

FAQs on the SEC's Prescribed Clawback Policy

by Cam C. Hoang, Christopher L. Doerksen, James Guttman, Anthony Epps, and Dan Lyman

Earlier this year, Nasdaq, NYSE and NYSE American proposed listing standards requiring that listed issuers adopt clawback policies to recoup incentive-based compensation granted to executive officers on the basis of financial results that are subsequently restated, in connection with final rulemaking by the Securities and Exchange Commission (the "SEC").

While the SEC may further postpone this deadline, listed issuers would be advised to prepare their boards now to approve compliant clawback policies by **August 8, 2023**, the 60-day deadline assuming that the SEC approves the listing standards by June 9, 2023, the Friday before the June 11 date by which it will either approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed listing standards.

Which companies must adopt the SEC's prescribed clawback policy?

Substantially all listed issuers, including foreign private issuers ("FPIs"), emerging growth companies ("EGCs") and smaller reporting companies ("SRCs") must adopt policies that comply with Rule 10D-1 of the Securities Exchange Act of 1934 (the "Exchange Act") and either Nasdaq Listing Rule 5608, NYSE Section 303A.14 or NYSE American Section 811.

Which individuals are subject to the clawback policy?

The listing standards apply to an issuer's current and former executive officers, meaning individuals who meet the definition of "officer" under Rule 16a-1(f) of the Exchange Act.¹ Rule 10D-1 specifies that executive officers of the issuer's subsidiaries are included if they perform such policy-making functions for the issuer, but it is not intended to include policy-making functions that are insignificant. Furthermore, executive officers will include, at minimum, the executive officers identified by the issuer in its Form 10-K or annual proxy statement pursuant to Item 401(b) of Regulation S-K of the Securities Exchange Act of 1934 (the "Exchange Act").

Related People

- Cam C. Hoang
- Christopher L. Doerksen
- James Guttman
- Anthony Epps
- Dan Lyman

Related Capabilities

- Corporate Governance & Compliance
- Investment Funds
- Investment Management
- Securities & Financial Services Litigation & Enforcement

Recovery is required only of incentive-based compensation received by a person (1) after beginning service as an executive officer and (2) if that person was an executive officer during the three-year look back period, and then, only if the other conditions under Rule 10D-1 and the listing standards are fulfilled.

What triggers the obligation to recover compensation?

The issuer must recover the amount of erroneously awarded incentive-based compensation if the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the federal securities laws. There is no fault or misconduct required to trigger a clawback. Furthermore, a clawback may be triggered by a “Big R” restatement (to correct an error in previously issued financial statements that is material to the previously issued financial statements) or a “little r” restatement (that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period).

Restatements that do not result from the correction of an error do not trigger a mandatory recover of incentive-based compensation. For example, restatements due to changes to accounting principles, certain internal restructurings, certain adjustments in connection with business combinations, and revisions due to stock splits are not considered “errors” triggering clawbacks.

In implementing the clawback policy, boards and management will need a process to determine when a restatement is “required.”² There will be judgment involved in such a determination, and the judgment is open to review by courts or regulators. According to Rule 10D-1, a restatement is “**required**” on the earlier of (1) the date the issuer’s board of directors, a committee thereof or the officer(s) 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; or (2) the date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.

What compensation is subject to recovery?

Erroneously awarded “incentive-based compensation” is subject to recovery. In other words, the amount(s) by which the executive officer’s incentive-based compensation for the relevant period(s) exceeded the amount(s) that the executive officer otherwise would have received had such incentive-based compensation been determined based on the restated amounts. All amounts shall be computed without regard to taxes paid.

“**Incentive-based compensation**” is defined as compensation granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure, which can include stock price or total shareholder return (“TSR”). It includes amounts contributed to benefit plans based on erroneously awarded compensation and earnings to date (eg, long-term disability plans, life insurance plans, and SERPs, but not tax-qualified plans).

Incentive-based compensation does not include awards that are granted, earned and

vested without regard to attainment of financial reporting measures, such as time-vesting awards, discretionary awards and awards based wholly on subjective standards, strategic measures or operational measures.

“Financial reporting measures” are those that are determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements (including non-GAAP financial measures) and any measures derived wholly or in part from such financial measures. For the avoidance of doubt, financial reporting measures include stock price and TSR. A measure need not be presented within the financial statements or included in a filing with the SEC to constitute a financial reporting measure for purposes of a clawback policy.

How should an issuer quantify the impact of a financial restatement on TSR or stock price, if either is a financial performance measure?

The SEC recognized that quantifying the impact of a restatement on TSR or stock price performance will be difficult. Rule 10D-1 and the proposed listing standards provide that the amount to be recovered must be based on a reasonable estimate of the effect of the restatement on the stock price or TSR upon which the incentive-based compensation was received, and the issuer must maintain documentation of the determination of that reasonable estimate and provide such documentation to the stock exchange.

Is it pre- or post-tax compensation that is to be recovered?

The SEC mandates recovery of pre-tax compensation, which leads to the question of whether executive officers will be able to recover the income tax paid on recovered compensation. IRS precedent in this area is limited and tenuous, though we expect further developments. Officers may elect to defer receipt of incentive-based compensation for the applicable recovery period, in order to defer taxation.

What is the recovery period?

Incentive-based compensation “received” during a recovery period of three fiscal years immediately preceding the determination that a restatement is required is subject to clawback.

Incentive-based compensation is “**received**” in the fiscal period during which the financial reporting measure is attained, even if the grant occurred prior to the recovery period, and even if the payment or grant of the compensation occurs after the end of that period. The recovery period also includes transition periods resulting from a change in the issuer’s fiscal year.

Are there requirements as to the method of recovery?

Issuers are permitted to exercise discretion as to the method of recovery as long as it is done reasonably promptly depending on the facts and circumstances of the issuer, the incentive-based compensation, and the executive officer. Such methods which may

include, without limitation:

- requiring reimbursement of incentive-based compensation previously paid;
- forfeiting any incentive-based compensation contribution made under the issuer's deferred compensation plans;
- offsetting the recovered amount from any compensation that the executive officer may earn or be awarded in the future;
- some combination of the foregoing; or
- taking any other remedial and recovery action permitted by law.

What are the exceptions to the clawback requirement?

The issuer must recover erroneously awarded compensation except to the extent that one of the following conditions are met, and the issuer's committee of independent directors responsible for executive compensation decisions, or in the absence of such a committee, a majority of the independent directors serving on the board, has made a determination that recovery would be impracticable:

- The direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered (before doing so, the issuer must make a reasonable attempt to recover the erroneously awarded compensation, document such reasonable attempt(s) and provide that documentation to the exchange).
- Clawback would violate home country law if the law was adopted prior to November 28, 2022 (before doing so, the issuer must obtain an opinion of home country counsel, acceptable to the exchange, that recovery would result in such a violation and must provide that opinion to the exchange).
- Clawback would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees, to fail to meet the requirements of Internal Revenue Code Sections 402(a)(13) or 411(a) and regulations there under. This exception was added to satisfy the anti-alienation rules and other qualification requirements applicable to such plans under the Internal Revenue Code. There is no exception with respect to non-U.S. retirement arrangements with similar limitations.

What if our existing clawback policy is broader than the SEC-prescribed policy, or we want to adopt a broader policy?

The SEC-prescribed policy must be filed and publicly available as an annual report exhibit. To the extent that the issuer wishes to maintain or adopt a policy that covers a broader range of employees or circumstances, for example, certain types of employee misconduct, the issuer may include such provisions in its publicly filed policy or adopt a separate policy that is not subject to public disclosure.

Issuers should consider the viewpoints of its investors and proxy advisory firms when deciding whether or not to adopt a broader policy. For example, under ISS's equity plan scorecard ("EPSC"), in order to receive points for the clawback policy, the policy should authorize recovery upon a financial restatement and cover all or most equity-based compensation for all named executive officers (including both time- and performance-vesting equity awards). A clawback policy that adheres to the minimum requirements of the SEC's finalized clawback rules under Dodd-Frank will not receive EPSC points

because the final rules generally exempt time-vesting equity from compensation that must be covered by the policy.

How does the SEC-prescribed policy impact recovery under the Sarbanes-Oxley Act?

Rule 10D-1 is not intended to alter or otherwise affect the interpretation of other recovery provisions, such as Section 304 of the Sarbanes-Oxley Act ("SOX"). Unlike the clawback provisions applicable to the CEO and CFO under SOX, the SEC does not require a finding that the executive engaged in misconduct that contributed to the financial restatement.

To the extent that the SEC-prescribed clawback policy would provide for recovery of incentive-based compensation that the issuer has already recovered pursuant to SOX or other recovery obligations, it would be appropriate for the amount recovered to be credited to the required recovery under the clawback policy. However, amounts recovered under the issuer's SEC-prescribed clawback policy do not reduce amounts recoverable under SOX.

Can an issuer indemnify its executive officers against loss of the recovered amount?

An issuer cannot indemnify any executive officer against the loss of erroneously awarded compensation, including by paying or reimbursing for premiums for any insurance policy covering any potential losses. Similarly, an issuer may not advance any costs or expenses to an executive officer in connection with any action to recover the compensation.

What are the clawback disclosure requirements?

The SEC adopted amendments to Item 402 of Regulation S-K, Form 10-K, Form 40-F, and Form 20-F (and for listed funds, Form N-CSR) to include new disclosure requirements related to the clawback policies.

Under the new rules, a listed issuer must file its policy as an exhibit to its annual report. In addition, the cover page of the annual reports include two new check boxes:

If securities are registered pursuant to Section 12(b) of the Act, indicate by check mark whether the financial statements of the registrant included in the filing reflect the correction of an error to previously issued financial statements. ☐

Indicate by check mark whether any of those error corrections are restatements that required a recovery analysis of incentive-based compensation received by any of the registrant's executive officers during the relevant recovery period pursuant to §240.10D-1(b). ☐

For domestic 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 erroneously awarded compensation, or there was an outstanding balance as of the end of the last completed fiscal year of erroneously awarded compensation, an issuer must disclose in its proxy statement how it has applied the policy, including, as relevant:

- the date it was required to prepare an accounting restatement;
- the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (including an analysis of how the amount was calculated);
- if applicable, the estimates used in calculating the amount in the case of awards based on stock price or TSR;
- the aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed fiscal year and any outstanding amounts due from any current or former named executive officer that has been outstanding for 180 days or more;
- if the aggregate amount has not yet been determined, this fact and the reasons why not; and
- details regarding any reliance on the impracticability exceptions, including, for each current and former named executive officer and for all other current and former executive officers as a group, the amount of recovery foregone and a brief description of why the issuer decided not to pursue recovery.

if at any time during or after the last completed fiscal year, the issuer was required to prepare a restatement, and the issuer concluded that recovery of erroneously awarded compensation was not required, it should briefly explain why application of the clawback policy resulted in this conclusion.

Any amounts recovered will reduce the amount reported in the applicable column of the Summary Compensation Table for the fiscal year in which the amount recovered initially was reported, and with those amounts identified by footnote.

The information will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, except to the extent that the issuer specifically incorporates it by reference.

Issuers will be required to use Inline XBRL to tag their compensation recovery disclosure.

Are there disclosure requirements specific to foreign private issuers?

FPIs will be required to provide the same information called for by Item 402(w) of Regulation S-K, on their applicable annual report. An FPI will be deemed to comply if it provides the information required by Items 6.B, 6.E.2, and 6.F of Form 20-F, with more detailed information provided if otherwise made publicly available or required to be disclosed by the issuer's home jurisdiction or a market in which its securities are listed or traded, or if it provides the information required by paragraph (19) of General Instruction B of Form 40-F, as applicable.

Item 6.F of Form 20-F provides for individualized disclosure for an FPI's named

executive officers. FPIs that file on domestic forms and provide executive compensation disclosure under Item 402(w) of Regulation S-K should provide individualized disclosure for their named executive officers to the extent required by Form 20-F. For FPIs that use Form 20-F, individualized disclosure is required about members of their administrative, supervisory, or management bodies for whom the issuer otherwise provides individualized compensation disclosure in the filing. Item B.(19) of Form 40-F provides for individualized disclosure for an issuer's named executive officers. Such individualized disclosure is required about executive officers for whom the issuer otherwise provides individualized compensation disclosure in the filing.

What are the compliance deadlines?

Assuming that the SEC approves the proposed listing standards by June 9, 2023, issuers will be required to adopt a compliant clawback policy by August 8, 2023. Issuers subject to the listing standards will be required to adopt a clawback policy no later than 60 days following the date on which the applicable listing standards become effective and must begin to comply with these disclosure requirements in proxy and information statements and the issuer's annual report filed on or after the issuer adopts its recovery policy.

What are the consequences of failure to comply with the rules?

An issuer may be subject to delisting if it does not adopt and comply with the prescribed clawback policy. In addition, an issuer may be subject to delisting if it does not disclose its clawback policy in accordance with the applicable SEC rules.

How should companies prepare now?

- Adopt a new clawback policy or update the existing clawback policy to comply with SEC requirements and consider whether to adopt broader clawback provisions, either in the same policy or a separate policy that will not be publicly disclosed.
- Review and revise executive employment agreements, incentive compensation plans and/or related award agreements to confirm that they contain provisions that will facilitate the enforcement of the clawback policy.
- Evaluate the use of financial performance measures in executive employment agreements and incentive programs and strengthen related controls to minimize the risk of restatement.
- Discuss with internal and external auditors ways to mitigate the restatement risk.
- Revise officer indemnification agreements to specify that indemnification is not available for the loss of compensation recovered under the clawback policy and applicable law.

¹Rule 16a-1(f) defines an officer as the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer 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 issuer.

²As noted in the SEC's adopting release, a "Big R" restatement triggers the filing of an Item 4.02 Form 8-K and prompt filings of amendments to restate the previously issued financial statements. In contrast, a "little r" restatement generally does not trigger an Item 4.02 Form 8-K, and an issuer may make any corrections "the next time the registrant files the prior year financial statements."