clawback policy for misconduct that applies to the company's general employee population.
- Be prepared: Audit your current compensation plans and agreements to determine whether they provide for incentive compensation arrangements that may be subject to the clawback policy in the event of an accounting restatement, and how the arrangement might be impacted if the company were to do a restatement. If the compensation arrangement does not currently permit the company to unilaterally recoup compensation that must be recovered under the new rules, consider the steps you may need to take to seek recovery.

Please do not hesitate to contact us for further information or to help with your clawback policy or auditing your compensation arrangements.

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SEC Clawback Rule

Questions and Answers

What companies are subject to the rule?

All listed companies, including emerging growth companies, smaller reporting companies, foreign private issuers, and controlled companies, as well as companies whose only listed securities are debt securities, are subject to the rule. The only exemptions from the rule are listing of security futures products, standardized options, securities issued by unit investment trusts, and registered investment companies that have not granted incentive compensation to their executive officers during the last three fiscal years. The stock exchanges would not have discretion to exempt other categories of listed companies or securities.

What must listed companies do under the new rule?

Listed companies must adopt and implement a written clawback policy that requires recovery of erroneously paid incentive compensation to current and former executive officers during the prior completed three fiscal years in the event that the company must prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws.

The company must also disclose its clawback policy in accordance with SEC rules, including filing the written policy as an exhibit to its annual reports, indicating in such reports whether the company's financial statements reflect a correction of an error to previously issued financial statements and if such corrections are restatements requiring recovery analysis, and disclosing any actions taken pursuant to the clawback policy.

What accounting restatements could trigger a clawback?

A listed company must apply its clawback policy if the company is required to prepare an accounting restatement that corrects an error in previously issued financial statements that is material to such financial statements (a so-called "Big R" restatement), or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (a so-called "little r" restatement).

If the company must prepare an accounting restatement, is there a time period during which the clawback applies?

Yes. Recovery is required of any excess incentive compensation received during the completed three fiscal years immediately preceding the date on which the listed company is required to prepare an accounting restatement. The rule defines the date as of which a listed company is required to prepare an accounting restatement as the earlier of (a) the date the company's board of directors, a committee of the board of directors, or the officer or officers of the company authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws, or (b) the date a court, regulator or other legally authorized body directs the company to prepare an accounting restatement. For example, if a calendar year listed company determines in November 2027 that a restatement is required and files the restated financial statements in 2028, the clawback policy would apply to incentive compensation received by the company's current and former executive officers in 2024, 2025, and 2026.

Which executive officers are subject to the rule?

The clawback policy must apply to an individual (a) after beginning service as an executive officer and (b) if that individual served as an executive officer at any time during the recovery period. Thus, recovery of compensation received while an individual was serving in a non-executive capacity prior to becoming an executive officer will not be required and, further, 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 compensation is subject to recovery.

The rule defines the term "executive officers" to cover the same individuals who are subject to Section 16 of the Securities Exchange Act. This includes the listed company's president, principal financial officer, principal accounting officer (or, if none, the controller), any vice-president of the company 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 company. Some listed companies, such as foreign private issuers and debt-only filers, which previously may not have identified "Section 16" officers, may now need to determine who their executive officers are for purposes of the clawback policy.

Recovery is required of the executive officer regardless of whether the executive officer is "at fault" for the accounting errors that led to a restatement or bears any responsibility for the preparation of the financial statements.

What is "incentive compensation" for purposes of the clawback policy?

The rule defines the compensation which is subject to clawback using a "principles" approach. Incentive compensation is defined as "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure." Financial reporting measures are defined as (a) measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, (b) measures derived wholly or in part from such information, and (c) stock price and total shareholder return (TSR). A metric meeting this definition would be included even if the amount was not included in the company's financial statements or filed with the SEC.

Because the Dodd-Frank Act specifies that compensatory stock options should be subject to clawback, the rule includes as incentive compensation stock options and other equity awards, but limits such awards to those whose grant or vesting is based wholly or in part on attainment of metrics based on or derived from financial reporting measures. As a result, most time-vested stock options and other equity awards would be excluded from the definition. If shares are subject to clawback under this standard, the proceeds from the sale of such shares would also be subject to clawback.

Excluded from the definition of incentive compensation is compensation based on performance metrics that are not financial reporting measures. The SEC gives as examples the opening of a specified number of stores, obtaining market share, and completing a merger or divestiture. Similarly, bonuses paid solely at the discretion of the compensation committee or board will not be subject to clawback. However, discretionary bonuses paid out of a bonus pool whose size is determined wholly or in part based on a financial reporting measure will be subject to clawback. While salaries will not be subject to clawback, the SEC states that any salary increase earned wholly or in part based on attainment of a financial reporting measure would be subject to clawback.

When is incentive compensation deemed "received"?

Incentive compensation will be deemed received in the fiscal period during which the financial reporting measure specified in the incentive compensation award is attained, even if the payment or grant occurs before or after the end of such period. For example, if an equity award vests only upon satisfaction of a financial reporting measure performance condition, the award would be deemed received in the fiscal period when it vests (regardless of the fact it may have been granted in a prior year).

How is the amount of incentive compensation subject to clawback determined?

The amount of incentive compensation subject to clawback is "the amount of incentive compensation received by the executive officer or former executive officer that exceeds the amount of incentive compensation that otherwise would have been received had it been determined based on the accounting restatement." For incentive

compensation based on stock price or TSR, where the amount of erroneously awarded compensation is not subject to recalculation directly from the information in an accounting restatement, the amount must be based on a reasonable estimate of the effect of the accounting restatement and the company must document the determination of that reasonable estimate and provide it to the exchange.

Where the incentive compensation is based only in part on the achievement of a financial reporting measure performance goal, the company would first need to determine the portion of the original incentive compensation based on or derived from the financial reporting measure that was restated. The company would then need to recalculate the affected portion based on the financial reporting measure as restated, and recover the difference between the greater amount based on the original financial statements and the lesser amount that would have been received based on the restatement.

To ensure the company recovers the full amount of incentive compensation that was erroneously awarded, the final rules provide that the calculation of erroneously awarded compensation must be done without regard to tax liabilities incurred or paid by the executive officer. (The SEC acknowledged that this could impose adverse tax consequences on the executive officer, but blames the tax rules for any such adverse consequences.)

Are there any impracticability exceptions?

Yes. The SEC's rules require that a listed company must recover erroneously awarded compensation in compliance with its clawback policy except to the extent that pursuit of recovery would be "impracticable" in very limited circumstances. The adopted impracticability exceptions are as follows: (a) the direct cost of recovery would exceed the amount of recovery, (b) the recovery would violate home country law of the company and additional conditions are met, and (c) the recovery is from a tax-qualified retirement plan.

In determining whether recovery is impracticable due to cost, the only permissible criterion is whether the direct costs paid to a third party (such as reasonable legal and consulting fees) to assist in enforcing recovery exceed the erroneously awarded compensation amounts. Further, before concluding that recovery is impracticable, the company must first make a reasonable attempt to recover the erroneously awarded compensation, document the attempt(s) at recovery, and provide such documentation to the exchange.

Before concluding that recovery is impracticable because it would violate the listed company's home country law (such law must be in effect as of the date of publication of the rules in the Federal Register), the company must first obtain an opinion of home country counsel, acceptable to the applicable exchange, that recovery would result in such a violation.

The SEC does not include an exception or provide board discretion not to pursue recovery due to potential state law conflicts, concluding "that state law will not pose a significant obstacle to recovery" because the listing standards adopted by national securities exchanges and associations at the direction of Congress and the SEC can preempt state laws in certain circumstances.

After comments to the proposed rules noted that the statutory anti-alienation rule prohibits a tax-qualified retirement plan from complying with a request for recovery, the final rules adopt an exception permitting companies to forgo recovery from tax-qualified retirement plans.

Any determination that recovery is impracticable due to any of these three circumstances must be made by the company's committee of independent directors responsible for executive compensation decisions. In the absence of a compensation committee, the determination is to be made by a majority of the independent directors serving on the board.

Is there discretion as to how to recover the incentive compensation?

Listed companies may exercise discretion in how to accomplish recovery of erroneously awarded incentive compensation, so long as the company recovers the compensation "reasonably promptly." The SEC acknowledges and accepts that facts and circumstances may warrant a "deferred payment" plan so that an impacted executive officer may repay without incurring unreasonable economic hardship.

May a company insure or indemnify an executive officer against the loss of erroneously awarded incentive compensation?

Listed companies are prohibited from insuring or indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation. Further, while an executive officer may be able to purchase third-party insurance to fund potential recovery obligations, the indemnification provision prohibits a company from paying or reimbursing the executive officer for premiums for such an insurance policy.

What disclosure rules apply to clawback policies and in the event of an accounting restatement?

U.S. Companies. The final rules require each domestic listed company to file its clawback policy as an exhibit to its annual report on Form 10-K (or, for registered management investment companies, on Form N-CSR). In addition, check boxes will be added to the cover page of Form 10-K that indicate separately (a) whether the financial statements included in the filing reflect correction of an error to previously issued financial statements, and (b) whether any of those error corrections are restatements that required a recovery analysis of incentive compensation received by any executive officers during the relevant recovery period.

Item 402 of Regulation S-K has been amended (by adding a new Item 402(w)) to require listed companies to disclose (in proxy statements and annual reports) how they have applied their clawback policies. This disclosure item is triggered if during the last completed fiscal year there was either a restatement that required recovery of excess incentive compensation or an outstanding balance of excess incentive compensation that was required to be recovered based on a prior restatement. Specifically, the company would be required to disclose:

- for each restatement, the date the company was required to prepare the restatement, the aggregate dollar amount of excess incentive compensation attributable to the restatement (including analysis of how the amount was calculated), and the amount of excess incentive compensation that remains unrecovered as of the end of the last completed fiscal year;
- the estimates used to determine the amount of any excess incentive compensation related to measures of stock price or TSR and an explanation of the methodology used for such estimates;
- if recovery would be "impracticable" (as discussed above), the amount of recovery forgone and a brief description of the reason the company decided in each case not to pursue recovery, for each current and former named executive officer and for all other current and former executive officers as a group; and
- the name of each current or former executive officer from whom, at the end of the last completed fiscal year, excess incentive compensation had been outstanding for 180 days or more since the date the company determined the amount owed by such person, and the dollar amount of excess compensation due from such person.

The disclosure required by Item 402(w) will also be required to be provided in interactive data format, using machine-readable XBRL. The interactive data will be required to be provided as an exhibit to the proxy statement and Form 10-K.

The Summary Compensation Table is also revised to require that amounts reported in the table as paid in a prior year be reduced by the amount recovered, with footnote disclosure of the amount recovered. This disclosure

would apply only if the clawback related to incentive compensation paid in a year covered by the table.

Foreign Issuers. Foreign issuers will be required to file their clawback policies as exhibits to their annual reports on Form 20-F or 40-F. In addition, check boxes will be added to the cover page of Forms 20-F and 40-F that indicate separately (a) whether the financial statements included in the filing reflect correction of an error to previously issued financial statements, and (b) whether any of those error corrections are restatements that required a recovery analysis of incentive compensation received by any executive officers during the relevant recovery period.

The Form 20-F would also require disclosure parallel to that called for by Item 402(w) (as discussed above for U.S. companies), including the requirement to tag the disclosure in an interactive data format.

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