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Skadden

Executive Compensation and Benefits Alert

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SEC Adopts Final Clawback Rules and Disclosure Requirements

On October 26, 2022, the U.S. Securities and Exchange Commission (SEC) adopted long-awaited final rules implementing the incentive-based compensation recovery (clawback) provisions of the Dodd-Frank Act. The final rules direct the stock exchanges to establish listing standards requiring listed companies to develop and implement a policy providing for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers and to satisfy related disclosure obligations.

The final rules largely track the proposed rules originally released in July of 2015, although (as described below) there are some important differences that should be noted, especially when evaluating existing clawback policies that were designed to comply with the proposed rules. For example, even some "little r" restatements that did not involve a material misstatement in past years may trigger a clawback under the final rules, and the new rules require more detailed disclosures about how a company's policy was implemented in the most recent fiscal period.

Clawback Policy Requirements. Listed companies will be required to adopt a clawback policy providing for recovery of incentive-based compensation erroneously received by current or former executive officers during the three completed fiscal years immediately preceding the year in which the company is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements. Erroneous payments must be recovered even if there was no misconduct or failure of oversight on the part an individual executive officer.

Listed companies will be required to (i) file their written clawback policies as exhibits to their annual reports; (ii) indicate by check boxes on the cover page of their annual reports whether the financial statements included in the filings reflect a correction of an error to previously issued financial statements and whether any of those error corrections are restatements requiring a recovery analysis of incentive-based compensation under their clawback policies; and (iii) disclose how they have applied their clawback policies during or after the last completed fiscal year.

Under the new rules, a company could be subject to delisting if it does not adopt a clawback policy that complies with the applicable listing standard, disclose the clawback policy and any application of the policy in accordance with SEC rules, or enforce the clawback policy's recovery provisions.

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Issuers Subject to the Final Rules. Almost all listed companies (including foreign private issuers (FPIs), controlled companies, smaller reporting companies and emerging growth companies, but excluding certain registered investment companies) are subject to the final rules. While many commenters raised concerns about the potential difficulties that the final rules would impose on FPIs, the SEC was unpersuaded. The only exempted listed companies under the final rules are issuers of security futures products, standardized options, unit investment trust securities and certain registered investment company securities.

Covered Executive Officers. The final rules adopt the same definition of "executive officers" used to determine a listed company's officers under Exchange Act Rule 16a-1 (for domestic issuers, the "Section 16 officers"). These executive officers, including former executive officers who are no longer serving at the time the clawback is required, are subject to the clawback requirements without regard to any individual knowledge or responsibility related to the restatement or the mistaken payments.

However, in a change from the proposed rules, the final rules do not require recovery of incentive-based compensation in circumstances where (i) the compensation was received by a person before beginning service as an executive officer or (ii) if that person did not serve as an executive officer at any time during the three-year lookback period to which the clawback rules apply.

Triggering Events. Application of the clawback policy will be triggered before the accounting restatement is actually filed. The three-year look-back period starts on the earlier of (i) the date the company's board of directors, committee and/or management concludes (or reasonably should have concluded) that a restatement is required or (ii) the date a regulator, court or other legally authorized entity directs the company to restate previously issued financial statements.

Covered Accounting Restatements. The final rules require that the clawback policy adopted be triggered by both "Big R" and "little r" restatements. A "Big R" restatement occurs when a company is required to prepare 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 requires the company to file an Item 4.02 Form 8-K and to amend its filings promptly to restate the previously issued financial statements. By contrast, a "little r" restatement corrects an error that would result in a material misstatement if the error was not corrected in the current period or was corrected in the current period and generally does not require Form 8-K filing.

The SEC provides the following example of a "little r" restatement: Assume that an improper expense accrual (such as an overstated liability) has built up over five years at $20 per year. Upon identification of the error in year five, the company evaluated the misstatement as being immaterial to the financial statements in years one through four (at only $20 per year). To correct the overstated liability in year five, a $100 credit to the statement of comprehensive income would be necessary, and $80 of this credit would relate to the previously issued financial statements for years one through four.

During the preparation of its annual financial statements for year five, the company determines that, although a $20 annual misstatement of expense would not be material to year five, the adjustment to correct the $80 cumulative error from previously issued financial statements would be material to comprehensive income for year five. Accordingly, instead of correcting the full $100 error in year five (which would result in a "material misstatement if the error … was corrected in the current period") or not correcting the error at all (which would result in a "material misstatement if the error was not corrected in the current period"), the company must correct the financial statements for years one through four to the extent they appear in the current filing for year five.

The SEC noted in the adopting release that its estimates reflect that "little r" restatements may be roughly three times as common as "Big R" restatements. The 2015 proposed rules provided that only a "big R" restatement triggered a clawback, and many companies that proactively adopted clawback policies based on the proposed rules have not incorporated a triggering event for "little r" restatements into their existing policies.

Recovery of Erroneously Awarded Incentive-Based Compensation. The final rules require that clawback policies provide for recovery of "incentive-based compensation," 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" may include both GAAP and non-GAAP financial measures, including stock price and total shareholder return (TSR). Awards based solely on continued employment need not be subject to clawback under the policy.

The amount of compensation subject to recovery ("erroneously awarded") is the excess of:

- the incentive-based compensation actually paid during the fiscal period when the applicable financial reporting measure is attained; over
- the amount that would have been received had the financial statements been correct in the first instance.

Examples of compensation that do not meet the definition of "incentive-based compensation" for purposes of the final rules include, but are not limited to:

- salaries;
- bonuses paid solely at the discretion of the compensation committee or the board of directors that are not paid from a "bonus pool" that is determined by achieving a financial reporting measure;
- bonuses paid solely upon satisfying one or more subjective standards and/or completion of a specified employment period;
- non-equity incentive plan awards earned solely upon satisfying one or more strategic measures (*e.g.*, consummating a merger or divestiture), or operational measures (*e.g.*, opening a specified number of stores, completion of a project, increase in market share); and
- equity awards for which the grant is not contingent upon achieving any financial reporting measure and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more nonfinancial reporting measures (*e.g.*, discretionary grants of time-vesting restricted stock, restricted stock units or stock options).

When Incentive-Based Compensation Is "Received." Incentive-based compensation will be deemed "received" for purposes of the clawback policy requirements in the fiscal period during which the financial reporting measure is attained, even if the payment or grant occurs after the end of that period. The date the compensation is "received" depends upon the terms of the award. For example:

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

Exceptions to Recovery. The new listing standards provide for limited exceptions the company's obligation to enforce the application of the clawback policy due to impracticability of such recovery. These exceptions are only available where:

i. pursuing such recovery would be impracticable because the direct expense paid to a third party to assist in enforcing the policy would exceed the recoverable amounts and the issuer has (A) made a reasonable attempt to recover such amounts and (B) provided documentation of such attempts to recover to that company's applicable listing exchange;

ii. pursuing such recovery would violate the listed company's home country laws and the company provides an opinion of counsel to that effect to the exchange; or

iii. recovery would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees of the registrant, to fail to meet the requirements of the Internal Revenue Code.

Restrictions on Indemnification and Insurance. Under the new rules, listed companies are prohibited from indemnifying or reimbursing any current or former executive officer against the recovery of erroneously awarded compensation. Companies are further prohibited from paying the premiums on an insurance policy that would cover an executive officer's potential clawback obligations.

New Disclosure Requirements. The final rules include new disclosure requirements on how the clawback policy is implemented, during or following the end of the most recently completed fiscal year, including a requirement to provide:

- the date on which the listed issuer was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded incentive-based compensation attributable to such accounting restatement;
- the aggregate amount of incentive-based compensation that was erroneously awarded to all current and former named executive officers that remains outstanding at the end of the last completed fiscal year;
- any outstanding amounts due from any current or former executive officer for 180 days or more, separately identified for each named executive officer (or, if the amount of such erroneously awarded incentive compensation has not yet been determined as of the time of the report, disclosure of this fact and an explanation of the reasons why); and

if recovery would be 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 the listed registrant decided in each case not to pursue recovery.

Such disclosure will be required as part of the executive compensation disclosure provisions in new Item 402(w) of Regulation S-K (or analogous disclosure provisions in the forms applicable to FPIs and listed funds). Note that, if an amount is properly determined to be not recoverable due to impracticality, such amount will not be considered to be outstanding at the last fiscal year for purposes of the disclosure requirements described above.

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Companies must also incorporate any recoupment of compensation into the amounts shown for such year in the Summary Compensation Table by subtracting the amount recovered from the amounts reported in the Summary Compensation Table for that year and quantify the amount recovered in a footnote.

New Exhibit Filing; XBRL. The new rules will require the clawback policy to be filed as an exhibit to the annual report on Form 10-K, 20-F or 40-F. The new disclosure on the cover page of the Form 10-K, 20-F or 40-F, as applicable, and Item 402(w) with respect to domestic companies, must be tagged in interactive block text tag format using eXtensible Business Reporting Language (XBRL).

Effect on Existing Clawback Rules. Chief executive officers (CEOs) and chief financial officers (CFOs) remain subject to the clawback provisions of the Sarbanes-Oxley Act of 2002 (SOX), which provide that if a company is required to prepare an accounting restatement because of "misconduct," the CEO and CFO are required to reimburse the company for any incentive or equity-based compensation and profits from selling company securities received during the year following issuance of the inaccurate financial statements. To the extent that the Dodd-Frank clawback policy and SOX cover the same recoverable compensation, the CEO or CFO would not be subject to duplicative reimbursement. Recovery under the new rules will not preclude recovery under SOX to the extent any applicable amounts have not been reimbursed to the issuer.

When the New Rules Take Effect. The SEC's final rules will become effective 60 days after publication in the Federal Register, but the stock exchanges have up to 90 days post-publication to propose new listing standards, and those only need to become effective within one year following the Federal Register publication date.

Following the effective date of the new listing standards, listed companies will have 60 days to adopt the required clawback policy. A listed company must recover all erroneously awarded incentive-based compensation that is received on or after the effective date of the applicable listing standard.

What Companies Should Do Now. Listed companies that will be subject to the new requirements should consider the following actions:

- Review their existing clawback policies to consider what changes may be required, particularly given the additional requirements imposed since the 2015 proposed regulations. Note, however, that companies may want to wait for the stock exchanges to release their implementing listing standards (which could be broader than the SEC requirements) before actually adopting or amending clawback policies to comply with the new rules;
- Start considering which aspects of their compensation plan design should be reviewed and possibly supplemented in light of the clawback mandate;
- Review their executive officer determinations in light of the new significance of this designation.

For additional information on the new rules, see the press release announcing adoption of the final rules and the fact sheet issued by the SEC.

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