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SEC Adopts No Fault Executive Compensation Clawback Rules for Listed Companies: Covers "little r" Restatements

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The U.S. Securities and Exchange Commission (SEC) adopted the long-debated rule that will require listed companies to adopt policies requiring the recovery (or "clawback") of erroneously awarded incentive compensation from current or former executive officers, implementing the provisions of Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The final rules, available here, direct the national securities exchanges to establish listing standards requiring companies to develop, implement and comply with a compensation clawback policy. Issuers that do not adopt and comply with their compensation recovery policy would be subject to delisting. The clawback policy must mandate recovery of incentive-based compensation from current and former executive officers who received such compensation during the three fiscal years preceding the date on which the listed 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. The final rules: leave little discretion to the board of directors of the company; apply irrespective of misconduct; apply to a broad-base of listed companies, including foreign private issues, smaller reporting companies, emerging growth companies, controlled companies and debt-only issuers; and apply to both "Big R" and "little r" restatements. The new rules also require listed issuers to provide disclosure about such policies and how they are being implemented.

Below we summarize the key elements of the rule, and offer considerations on "***What to do now?***"

Summary of New "Clawback" Rules

Effective Dates

The SEC's new rules become effective 60 days following the publication of the adopting release in the Federal Register. The exchanges have 90 days from such publication date to propose listing standards to comply with new Exchange Act Rule 10D-1, and the listing standards must be effective no later than one year following such publication date. This means a listing standard effective date possibly in November 2023, assuming typical Federal Register time-frames and the exchanges using the full time periods permitted. Listed companies are required to adopt a clawback policy complying with the listing standards no later than 60 days after such standards become effective. Companies must begin to comply with the disclosure requirements of the rules in proxy and information statements and the company's annual Form 10-K on or after the listing standard becomes effective.[1]

Listed companies will be required to recoup any incentive-based compensation that is "received" by current or former executive officers on or after the effective date of the applicable listing standard, even if prior to the adoption by the company of its own policy and even if such compensation is received pursuant to pre-existing contracts or arrangements.

"Big R" and "little r" Restatements Triggers

Perhaps the most significant departure from the rule as originally proposed in 2015, available here, is that the final rule reflects a broader construction of the phrase "an accounting restatement due to the material noncompliance of the issuer of any financial reporting requirement under the securities law" – covering both:

- "Big R" restatements, which stems from an error was material to previously issued financial statements (requiring a company to file an Item 4.02 Form 8-K); and
- "little r" restatements, which corrects errors that were not material to previously issued financial statements but that would result in a material misstatement in the current period if (i) the error was left uncorrected in the current period, or (ii) the correction of the error was recognized only in the current period.

Certain retrospective accounting changes to an issuer's financial statements do not trigger compensation recovery under the rules, including: (i) application of a change in accounting principle; (ii) revisions to reportable segment information due to a change in the structure of an issuer's internal organization; (iii) reclassification due to a discontinued operation; (iv) application of a change in reporting entity, such as from a reorganization of entities under common control; and (v) revisions for stock splits, reverse stock splits, stock dividends or other changes in capital structure etc. Furthermore, an "out-of-period adjustment" (i.e., when the error is immaterial to the previously issued financial statements and the correction of the error is immaterial to the current period) should not trigger a clawback analysis under the rules because it is not an "accounting restatement."

Based on an SEC staff study of restatements occurring in 2021 (excluding SPACs), the Staff estimated that "little r" restatements accounted for approximately three times as many restatements as "Big R" restatements. However, the SEC notes that not all restatements will trigger a recovery of compensation that was earned as a result of meeting performance measures. The SEC also expects that recovery of incentive-based compensation that is tied to TSR would be relatively small and infrequent as a result of "little r" restatements because these restatements are less likely to be associated with significant stock price reactions.

Current and Former Executive Officers Covered

The rule applies to any current or former executive officer of the issuer. The definition of "executive officer" generally mirrors the definition of "officer" in Rule 16a-1(f) (i.e., Section 16 officers). The rule only requires recovery of incentive-based compensation received by a person (i) after beginning service as an executive officer, and (ii) if that person served as an executive officer at any time during the recovery period. Recovery would not be required from someone who is an executive officer at the time recovery is triggered but was not an executive officer during the period requiring the restatement of the financial statements.

Mandatory Recovery in the Event of a Restatement: No Fault Required

Although many clawback policies in place today require that an executive bear some fault or responsibility with respect to a resulting restatement or that the executive participated in other bad conduct, the final SEC rules are unqualified. The rules provide that recovery must be on a "no-fault" basis, meaning that there need not be any misconduct, fault or responsibility by the covered person in order for recoupment to be triggered.

Recovery Period: Three-Year Look-Back

The new rule requires the recovery of excess compensation during the three-year fiscal period preceding the date on which the issuer is required to prepare an accounting restatement. The rule provides that this date is the earlier to occur of: (i) the date the issuer's board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take such action if board action is not required, concludes, or "reasonably should have concluded," that the issuer is required to prepare an accounting restatement due to a material noncompliance of the issuer with any financial reporting requirement under the securities law as described in Rule 10D-1(b)(1) – this timing is expected to coincide with the occurrence of the event described in Item 4.02(a) of Form 8-K in the case of a "Big R" restatement; or (ii) the date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement. In applying the reasonableness standard to the determination of a three-year look-back period, while not dispositive, an additional factor cited by the SEC is the receipt of any notice as to a potential material error from its independent auditor. An example of the look-back is as follows: If a calendar year issuer concludes in November 2027 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2028, the recovery policy would apply to compensation received in 2024, 2025, and 2026.

Compensation is "Received" When Attained

Compensation is deemed "received" during the period when the performance measure that must be achieved is *attained or satisfied*, rather than when the award is granted, vested or ultimately paid. Specifically, the SEC stated that "ministerial" acts or other conditions necessary to effect the issuance or payment, such as calculating the amount earned or obtaining board or committee approve, does not affect the determination of the date "received."

Financial Reporting Measures Broadly Defined; Incentive-Based Award Covered

The type of "incentive-based compensation" is any compensation award, including cash or equity, granted, earned or vested based in whole or in part on the attainment of any "financial reporting measure."

A "financial reporting measure" is defined as any measure that is determined and presented in accordance with the principles used in preparing the issuers' financial statements, and any measure derived wholly or in part from such measures. These measures include accounting-related measures such as revenues and EBITDA, and notably, performance measures that are not purely accounting-based such as stock price and total shareholder return, or "TSR." Non-GAAP measures, as well as ratios and metrics that are not non-GAAP like same store sales are also covered. A financial reporting measure is subject to the rule even if it is not actually presented in the company's financial statements or included in an SEC filing. Therefore, many types of "financial reporting measures" fall within the scope of the final rule.

Specific examples of "incentive-based compensation" cited by the SEC include:

- 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.

Examples of compensation that is <u>not</u> "incentive-based compensation" include:

- Salaries;
- 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;
- Bonuses paid solely upon satisfying one or more subjective standards (e.g., demonstrated leadership) 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 performance goal and vesting is contingent solely upon completion of a specified employment period (e.g., time-based options, restricted stock or RSUs) and/or attaining one or more nonfinancial reporting measures.

Amount of Recovery – "Excess Compensation"

The amount of incentive-based compensation to be recovered is the amount received by the executive officer that exceeds the amount they would have received had the incentive-based compensation been determined based on the restated financial statements, computed on a pre-tax basis. Applying this definition, after an accounting restatement, a company will first recalculate the applicable financial reporting measure and the amount of incentive-based compensation based thereon, and then determine whether, based on that financial reporting measure as calculated by relying on the original financial statements and taking into account any discretion that the compensation committee had applied to reduce the amount originally received, the executive officer received a greater amount of incentive-based compensation than would have been received applying the recalculated financial reporting measure. For incentive-based compensation based on stock price or TSR, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the amount must be based on a "reasonable estimate" of the effect of the restatement on the applicable measure to determine the amount to be recovered, recognizing that there are a number of methods with different levels of complexity and costs that may be used to "reasonably estimate" the effect on the stock price.

Erroneously awarded compensation must be calculated without respect to tax liabilities that may have been incurred or paid by the executive. The adopting release includes suggested guidelines for calculations: (i) for cash awards, 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 measure; (ii) for cash awards paid from bonus pools, 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; (iii) for equity awards, if the shares, options, or SARs are still held at the time of recovery, the number of such securities received in excess of the amount that should have been received given the restatement; and (iv) for equity awards, if the options or SARs have been exercised, but the underlying shares have not been sold, the number of shares underlying the excess options or SARs (or the value there).

Limited Board Discretion to Not Seek Recovery; Board Discretion Retained for "Means" of Recovery

The SEC has given boards of directors very narrow discretion on when they can choose not to seek recovery pursuant to a clawback policy, providing an exception only when doing so would be impracticable. The three instances of impracticability are when: (1) the direct costs paid to a third party (such as reasonable legal expenses and consulting fees) to assist in enforcing recovery would exceed the erroneously awarded compensation amounts; (2) recovery would violate home country law; and (3) recovery is from tax-qualified plans. In the first instance, a company is still required to make a reasonable attempt at recovering the excess compensation, documenting such attempts, providing the underlying documentation to the stock exchange and disclosing why it chose not to pursue recovery. In the second instance, a company is required to obtain an opinion from home country counsel stating that seeking recovery would violate home country law. The third exemption allows tax-qualified retirement plans to continue to meet the statutory requirements for tax exemption, preventing adverse tax consequences for all plan participants including rank-and-file employees. Contribution to plans limited only to executive officers, SERPs, or other nonqualified plans and benefits therefrom, would still be subject to recovery and not fall within the exemption.

Boards of directors may exercise discretion in the *means* in which the board recovers excess compensation. For example, boards have the discretion to determine whether recovery should be achieved through cancelling unrelated unvested compensation awards, offsets against nonqualified deferred compensation and unpaid incentive compensation, future compensation obligations, dividends on company stock owned to an executive officer. Nevertheless, the recovery must be sought "reasonably promptly" and must be settled for the full recovery amount unless impracticable.

No Exceptions for FPIs, EGCs, SRC and Controlled Companies

All listed companies are covered by the final rule, including certain companies that are often exempt from certain listing rules such as foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies, management investment companies, and companies with only listed debt securities. However, the final rule does not cover listed registered management investment companies who files annual reports on Form N-CSR if they have not awarded incentive-based compensation to any executive officers during the last three fiscal years. Also exempt from the rules are certain security futures products, standardized options, securities issued by unit investment trusts, and the securities issued by certain registered investment companies from the mandated listing standards.

No Indemnification or Insurance to Mitigate Losses

Companies are prohibited from indemnifying executive officers against, or paying the premiums for any insurance policy to cover, losses incurred under the clawback policy.

Disclosure Requirements

File Policy as Exhibit

Each listed company is required to file the clawback policy as an exhibit to its Form 10-K or Form 20-F and 40-F.

Disclosure of Recovery

The rules add a new Item 402(w) of Regulation S-K, pursuant to which companies will be required to disclose in a proxy or information statement that calls for Item 402 disclosure and in its Form 10-K: (1) the date the company was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (including an analysis of how the amount was calculated and the estimates used in calculating the recoverable amount in the case of awards based on stock price or total shareholder return); (2) the aggregate amount that remains outstanding and any outstanding amounts due from any current or former named executive officer for 180 days or more; (3) details regarding any reliance on the impracticability exceptions; (4) reasons for not yet determining the amount of erroneously awarded compensation; and (5) an explanation if a restatement was prepared and no compensation was clawed back under the company's clawback policy. The Item 402(w) disclosure will not be deemed to be incorporated by reference into any filing under the Securities Act, except to the extent the company specifically incorporates it by reference.

Form 10-K Check-Box

Forms 10-K, 20-F and 40-F will include new "check boxes" that indicate separately whether (i) the previously issued financial statements included in the filing include an error correction and (ii) any such corrections are restatements that triggered a clawback analysis during the fiscal year. This means that both "Big R" and "little r" restatements will be easy to identify.

XBRL Tagging

The rule requires tagging of any specific data points included within the compensation recovery disclosures, as well as block text tagging of those disclosures, in Inline XBRL.

What to do Now?

- **Monitor Compliance Dates.** Listed companies and those preparing for listing should monitor the publication of the final SEC rule in the Federal Register and the filing by the exchanges of proposed listing standards. Among other things, companies will be required to recoup any incentive-based compensation that is "received" by current or former executive officers on or after the effective date of the applicable listing standard, even if prior to the adoption by the company of its own policy and even if such compensation is received pursuant to pre-existing contracts or arrangements.

- **Evaluate Existing Compensation Arrangements and Clawback Policies; Adopt Clawback Policy if None Exists.** Companies that have already adopted clawback policies or similar arrangements should review such policies and consider changes that may be necessary to meet the new requirements, or adopt a separate Rule 10D-1 compliant policy. Companies will need to evaluate existing incentive-based compensation arrangements to determine which are based on "financial performance measures" subject to a potential clawback, and consider whether those policies, plans or arrangements require modification consistent with the new rule. Many equity incentive plans already contemplate that existing clawback provisions may be subject to the SEC's clawback rules under Section 954 of the Dodd-Frank Act. Companies that do not have a current policy will need to develop and implement a clawback policy in compliance with the new rule. Listed companies also will want to review D&O insurance policies and indemnification agreements to ensure compliance with the limitations of the new rule. Companies also may want to consider the appropriate timing for updating current award agreements or new award agreements to cross-reference compliance with the clawback policy and the new SEC rule.
- **Consider Broader Policy.** Although the SEC's clawback rules are prescriptive, the SEC noted that companies could adopt policies more extensive than what is required by the new rules. One area in which companies have considered more extensive provisions are in circumstances where an executive's misconduct even in the absence of a restatement could lead to reputational damage for the company. Companies may wish to consider including clawbacks for circumstances relating to material breaches of company codes of conduct, reputational damage or breach of a restrictive covenant in order to establish a remedy for such conduct and enforce a culture of compliance. Companies may also wish to consider whether there is a desire to have a policy that covers a broader management group, beyond the executive officers mandated by the new rule.
- **Broadly Consider Executive Compensation Program.** The final rules could result in changes to the type of incentive compensation programs provided to executive officers with a shift towards greater time-vested or discretionary awards. Companies may consider whether to eliminate performance-based elements of compensation arrangements that are also discretionary in nature. In doing so, however, companies must consider incentives to achieve company strategic goals and the stakeholder pressures to keep such metrics performance-based.
- **Enhance Controls**. Companies will need to consider how to enforce and implement the new clawback policy, particularly for existing compensation arrangements. These tasks will require multiple disciplines (e.g., tax, accounting, HR, employment litigators) and guidance and oversight from the compensation committee. This may also require the coordination of the compensation and audit committees. Compliance with the new rule will require controls around the clawback policy and related SEC disclosures, including evaluating whether a restatement is required. Moreover, under certain circumstances, difficult and costly analyses may be needed to determine the amount of performance-based compensation subject to a clawback.

[1] Footnote 385 of the Adopting Release, however, states that disclosures are required on or after the issuer adopts its recovery policy.

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