

## SEC RULEMAKING

# SEC Adopts Final Rules Mandating Compensation Clawback Policies

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On October 26, 2022, the Securities and Exchange Commission (SEC) adopted final rules implementing Section 954 of the Dodd-Frank Act by directing national securities exchanges and associations, such as the New York Stock Exchange and Nasdaq, to adopt listing standards that will require listed companies to develop and implement compensation clawback policies.<sup>1</sup>

Under the final rules, listed companies will be required to have written compensation clawback policies that require the recoupment of certain incentive-based compensation received by current or former “executive officers” when an issuer has an accounting restatement. Listed companies will also be required to make certain disclosures about their clawback policies. The listing standards will generally apply to all issuers with a class of securities listed on a national securities exchange or association, including foreign private issuers, controlled companies, smaller reporting companies and emerging growth companies.

The final rules materially expand the scope of the SEC’s original compensation clawback policy proposal published in 2015. Public companies and their audit and compensation committees, executive officers and outside advisors should begin preparing now to deal with the significant implications of the final rules.

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## Required Elements of the Clawback Policies

The clawback policies mandated by the new Rule 10D-1 will have to meet various requirements as to their scope and application, as summarized below.

### Type of Restatement Triggering Recovery of Compensation

The clawback policy will be triggered when an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws. Triggering restatements will include any required accounting restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements, or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.

Thus, in a change from the proposed rule, under the final rule, triggering restatements will include both “Big R” restatements and “little r” restatements. In determining when a restatement is triggered, the SEC reminded issuers that SEC Staff has provided guidance on making materiality determinations in Staff Accounting Bulletin No. 99, *Materiality*, and Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*.

Rule 10D-1 does not define “accounting restatement” or “material noncompliance” as existing accounting standards and guidance set forth the meaning of those terms. Under current accounting standards, certain changes would not constitute an error correction, including the following: retrospective application of a change in accounting principle;

retrospective revision to reportable segment information due to a change in internal organization structure; retrospective reclassification due to a discontinued operation; retrospective application of a change in reporting entity; retrospective adjustment to provisional amounts in connection with a prior business combination; and retrospective revision for stock splits, reverse stock splits, stock dividends or other changes in capital structure.

### Individuals Covered

The clawback policy will be required to apply to any individual who served as an executive officer at any time during the performance period that applied to the incentive-based compensation that the individual received. Accordingly, the policy will apply to both current and former executive officers.

Rule 10D-1 uses a definition of “executive officer” similar to the definition under Rule 16a-1(f) of the Securities Exchange Act of 1934 (Exchange Act), rather than the definition of “executive officer” under Rule 3b-7 under the Exchange Act. This definition generally includes the issuer’s president, principal financial officer, principal accounting officer (or, if none, the controller), any vice-president in charge of a principal business unit, division or function, and any other officer who performs a policy-making function, or any other person who performs similar policymaking functions.

It will not be relevant whether there is any fault on the part of the executive officer or whether the executive officer was involved in preparing the financial statements. Companies will not be able to indemnify officers or pay for insurance to cover amounts that are clawed back.

### Definition of “Incentive-Based Compensation” Subject to Recovery

The clawback policy will be required to apply to “incentive-based compensation,” which is defined as compensation that is granted, earned or vested based wholly or in part upon the attainment of a “financial reporting measure.” “Financial reporting measure” is defined as a measure that is

determined and presented in accordance with the accounting principles used in preparing financial statements, and any measures derived from such measures.

This includes non-GAAP financial measures and other measures not presented in the financial statements or SEC filings. “Financial reporting measure” is also defined to include stock price and total shareholder return (TSR).

The SEC noted that “incentive-based compensation” is to be determined in a principles-based manner so that new forms of compensation and new measures of performance will be captured. The SEC provided in the adopting release a non-exhaustive list of examples of “incentive compensation”:

- Non-equity incentive plan awards that are earned based wholly or in part on satisfying a financial reporting measure performance goal;
- Bonuses paid from a “bonus pool,” the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal;
- Other cash awards based on satisfaction of a financial reporting measure performance goal;
- Restricted stock, restricted stock units, performance share units, stock options, and stock appreciation rights (SARs) that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal; and
- Proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal.

The SEC also provided examples of compensation that is not “incentive-based compensation”:

- Salaries (unless an increase is based wholly or in part on satisfying a financial reporting measure performance goal);
- Discretionary bonuses not paid from a “bonus pool” determined by satisfying a financial reporting measure performance goal;

- Bonuses paid solely upon satisfying one or more subjective standards or completion of a specified employment period;
- Non-equity incentive plan awards earned solely upon satisfying strategic or operational measures; and
- Equity awards for which the grant is not contingent on achieving any financial reporting measure performance goal and vesting if contingent solely upon continued employment or attaining nonfinancial reporting measures.

### Time Periods Covered

The clawback policy will apply to incentive-based compensation “received” during the three fiscal years (and certain transition periods resulting from a change in fiscal year) preceding the date on which the issuer is required to prepare the accounting restatement. Compensation will be deemed “received” when the performance condition is satisfied, even if the compensation is not actually paid or granted until a later date. The SEC noted in the adopting release that the date of receipt of the compensation depends on the terms of the award and provided the following examples:

- If the grant of an award is based, either wholly or in part, on satisfaction of a financial reporting measure performance goal, the award would be deemed received in the fiscal period when that measure was satisfied;
- 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;
- A non-equity incentive plan award would be deemed received in the fiscal year that the executive officer earns the award based on satisfaction of the relevant financial reporting measure performance goal, rather than a subsequent date on which the award was paid; and
- A cash award earned upon satisfaction of a financial reporting measure performance goal would be deemed received in the fiscal period when that measure is satisfied.

The date on which the issuer is required to prepare the accounting restatement will be the earlier of (a) the date the board, committee or authorized officer concludes, or should reasonably have concluded, that the issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement or (b) the date a court, regulatory or other legally authorized body orders a restatement. The SEC noted in the adopting release that the determination an issuer is required to prepare an accounting restatement may occur before the precise amount of the error has been determined.

For an accounting restatement for which an issuer is required to file an Item 4.02(a) Form 8-K, the conclusion that the issuer is required to prepare an accounting restatement is expected to coincide with the occurrence of the event disclosed in the Form 8-K. Furthermore, in determining when there should reasonably have been a conclusion to prepare an accounting restatement, the SEC noted that an issuer would have to consider any notice it may receive from its auditor that previously issued financial statements contain a material error.

### Amount of Recovery

The amount of the recovery will be the amount by which the incentive-based compensation the executive officer actually received exceeds the amount the executive officer would have received based on the restated numbers. The amount of the recovery will be calculated on a pre-tax basis. Where the incentive-based compensation is based on stock price or TSR, reasonable estimates can be used to calculate the excess amount, but the issuer must maintain documentation of the determination of the reasonable estimate and provide the documentation to its national securities exchange or association.

The SEC noted that the definition of erroneously awarded compensation is intended be applied in a principles-based manner but provided the following guidance:

- 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 will be a 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, options, or stock appreciation rights (SARs) are still held at the time of recovery, the erroneously awarded compensation will be 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 the options or SARs have been exercised, but the underlying shares have not been sold, the erroneously awarded compensation will be the number of shares underlying the excess options or SARs (or the value thereof).

Amounts recovered from the executive under Section 304 of the Sarbanes-Oxley Act of 2002 may be credited as a reduction in the amount required to be recovered under the Rule 10D-1 clawback, but the adopting release states that recovery under Rule 10D-1 will not preclude recovery under the Sarbanes-Oxley Act to the extent any applicable amounts have not been reimbursed to the issuer.

### **Recovery Mandatory Unless Impracticable for One of Three Reasons**

Recovery of incentive-based compensation subject to the clawback will be mandatory unless the issuer's compensation committee comprising independent directors, or a majority of independent directors in the absence of a committee, determine that recovery is "impracticable" for one of the following three reasons:

- The direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered. This basis for

impracticability would be available only after the issuer has made a reasonable attempt to recover compensation, documented such attempt and provided the documentation to its national securities exchange or association.

- Recovery would violate home country law where the law was adopted prior to the date of the final rule's publication in the Federal Register. This basis for impracticability would be available only after the issuer has obtained an opinion of home country counsel as to the violation and provided the opinion to its national securities exchange.
- Recovery would likely cause an otherwise tax-qualified, broad-based retirement plan to fail to meet the requirements of Section 401(a)(13) or Section 411(a) of the Internal Revenue Code of 1986, as amended.

Boards will be permitted to exercise discretion, subject to reasonable restrictions, as to the means of recovery.

The recovery, however, must be effectuated reasonably promptly. The rule does not define "reasonable promptness," but the SEC noted in the adopting release its expectation that the issuer and its directors will pursue the most appropriate balance of cost and speed in determining the appropriate means to seek recovery in light of their fiduciary duty to safeguard the assets of the issuer, taking into account the time value of money.

The SEC also noted in the adopting release that an issuer may be acting reasonably promptly in establishing a deferred payment plan that allows repayment as soon as possible without unreasonable economic hardship to the executive officer.

### **Clawback Policy Disclosures**

The final rules include several disclosure requirements relating to the clawback policy. An issuer's compliance with the disclosure requirements will be an element of the listing standards.

### Filing of Clawback Policy

The issuer will need to file the clawback policy as an exhibit to its annual report on Form 10-K.

### Proxy Statement/Annual Report Disclosures

The rule amends Item 402 of Regulation S-K to require disclosure by listed issuers if at any time during or after the last completed fiscal year the issuer was required to prepare an accounting restatement that required recovery of excess incentive-based compensation or, as of the end of the last completed fiscal year, there was an outstanding balance of excess incentive-based compensation attributable to a prior restatement.

The required disclosure under Item 402 will include:

- For each restatement, (a) the date on which the issuer was required to prepare the restatement, (b) the aggregate dollar amount of erroneously awarded compensation attributable to the restatement, including an analysis of how the amount was calculated, (c) if the financial reporting measure related to stock price or TSR, the estimates that were used in determining the erroneously awarded compensation attributable to the restatement and an explanation of the methodology used for such estimates, (d) the aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed year, and (e) if the amount of erroneously awarded compensation has not yet been determined, that fact and the reasons for such non-determination.
- If recovery would be impracticable, disclosure of the amount of recovery forgone (for each current and former named executive officer individually and for all other executive officers as a group) and a brief description of the reason the issuer decided not to pursue recovery.
- For each current and former named executive officer, the amount of outstanding unrecovered excess compensation that had been outstanding for 180 days or longer since the date the issuer determined the amount owed.

If the issuer was required to prepare a restatement during or after the issuer's last completed fiscal year and concluded that recovery of compensation was not required under the issuer's policy, the issuer must briefly explain why application of the policy resulted in that conclusion.

As long as an issuer provides the new Item 402 disclosure with respect to clawbacks, the issuer need not also make a disclosure under Item 404(a) relating to related party transactions with respect to the clawback activity.

The Item 402 disclosure will need to be provided in XBRL format, but will be required only in annual reports on Form 10-K and proxy statements whenever other Item 402 disclosure is required. The disclosure, therefore, will not be required in registration statements under the Securities Act of 1933. In addition, the disclosure will not be deemed incorporated by reference into any filing under the Securities Act of 1933 unless specifically incorporated by reference.

For any registered management investment company subject to Rule 10D-1, information mirroring the new Item 402 disclosure will need to be included in annual reports on Form N-CSR and in proxy statements and information statements relating to the election of directors. Foreign private issuers will be required to provide the new Item 402 disclosure in annual reports filed with the SEC under Section 13(a) of the Exchange Act.

The Summary Compensation Table rules are amended to require that any amounts recovered under a clawback policy reduce the amount reported in the table for the fiscal year in which the original payment was reported and be identified in a footnote.

### Form 10-K Checkboxes

The rule adds two new checkboxes to the cover page of Form 10-K relating to whether the financial statements included in the Form 10-K reflect the correction of an error to previously issued financial statements and whether any of those error corrections are restatements that require a recovery analysis

of incentive-based compensation received by executive officers.

## Timing of Effectiveness of the Final Rules

The national securities exchanges will have to file with the SEC proposed listing standards implementing the rule no later than 90 days after the SEC final rules are published in the Federal Register. Those new listing standards will need to become effective no later than one year after the publication of the SEC final rules.

Issuers then will need to adopt clawback policies no later than 60 days after the exchanges' listing standards become effective. The clawback policies will need to apply to all incentive-based compensation received by current or former executive officers (after beginning service as an executive officer and who served as an executive officer during the applicable performance period) on or after the effective date of the applicable listing standard. The clawback policy will be expected to apply to such compensation even if the compensation is received under a pre-existing contract or arrangement.

Compliance with the new Item 402 disclosure rule will be required for all applicable filings with the SEC after the effective date of the exchanges' listing standards.

## Recommended Actions for Listed Companies

- Review any existing clawback policies to determine what revisions will be needed to comply

with the final rules and listing standards. Among other items, revisions may be needed relating to the individuals covered, the types of compensation covered, the types of restatements that trigger the policy, the lookback period of the policy, the required mandatory nature of clawbacks and the exceptions to mandated clawbacks.

While we do not expect the national securities exchanges to add any additional requirements in their listing standards, it is possible that they may do so, and therefore issuers should not finalize their policies until the listing standards are published.

- Review existing incentive-based compensation arrangements and any other plans or agreements that are affected by, or require the payment of, incentive compensation to determine whether there is an existing contractual right to recover compensation, and consider whether to modify the arrangements to permit recovery in the future.
- Consider the impacts on internal control over financing reporting, quarterly financial reporting closing and disclosure committee processes, determinations of when a restatement is required, procedures and controls through which clawback policies will be implemented if there is a restatement, and compensation program design. Audit committees and compensation committees will need to work together closely on these items.

### Note

1. <https://www.sec.gov/rules/final/2022/33-11126.pdf>.