How The SEC's New Clawback Rules Could Operate In Practice: A Hypothetical

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On December 1, 2023, the clawback policy listing standards established by NASDAQ and NYSE went into effect. Specifically, these listing standards require issuers to implement policies that require the issuer to recover erroneously awarded compensation received by current and former executive officers during the three-year period preceding the date the issuer is required to prepare an accounting restatement. Implementation and continued compliance with the policies established by these listing standards present complexities in assessing whether the policy has been triggered and, once triggered, who has to remit what forms of "incentive-based compensation" and how much of such compensation needs to be recovered.

We have prepared the hypothetical below and a Q&A to help illustrate how a compliant clawback policy might operate, as a hypothetical sometimes helps to focus the lens on the complex issues that arise.

Hypothetical: John Smith is the chief executive officer (CEO) of Company X, whose equity securities are listed on NASDAQ, and he's held this role since Jan. 1, 2010. In February 2021, the Board of Company X approved a compensation package for the CEO that included a performance-based equity incentive award for the Jan. 1, 2021, through Dec. 31, 2023 performance period. The target performance-based equity incentive award was based on 150 percent of base salary, which equaled 11,000 shares for the CEO. The payout opportunity equaled 0 percent (minimum), 100 percent (target), and 200 percent (maximum), with the growth in earnings per share (EPS) compared to the growth in peer companies' EPS during the same period. Each named executive officer (NEO), including the CEO, was entitled to earn the performance shares at the end of the performance period depending on attainment level satisfied in respect of such EPS performance targets.

The Compensation Committee met in February 2024 to review the extent to which the CEO earned the 2021 equity incentive award. During the 2021-2023 performance period, the Compensation Committee analyzed the GAAP EPS growth over the performance period and using previously established payout matrix determined that the CEO was entitled to a payout of 200 percent of the target award. As a result, the CEO was awarded 22,000 shares in February 2024.

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The 10-K was filed in late February 2024. In April 2024, the accounting team, working with its external auditor, discovered an accounting issue. After an investigation into the issue, the Audit Committee determined that its financial statements for 2022 and 2023 would need to be restated via a big R" restatement. (A "big R" restatement requires the issuer to file an Item 4.02 Form 8-K and to amend its filings promptly 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.)

The restatement resulted in a decline in GAAP EPS for both 2022 and 2023. A 10-K/A was filed in May 2024 to restate the financial statements for the fiscal years ended Dec. 31, 2022 and 2023. The restated GAAP EPS amounts meant that the CEO was only entitled to 100 percent of the 2021-2023 target award, not 200 percent.

- **Will the Compensation Committee be required to clawback the award under the clawback policy?**

Answer: Most likely, yes. These awards qualify as "incentive-based compensation" because the rule defines such compensation as "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure." The performance awards in the hypothetical are wholly attained based upon the attainment of a financial reporting measure. (We note "financial reporting measure" is also defined in the rule.)

Pursuant to Rule 10D-1(b), a compliant recovery policy must apply to all incentive-based compensation "received" by a person under the following conditions:

(A) after such person began service as an executive officer ; and

(B) at a time when such person served as an executive officer:

a. during the performance period for that incentive-based compensation ;

b. while the issuer has a class of securities listed on a national securities exchange or a national securities association ; and

c. during the three completed fiscal years immediately preceding the date that the issuer is required to prepare an accounting restatement

Further, for purposes of Rule 10D-1(b), "incentive-based compensation" is deemed "received" in the fiscal period during which the financial reporting measure specified in the "incentive-based compensation" award is attained, not when the award is granted or paid.

Moreover, the transition guidance in the adopting release states, "[T]he final rules provide that each listed issuer is required to comply with the recovery policy for all incentive-based compensation received [] by current or former executive officers on or after the effective date of the applicable listing standard (as opposed to the effective date of Rule 10D-1)." The effective date of the listing standard is Oct. 2, 2023. Additionally, the SEC's adopting release states:

"Notwithstanding these extended transition periods, we recognize that there could be incentive-based compensation that is the subject of a compensation contract or arrangement that existed prior to the effective date of Rule 10D-1 which was not received until after the effective date of the applicable listing standards—and therefore would be subject to recovery under the final amendments. We do not believe this would be an inappropriate application of the mandated recovery policy. In our view, executives do not have a reasonable settled expectation in retaining compensation that was erroneously awarded based on misreported financial metrics, particularly when those financial metrics were attained on or after the effective date of the applicable listing standards, as contemplated by the final amendments. For similar reasons, we do not believe it is inappropriate to apply the mandated recovery policy to pre-existing compensation contracts or arrangements."

In our hypothetical, the CEO has been serving as an executive officer of an issuer that is listed on a national securities exchange since 2010. Thus, a compliant recovery policy would apply to awards granted to him after he commenced service in that role if such awards constitute "incentive-based compensation" subject to clawback. Specifically, the 2021 equity incentive award 1) constitutes "incentive-based" compensation because it is based on Company X's GAAP EPS growth, which is a financial reporting measure and 2) would be deemed "received" in December 2023 because the award is earned based on Company X's GAAP EPS growth for the three-year period ending on Dec. 31, 2023. The accounting team determined that Company X was required to file restatements for fiscal years 2022 and 2023 in April 2024 and so an award "received" in December 2023 (i.e., after the Oct. 2, 2023, effective date of the listing standards) would fall within the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement (i.e, April 2024).

- **If so, how much of the award must be recovered?**

Answer: The amount of incentive-based compensation that must be recovered is "the amount of incentive-based compensation received that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts, and must be computed without regard to any taxes paid."

Section II.C.3. of the SEC's Adopting Release provides guidance on calculating the amount that should be recovered when the award is in the form of equity awards:

"For equity awards, if the shares, options, or SARs are still held at the time of recovery, the erroneously awarded compensation is the number of such securities received in excess of the number that should have been received applying the restated financial reporting measure (or the value of that excess number). If the options or SARs have been exercised, but the underlying shares have not been sold, the erroneously awarded compensation is the number of shares underlying the excess options or SARs (or the value thereof)."

Therefore, assuming the CEO has not sold the shares, the recovery would be 11,000 shares (the difference between the number of shares received and the amount that should have been received applying the restated financial reporting measure).

- **How do the indemnification provisions in bylaws and contractual indemnification agreements interplay with the Compensation Committee's decision?**

Answer: With respect to the indemnification provision in the bylaws and what is required under the clawback rules, the SEC's adopting release states:

"We further believe that Section 29(a) of the Exchange Act would render any indemnification agreement void and unenforceable to the extent that the agreement purported to relieve the issuer of its obligation under Section 10(D), Rule 10D-1, and a resulting listing standard to recover erroneously paid incentive-based compensation. Section 29(a) provides that any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void. As courts have noted, by its terms, Section 29(a) prohibits waiver of the substantive obligations imposed by the Exchange Act. The underlying concern of this section is 'whether the [challenged] agreement weakens [the] ability to recover under the Exchange Act.'"[1]

We note, however, that this question is not free from doubt as it is probably going to wind up being a litigated issue.

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[1]The SEC adopting release's endnote 374 states: "See AES Corp. v. The Dow Chemical Company, 325 F.3d 174, 179 (3d Cir. 2003) (quoting Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 228, 230 (1987)). See also Cohen v. Viray, 622 F.3d at 195 (citing Section 29(a) in rejecting indemnification against Sarbanes-Oxley Act Section 304 liability); and Allied Artists Pictures Corp. v. Giroux, 312 F. Supp. 450 (S.D.N.Y. 1970) (Section 29(a) rendered general release given by corporation to former chairman 'unenforceable as a matter of law" in action by corporation to recover shortswing profits action under Section 16(b) of the Exchange Act).'" (emphasis added)