Paul | Weiss

CLIENT MEMORANDUM

October 31, 2022

# SEC Adopts Final Clawback Rules

The SEC has adopted final rules (available here) to implement Section 954 of the Dodd-Frank Act, largely as proposed in connection with the re-opening of the comment period last fall. New Rule 10D-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), mandates national securities exchanges and associations to establish listing standards requiring all listed companies to adopt and comply with compensation recovery (or "clawback") policies for incentive-based compensation received by current and former executive officers based on financial statements that are subsequently restated, and to disclose their clawback policies in accordance with SEC rules. The new rules apply to all companies listed in the United States (including emerging growth companies, smaller reporting companies, controlled companies and foreign private issuers, including multijurisdictional disclosure system (MJDS) issuers), except for certain registered investment companies.

## When will listed companies need to comply with these requirements?

Exchanges will have 90 days from the publication of the adopting release in the *Federal Register* to file proposed listing standards, which must become effective no later than one year following the publication date. Listed companies will be required to adopt clawback policies within 60 days of the date on which the applicable listing standards become effective, and must begin to disclose such policies and how they apply in the proxy/information statements and annual reports filed after they adopt such policy. Exchanges will be required to prohibit the initial or continued listing of any security of an issuer that is not in compliance with the clawback rules.

## Clawback Requirement

**What is the clawback requirement?**

If a listed company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, the company will be required to recover, pursuant to its policy, incentive-based compensation received by current and former executive officers during the three completed fiscal years immediately preceding the date on which the company is required to prepare the accounting restatement. Recovery will be required on a "no fault" basis, without regard to whether any issuer or executive misconduct occurred or to an executive officer's responsibility for the erroneous financial statements.

**Who is subject to the clawback requirement?**

New Rule 10D-1 applies to current and former executive officers of listed companies. The definition of "executive officer" is modeled on the definition of "officer" under Section 16 of the Exchange Act and includes the company's president, principal financial officer, principal accounting officer (or controller), any vice-president in charge of a principal business unit, division or function and any other person who performs policy-making functions for the company (including executive officers of a parent or subsidiary). Notably, this definition is significantly broader than that in the clawback provisions of Section 304 of the Sarbanes-Oxley Act, which currently are in effect and only apply to the CEO and CFO. The rules prohibit a company from insuring or indemnifying an executive officer for the loss of compensation that the officer is required to pay back under the clawback policy, whether directly or indirectly, without regard to fault.

**How much would be required to be clawed back?**

Companies will be required to recover the amount of incentive-based compensation paid that exceeds the amount the executive officer would have received during the applicable period had the incentive-based compensation been determined based on the restated financial statements. The recoverable amount is to be calculated on a pre-tax basis.

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**What constitutes "an accounting restatement due to the material noncompliance of the company with any financial reporting requirement"?**

While the SEC has chosen not to define "accounting restatement" or "material noncompliance" for the purpose of new Rule 10D-1 (companies are to look to existing accounting standards and guidance), it has clarified its interpretation that both big "R" restatements (to correct an error material to previously issued financial statements) and little "r" restatements (to correct errors that were not material to those previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period) will trigger a clawback.

Certain restatements, including those due to changes in accounting principles, certain internal restructurings, certain adjustments in connection with business combinations and revisions due to stock splits, would not be considered corrections triggering clawbacks.

**Will the company be required to recover all such erroneously awarded incentive compensation?**

The unqualified "no-fault" recovery mandate of the clawback provisions means that companies will be required to pursue recovery unless they have determined that such recovery would be impracticable because either (i) the direct costs of enforcing recovery would exceed the amount to be recovered (though companies must make a reasonable attempt at recovery and must provide documentation of these efforts to the exchange), (ii) for foreign private issuers, recovery would violate home country law of the jurisdiction of incorporation adopted prior to the date on which these rules are published in the Federal Register (issuers would be required to provide an opinion of counsel acceptable to the exchange), or (iii) recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet certain ERISA requirements. In addition, in all three of these cases, the committee of independent directors responsible for executive compensation (or, in the absence of one, a majority of the independent directors) must also determine that recovery would be impracticable. In light of these limited exceptions, companies will be required to pursue recovery in most instances.

## Incentive-Based Compensation

**What will be included in "incentive-based compensation"?**

"Incentive-based compensation" is defined as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure." "Financial reporting measures" are measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, any measures derived wholly or in part from such financial information (including non-GAAP measures) and stock price and total shareholder return. Certain compensation, such as bonuses paid solely upon satisfying one or more subjective standards, non-equity incentive plan awards earned solely upon satisfying one or more strategic or operational measures and equity awards the grant of which is not contingent upon achieving any financial reporting measure performance goal and the vesting of which is contingent solely upon the attainment of non-financial reporting measures and/or completion of a specified employment period (e.g., time vested RSUs) would not be considered incentive-based compensation.

**When will incentive-based compensation be deemed to be "received" for the purposes of the clawback rules?**

Incentive-based compensation will be deemed received in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award was attained, even if the payment or grant occurs after the end of that period. Under this standard, the date of receipt would depend on the terms of the award. If the grant of an award is based, either wholly or in part, on satisfaction of a financial reporting measure, the award would be deemed received in the fiscal period when that measure was satisfied, even if paid or granted after the end of that period. If an equity award vests upon satisfaction of a financial reporting measure, the award would be deemed received in the fiscal period when it vests.

**How will the amount to be clawed back in respect of incentive-based compensation based on stock price or total shareholder return be calculated?**
For incentive-based compensation based on stock price or total shareholder return, companies may use a reasonable estimate of the effect of the restatement on the applicable measure to determine the amount to be recovered (companies will be required to provide documentation of their calculation to the exchange).

## Disclosure Requirements

**Where will companies disclose their clawback policies?**
Each listed company will be required to file its compensation recovery policy as an exhibit to its applicable Exchange Act annual report on Form 10-K, 20-F or 40-F or, for registered management investment companies, on Form N-CSR.

**What do companies need to disclose regarding clawed back compensation?**
If, during its last completed fiscal year, the company either was required to prepare a restatement that required recovery of excess incentive-based compensation, or there was an outstanding balance of excess incentive-based compensation relating to a prior restatement, the company must disclose:

- the date on which it was required to prepare each accounting restatement;
- the aggregate dollar amount of excess incentive-based compensation attributable to the restatement (including an analysis of how that amount was calculated);
    - if the incentive-based compensation was based on a stock price or total shareholder return metric, the estimates used and an explanation of the methodology used for such estimates;
- the aggregate dollar amount that remained outstanding at the end of its last completed fiscal year;
- if the aggregate dollar amount of excess incentive-based compensation has not been determined, the fact that it has not been determined, and the reasons for the lack of determination;
    - in such case, the information must be disclosed in the next proxy/information statement or annual report containing compensation disclosure;
- if the company has determined that recovery of some or all excess incentive-based compensation would be impracticable,
    - for *each* current and former named executive officer, the amount of recovery forgone and a brief description of the reason(s) the company has not pursued recovery; and
    - for all other current and former executive officers as a group, the aggregate amount of recovery forgone and a brief description of the reason(s) the company has not pursued recovery;
- if amounts of excess incentive-based compensation paid to any current or former named executive officer are outstanding for 180 days or more, the name of and amount due from such person at the end of the company's last completed fiscal year; and
- if the company prepared an accounting restatement and concluded that no clawback was required, a brief explanation why the application of its clawback policy resulted in this conclusion.

The disclosure would be included along with the listed company's other executive compensation disclosure in annual reports on Forms 10-K, 20-F and 40-F and any proxy or information statements in which executive compensation disclosure is required, and

for registered management investment companies subject to Rule 10D-1, in annual reports on Form N-CSR and in proxy statements and information statements relating to the election of directors. Disclosure will not be deemed incorporated by reference into any filing under the Securities Act of 1933, as amended, unless specifically done so. Listed companies will also be required to tag specific data points and to block tag the disclosure in an interactive data format using eXtensible Business Reporting Language (XBRL).

The new rules also include amendments to the Summary Compensation Table disclosure requirements if a clawback has been effected. A new instruction to the Summary Compensation Table will require that any amounts recovered pursuant to a listed company's erroneously awarded compensation recovery policy reduce the amount reported in the applicable column as well as the total column for the fiscal year in which the amount recovered initially was reported, and be identified by footnote.

**How will companies disclose restatements that are not correcting a material error to previously issued financial statements?**
Because a Form 8-K is not typically filed for an error that is not material to the previously issued financial statements, the SEC is amending the cover pages of Form 10-K, Form 20-F and Form 40-F to add check boxes for companies to indicate (a) whether the financial statements included in the filing include an error correction to previously filed financial statements, and (b) whether any such corrections are restatements that triggered a clawback analysis during the fiscal year.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content.
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