GIBSON DUNN

SEC Releases Final Clawback Rules

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On October 26, 2022, the Securities and Exchange Commission ("SEC" or "Commission"), in a 3-to-2 vote, adopted final rules that will require listed companies to implement policies for recovery (*i.e.*, "clawback") of erroneously awarded incentive compensation, implementing Section 10D of the Securities Exchange Act, which was added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The SEC originally proposed clawback rules on July 14, 2015,[2] but the proposed rules remained dormant until October 14, 2021, when the SEC reopened the comment period[3] (and which was reopened for a second time on June 8, 2022).[4] The final rules add new Exchange Act Rule 10D-1 ("Rule 10D-1"), which largely tracks the long-pending proposed rules but also incorporate terms previewed in the 2021 release reopening the comment period.

Rule 10D-1 directs the national securities exchanges to establish listing standards that require issuers to adopt and comply with written clawback policies meeting strict conditions:

- The clawback policy must provide that, in the event the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the federal securities laws, the company will recover (on a pre-tax basis) the amount of incentive-based compensation received by its current and former executive officers in excess of the amount of incentive-based compensation that would have been received had it been determined based on the restated amount, subject to limited exceptions.
- Compensation recoupment is required regardless of whether the executive officer engaged in any misconduct and regardless of fault.
- The policy must apply to compensation "received"—which is defined as occurring when the financial reporting measure was attained regardless of when payment is actually made—during the three-year "recovery period" preceding the date the company is required to prepare the accounting restatement (the three-year period was mandated by the Dodd-Frank Act).
- The clawback policy must apply both to material accounting errors that require a restatement of prior years' financial results (commonly known as "Big R" restatements), *as well as* to errors that are corrected in the current year's results (commonly known as "little r" restatements).

In addition, the final rules require companies to file a copy of their policy as an exhibit to their Form 10-K, 20-F, 40-F or N-CSR, as applicable, and to publicly disclose how they have applied the policy whenever they experience a restatement. Rule 10D-1 also requires that issuers add two checkboxes to the cover page of their 10-Ks (or 20-Fs or 40-Fs): one checkbox to indicate whether the financial statements included in the filing reflect the correction of an error to previously issued financial statements, and one to indicate whether any of the error corrections require a recovery analysis under the company's Rule 10D-1 clawback policy.

Almost all issuers are subject to the clawback rules, including those companies that are otherwise excluded from other SEC disclosure requirements related to executive compensation. A company would be subject to delisting if it does not adopt and comply

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with an exchange-compliant clawback policy.

The final rules release is available here and a Fact Sheet (*Recovery of Erroneously Awarded Compensation*) is available here. Set forth below is a summary of the final rules and considerations for companies.

When the Rules Take Effect

Each exchange will be required to propose rules or rule amendments consistent with Rule 10D-1 no later than 90 days following the date of the publication of the rules in the Federal Register. The listing standards must be effective no later than one year following the final rules publication date. Each company subject to such listing standards must adopt a compliant recovery policy no later than 60 days following the date on which the applicable listing standards become effective. The mandated clawback policies must apply to any incentive-based compensation that is received by current or former executive officers on or after the effective date of the applicable listing standard (which is a modification from the proposed rules). Compliance with the disclosure requirements is required in the first annual report or proxy or information statement required to be filed after the effective date of the new listing standards.

Summary of the Final Rules

All listed companies are covered by the rule, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and companies with only listed debt securities, but certain registered investment companies are excluded to the extent they have not provided incentive-based compensation to any current or former executive officer of the fund in the last three fiscal years.

There are five key components of the final rules:

1. *Covered individuals*. Current and former “executive officers” are subject to clawback of incentive-based compensation. “Executive officer” includes the company’s president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division or function, and any other person who performs policymaking functions for the company and otherwise conforms to the full scope of the Exchange Act Section 16 definition. In a change from the proposed rules, the final rules will only require 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 of compensation received prior to becoming an executive officer will not be required, although compensation received during the recovery period by former executive officers is covered.
2. *Restatements that trigger application of clawback policy*. In a change from the proposed rules, the final rules require recoupment of erroneously awarded compensation (i) when the 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 (commonly referred to as “Big R” restatement) and (ii) when the company is required to prepare an accounting restatement that corrects an error that is not material to previously issued financial statements, but that would result in a material misstatement if (A) the error was left uncorrected in the current report or (B) the error correction was recognized in the current period (commonly referred to as “little r” restatements). Application of the recovery policy would not be triggered by an “out-of-period adjustment” – a situation where the error is immaterial to the previously issued financial statements and the correction of the error is also immaterial to the current period. The recovery policy also would not be triggered by changes to prior period financial statements that do not arise due to error corrections, such as retrospective revisions to financial statements due to changes in accounting

principles or segments.

The Commission rejected a bright-light standard for determining when the recovery period begins, reasoning that doing so might incentivize companies to delay a restatement determination in order to manipulate the recovery date. Therefore, the final rules state that the recovery period runs from the earlier of: (i) the date the company's board of directors, committee of the board, or the officer or officers of the company authorized to take such action, concludes, or *reasonably should have concluded*, that the company is required to prepare an accounting statement due to the material noncompliance with any financial reporting requirement under the securities laws; or (ii) the date a court, regulator, or other legally authorized body directs the company to prepare an accounting restatement. The SEC stated in its October 14, 2021 Notice when it reopened the comment period: "For errors that are material to the previously issued financial statements, we generally expect the date . . . to coincide with the date disclosed in the Item 4.02(a) Form 8-K filed."

3. *Definition of incentive compensation and when it is "received."* "Incentive-based compensation" is any compensation (including cash and equity) granted, earned or vested based in whole or in part on the attainment of a "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, and any measures derived in whole or in part from such measures, as well as stock price and total shareholder return ("TSR"). 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. Incentive-based compensation does not include compensation that is based *solely* on continued employment for a specified period of time (*e.g.*, time-vesting awards, including time-vesting stock options), unless such awards were granted or vested based in whole or in part on a financial reporting measure. Incentive-based compensation also does not include base salary (however, in the preamble to the proposed rule the SEC indicated that if the executive officer receives a salary increase earned wholly or in part based upon the attainment of a financial reporting measure, such increase would be subject to recovery), compensation awarded solely at the board's discretion, or compensation awarded upon the achievement of subjective, strategic or operational measures that are not financial reporting measures (such as the achievement of ESG goals).

The Dodd-Frank Act specified that the compensation subject to clawback is that which was received by the executive during a recovery period that is defined as "the three-year period preceding the date on which the issuer is required to prepare an accounting restatement." The final rules provide that incentive-based compensation is "received," and thus subject to clawback, in the fiscal period during which the applicable financial reporting measure is attained, even if the payment or grant occurs after the end of that period. In other words, the date of "receipt" of such compensation is tied to the satisfaction of the financial reporting measure goal, irrespective of applicable vesting, grant or payment dates. An award subject to both time- and performance-based vesting conditions is considered received upon satisfaction of the performance metric even if the award continues to be subject to time-based vesting criteria.

4. *Calculating the amount of clawback*. The amount required to be recouped is the amount of incentive-based compensation received by the executive in excess of what would have been received if the incentive-based compensation was determined based on the restated financial statements. To the extent the incentive-based compensation was based on stock price or TSR, such excess amount must be based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. The company must maintain documentation of the determination of that reasonable estimate and provide it to the relevant exchange. In all cases, the calculation of erroneously awarded compensation would be calculated on a pre-tax basis. As discussed below, companies are required to disclose in their Form 10-K, 20-F, 40-F or N-CSR, as applicable, and proxy

statement information on their calculation of the amount subject to clawback.

5. *Minimal discretion regarding recovery and its enforcement*. The rules require a company to recover erroneously awarded compensation in compliance with its recovery policy subject to limited exceptions. Recovery is not required only if the company's board or compensation committee has determined that recovery is impracticable for one of three reasons: (1) because the direct expenses paid to third parties to assist in enforcing the policy would exceed the amount to be recovered and the company has made a reasonable attempt to recover; (2) in the case of a foreign private issuer, because pursuing such recovery would violate home country law in effect prior to publication of the final rules in the Federal Register and where the company provides an opinion of counsel to that effect to the exchange; or (3) because recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.[5] Clawback must be evaluated on a "no fault" basis – *e.*, without regard to whether any misconduct occurred or whether an executive bears responsibility. Executives may not be indemnified for the clawback, nor may companies pay premiums on an insurance policy that would cover an executive's potential clawback obligations. The rules require that companies pursue recovery "reasonably promptly," which suggests that boards may not allow covered executives to repay any clawed back amount in installments under a payment plan of any extended duration, barring any unreasonable economic hardship to the executive. In addition, under the new disclosure requirements (addressed further below), any amount subject to clawback from a current or former named executive officer but unpaid after 180 days must be disclosed.

New Disclosure Requirements

There are three key new disclosure requirements tied to the clawback rules:

1. *Clawback Policy Exhibit Requirement*. Each listed company must file its clawback policy as an exhibit to its annual report on Form 10-K, 20-F, 40-F or N-CSR, as applicable.
2. *New Item 402 disclosures*. Item 402 of Regulation S-K was amended to require companies to disclose how they have applied their recovery policies. If, during its last completed fiscal year, the company either completed a restatement that required recovery, or there was an outstanding balance of excess incentive-based compensation relating to a prior restatement, the company must disclose the following information for each restatement in any Form 10-K or proxy or information statements that includes executive compensation disclosure:

    (i) the date on which the company was required to prepare each accounting restatement and the aggregate dollar amount of excess incentive-based compensation attributable to the restatement, *including an analysis of how the recoverable amount was calculated* (an expansion of the proposed rules), or if the clawback amount has not been determined yet, an explanation of the reasons why it has not, and subsequent disclosure in the next filing that is subject to Item 402 of Regulation S-K;

    (ii) if the compensation is related to a stock price or TSR metric, the estimates used to determine the amount of erroneously awarded compensation attributable to such accounting restatement and an explanation of the methodology used for such estimates;

    (iii) the aggregate dollar amount of excess incentive-based compensation that remained outstanding at the end of the company's last completed fiscal year;

    (iv) where a company is invoking an impracticability exception, 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, as well as (to the extent applicable to the invoked impracticability exception) a brief explanation of the types of direct expenses paid to a third party to assist in enforcing the recovery policy, identification of the provision of foreign law the recovery policy would violate, or how the recovery policy would cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code; and

(iv) for each current and former named executive officer, the amounts of incentive-based compensation that are subject to a clawback but remain outstanding for more than 180 days since the date the company determined the amount owed.

The final rules also add a new instruction to the Summary Compensation Table to require that any amounts recovered pursuant to a company's 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, with the clawback identified by footnote.

The final rules require information mirroring the above Item 402 disclosures to be included in annual reports on Form N-CSR and in proxy statements and information statements relating to the election of directors; on Form 20-F or, if the foreign private issuer elects to use the registration and reporting forms that U.S. issuers use, on Form 10-K; and on Form 40-F.

3. *New check boxes on cover pages of Forms 10-K, 20-F and 40-F*. In addition, and according to the SEC, "to assure that issuers listed on different exchanges are subject to the same disclosure requirements regarding erroneously awarded compensation recovery policies," companies must indicate by check boxes on 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 such corrections are restatements that required a recovery analysis.

Observations and Considerations for Companies

Companies do not need to adopt a Rule 10D-1 clawback policy until after the stock exchanges' listing standards implementing Rule 10D-1 are proposed, adopted and become effective. Nevertheless, there are important steps that companies should be taking before that time to prepare for the new rules:

1. *Prepare for Implementation*. The new listing standards will require companies to adopt "and comply" with their Rule 10D-1 clawback policies. In addition, the clawback policy needs to apply to any incentive compensation "received" on or after the effective date of the new listing standards, even if that compensation was received pursuant to an award granted before adoption of the company's Rule 10D-1 clawback policy. Therefore, to the extent they have not done so already, companies should be adding a term to their existing incentive compensation plans or award agreements and taking any other appropriate measures to enhance the enforceability of their Rule 10D-1 clawback policy once it is adopted.
2. *Evaluate Incentive Compensation Arrangements*. Companies should evaluate their existing compensation arrangements to assess which have any element that relates to a "financial performance measure" as defined under the SEC rules. At the same time, companies may wish to evaluate whether to modify or clarify the

operation of arrangements that have financial performance measure elements. For example, companies with a legacy Section 162(m) bonus pool that is based on a financial performance measure, but under which actual payments are discretionary or based on other criteria, may wish to eliminate the performance-based funding of the bonus pool component. The clawback rules may also accelerate the trend toward the use of non-financial, strategic and ESG-related performance criteria in incentive compensation arrangements.

3. *Interaction with Existing Clawback Policies*. Companies will need to determine whether to integrate the Rule 10D-1 clawback policy with their existing policies, replace their existing policies, or adopt the Rule 10D-1 policy on a stand-alone basis. Various aspects of the Rule 10D-1 clawback requirements go beyond what companies typically have adopted to date, including the mandatory nature of the clawback, the timing and length of the recovery period and the no-fault standard. At the same time, many company policies cover triggering events beyond financial restatements, may cover a larger population, and may apply to broader categories of compensation. Given the differences, companies may find it easier to adopt a stand-alone Rule 10D-1 clawback policy, and simply modify their existing clawback policies to clarify that they apply only to the extent that the Rule 10D-1 clawback policy does not. As noted above, the new rules require attaching the clawback policy as an exhibit to the annual report, so it is advisable to review the policy in light of that anticipated public disclosure.
4. *Enhance Documentation Around Compensation Committee Determinations*. Going forward, it will be more important than ever to have clear documentation around the extent to which financial performance measures affect decisions regarding granting, vesting and settlement/payout of each element of executives' compensation. To the extent that a compensation committee is exercising discretion, particularly if awarding compensation without regard to financial results, those decisions should be documented. Finally, it will be important to enhance internal and disclosure controls so that the implications of any restatement, including a "little r" restatement, can be taken into account.

The Rule 10D-1 clawback rules are designed to enhance an environment promoting compliance with applicable accounting rules. However, their application on a no-fault basis means that executives could be subject to compensation clawbacks based on inadvertent failures to satisfy complex accounting standards. It will be important to assess whether that possibility will lead to inadvertent consequences, such as a move away from financial performance measures in compensation arrangements or the loss of talented executives who feel unfairly penalized under a clawback claim that they intend to contest.

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[1] Pub. L. No. 111-203, 124 Stat. 1900 (2010).

[2] Listing Standards for Recovery of Erroneously Awarded Compensation, Exchange Act Release No. 34-75432 (July 14, 2015), available here.

[3] Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation, Exchange Act Release No. 34-93311 (Oct. 14, 2021), available here.

[4] Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation, Exchange Act Release No. 34-95057 (June 8, 2022), available here, which sought review and comment on the memo prepared by the staff of the SEC's Division of Economic and Risk Analysis, available here.

[5] With respect to this exception, Rule 10D-1(b)(1)(iv)(C) provides: "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 26 U.S.C.

401(a)(13) or 26 U.S.C. 411(a) and regulations thereunder."

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