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SEC Adopts Final Executive Compensation Clawback Rules: What This Means and How to Prepare

Service

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On October 26, 2022, the Securities and Exchange Commission (SEC) adopted final rules that will require public companies to implement policies to recover, or claw back, erroneously awarded incentive-based compensation from current and former executive officers in the event of an accounting restatement, regardless of whether the executive officer was in any way responsible for the causes of the restatement. The SEC originally proposed clawback rules pursuant to the requirements of Section 10D of the Securities Exchange Act of 1934 (added by Section 954 of the Dodd-Frank Act) in July 2015. These rules remained dormant until October 14, 2021, when the SEC reopened the comment period on its proposed rules twice (on October 14, 2021 and June 8, 2022), leading to the adoption of final Exchange Act Rule 10D-1 (Rule 10D-1) at the end of October 2022 with certain changes in response to the collective comments received.

In addition to new Rule 10D-1, which requires stock exchanges to enact listing standards requiring each listed company to adopt and comply with a written clawback policy, the final rules also added (i) new Item 402(w) to Regulation S-K (Item 402(w)), which requires certain disclosures in the company's Form 10-K and proxy statement (separate from the Compensation Discussion and Analysis) where a restatement triggered a clawback during the last fiscal year and (ii) new Item 601(b)(97) to Regulation S-K (Item 601(b)(97), and together with Rule 10D-1 and Item 402(w), the Rules), which requires the filing of the clawback policy as an exhibit to Form 10-K and added new cover page checkboxes on the cover of each Annual Report indicating whether it contains a correction to an error on previously issued financial statements and whether such error required a compensation recovery analysis.

The Rules apply to all issuers, including emerging growth companies (EGCs), Smaller Reporting Companies (SRCs), and Foreign Private Issuers (FPIs), that list any security on a national securities exchange, including both equity and debt securities (but generally excluding securities futures products, standardized options, and securities issued by unit investment trusts and registered investment companies). The Rules became effective January 27, 2023 (60 days after publication in the Federal Register), but stock exchanges have until February 26, 2023 (90 days post-publication) to propose new listing standards, which must become effective no later than November 28, 2023 (one year following the Federal Register publication date). Following the effective date, listed companies must adopt a clawback policy (or amend an existing policy) to come into compliance with their exchange's applicable listing standard no later than 60 days after that standard becomes effective.

The key components of the Rules and related new disclosure requirements are summarized below.

Key components

1. Clawback policies apply to all executive officers regardless of fault.

A company's current and former "executive officers" as defined under Exchange Act Rule 16a-1(f)—including the company's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function, any other officer who performs a policy-making function, and any other person who performs similar policy-making functions for the company—will be subject to the clawback of erroneously awarded incentive-based compensation in the event of a covered restatement. This will be true regardless of whether a covered executive officer had any role in the accounting error that precipitated the restatement. While the definition of covered executive officers under the Rules is broad, incentive-based compensation received by a person before becoming an executive officer (i.e., when the individual was an employee but not an executive officer) will not be required to be subject to the clawback policy.

In contrast to policies adopted by many companies in response to the SEC's original proposal, the final Rules do not permit Boards any discretion to base recovery on a determination of "fault" or to forego "de minimis" recoveries. Rather, the only exceptions provided for in the final Rules are (i) an exception for compensation awarded pursuant to any tax-qualified retirement plan (where the plan's benefits may not be assigned or alienated without losing such qualification) and (ii) an exception where the issuer concludes, after a reasonable attempt, that recovering the compensation at issue would be impracticable because the associated cost would exceed the amount to be recovered, or that recovery would be in violation of home country law of the issuer in effect on the effective date of the Rules (subject in each case to additional documentation).

2. Both "big R" and "little r" restatements may trigger clawbacks.

The Rules will require clawback policies to provide that a clawback may be triggered by any restatement made to correct an error in previously issued financial statements. This means that a clawback may be triggered by both so-called "Big R" restatements, which restate historical financial statements to correct errors that were material to those previously issued financial statements (which would typically trigger disclosure under Item 4.02 of Form 8-K), and also—reflecting an expansion from the SEC's original proposal—"little r" restatements, where companies determine to restate errors that occurred in prior periods and were not material to previously issued financial statements, but would result in a material misstatement (a) if the errors were left uncorrected in the current period or (b) if the error correction was recognized in the current period financial statements.

3. Companies must calculate and recover the erroneously awarded incentive-based compensation.

Clawbacks under a clawback policy should recover compensation that is (1) incentive-based, (2) erroneously awarded, and (3) received by an executive officer during the three years preceding the date an accounting restatement was required (discussed below). For an accurate calculation, the company must understand each element of the amount recoverable.

Incentive-based compensation. Incentive-based compensation is defined as any compensation that is granted, earned, or vested based wholly or partially upon the attainment of any "financial reporting measure" that is 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"). For example, incentive-based compensation includes bonuses paid from a bonus pool, the size of which is determined based wholly or partially on financial reporting measures, but does not include cash salary increases or bonuses based solely on continued employment or subjective standards.

Erroneously awarded. Erroneously awarded compensation is "the amount of incentive-based compensation received by a current or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement," computed without regard to taxes paid. The final Rules also provide that, for incentive-based compensation based on TSR or stock price, 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 accounting restatement on the applicable measure and the issuer must maintain documentation of the determination of that reasonable estimate and provide it to the exchange. The SEC declined the request of some commenters to provide additional guidance or a “safe harbor” related to such estimates, stating that issuers should have the flexibility to determine the method most appropriate to their facts and circumstances from “a number of possible methods with different levels of complexity of the estimations and related costs.” Coupled with the mandate to provide these calculations to the issuer’s exchange, rather than requiring such supplemental disclosure only “on request,” this requirement seems likely to significantly increase compliance costs – and potential litigation risk – for any issuer required to recover incentive compensation based on TSR or stock price criteria.

Received during the applicable 3-Year period. The Dodd-Frank Act specified that the compensation subject to clawback is that which was received by the executive officer during a recovery period. The recovery period is defined as “the three-year period preceding the date on which the issuer is required to prepare an accounting restatement.” The final Rules, like the original proposal, define the “date on which an issuer is required to prepare an accounting restatement” as the earlier of (i) the date the issuer’s Board of Directors (or the officer or officers authorized to do so if no Board action is required) concludes, or reasonably should have concluded, that the issuer must prepare an accounting restatement due to 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 issuer to prepare an accounting restatement. The final Rules also 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-based metric, even if the award continues to be subject to further time-based vesting criteria.

4. Indemnification prohibited.

Companies will be prohibited from indemnifying any current or former executive officer against the loss of erroneously awarded compensation under the Rules.

Disclosure requirements

There are a few key disclosure requirements tied to the Rules:

Clawback policy exhibit filing requirements. A listed issuer will be required to file its policy as an exhibit to its Annual Report on Form 10-K, in addition to providing the disclosures summarized below concerning its application of the policy.

Application of recovery policy. Under Item 402(w), companies must disclose their clawback policies and 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 certain information, including, but not limited to, the following for each such restatement (including prescribed Inline XBRL tagging of compensation recovery disclosures):
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 the estimates used in calculating the recoverable amount in the case of awards based on stock price or TSR and an explanation of the methodology used for such estimates);
if the aggregate dollar amount of erroneously awarded compensation has not yet been determined, an explanation of the reasons and disclosure of all required information in the next company filing subject to Item 402 of Reg. S-K;
the amounts recovered and any amounts that remain outstanding at the end of the company's most recent fiscal year (as well as, for each current or former named executive officer, any amounts that remain outstanding for 180 days or longer since the company determined the amount owed);
if the company has determined to forego recovery of any amounts as "impracticable," then it must disclose for each current or former named executive officer, and for all other current or former executive officers as a group, the amount of recovery foregone and brief description of why recovery was not pursued; and
if the company was required to prepare an accounting restatement at any time during or after its last completed fiscal year and concluded that recovery of erroneously awarded executive compensation was not required in connection with such restatement, a brief explanation of why application of the company's recovery policy led to such conclusion.

These disclosures must be included in any Form 10-K or proxy statement that is required to include executive compensation disclosure pursuant to Item 402 of Regulation S-K.

Related party transactions discloser not required. Any recovery of erroneously awarded executive compensation in accordance with a policy required by the Rules will not be treated as a "related party transaction" subject to disclosure under Item 404 of Regulation S-K.

Summary compensation table (SCT) disclosures. Companies will be required to reduce amounts of compensation shown (including compensation shown for prior years) to reflect compensation clawbacks under their policy, with accompanying SCT footnote explanation.

New check boxes on cover pages of Forms 10-K, 20-F, and 40-F. 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 require a recovery analysis.

New Form 10-K C&DI clarifies timing. On January 31, 2023, the SEC issued a new Form 10-K Compliance & Disclosure Interpretation (No. 104.19) clarifying that, while the check boxes and other requirements referenced above were added to its rules and forms effective January 27, 2023, the SEC does not expect compliance with any of these new items until after issuers are required to have a clawback policy in place under their applicable exchange listing standard.

What this means to you

Although covered companies do not need to adopt a clawback policy that is fully compliant with Rule 10D-1 until after their applicable stock exchange listing standard becomes effective, there are important steps companies can take now to prepare for compliance.

Familiarize key stakeholders (the company's Board, executives, and compliance personnel) with requirements of the Rules and review executive compensation policies and practices to consider any changes that may be beneficial in light of the additional risks applicable to incentive-based compensation.

Identify existing incentive compensation programs and awards that will be subject to the Rules and consider whether any revisions may be needed to the company's disclosure controls and procedures to appropriately document the extent to which financial performance measures affect the granting, vesting, and settlement/payout of each such element of covered executives' compensation.

Review existing clawback policies – as well as plan documents and associated agreements related to outstanding compensation arrangements and awards – to determine what amendments will be required to comply with the new Rules, subject to fine-tuning once the new listing standard applicable to the company becomes available.

Review existing disclosures concerning executive compensation clawbacks for the company's upcoming 2022 Annual Report and 2023 proxy statement and determine any necessary revisions to reflect the impact of the new Rules.

Contact us

Husch Blackwell's Securities & Corporate Governance team will continue to monitor these changes and their implications. Should you have any questions, please do not hesitate to contact Steve Barrett, Ashley Inbau, Robert Fritsche, or your Husch Blackwell attorney.