BARNES & THORNBURG LLP

ALERTS

SEC's New Executive Compensation Clawback Rules To Become Effective In January 2023 – What That Means For Public Companies

December 9, 2022

Highlights

The SEC has adopted new rules that will require a public company listed on a national securities exchange to adopt and comply with an executive compensation clawback policy

Under the rules, with some exceptions, listed issuers will be required to recover erroneously awarded incentive-based compensation paid to their current and former executive officers

The new rules will become effective in January 2023; public companies must adopt new clawback policies no later than January 2024

On October 26, 2022, the Securities and Exchange Commission (SEC) adopted final rules that require national securities exchanges, including the New York Stock Exchange and The NASDAQ Stock Market, to establish new listing standards relating to policies for the recovery of erroneously awarded incentive-based executive compensation. These types of policies are typically referred to as "clawback policies." Specifically, under the new listing standards, a company listed on any

RELATED PEOPLE

David P. Hooper
Partner
Indianapolis

P 317-231-7333
F 317-231-7433
david.hooper@btlaw.com

RELATED PRACTICE AREAS

Corporate
Securities and Capital Markets

national securities exchange will be required to adopt a clawback policy providing that, in the event the company is required to prepare an accounting restatement, it will recover incentive-based compensation paid to its current or former executive officers based on any misstated financial reporting measure. The clawback policy must apply to compensation received during the three-year period preceding the date the listed company is required to prepare the accounting restatement. In addition, the new rules require a listed company to file the policy as an exhibit to its annual report and to include disclosures related to its recovery policy and recovery analysis in the event that a recovery is triggered under its clawback policy.

Policies providing for the recovery of erroneously awarded executive compensation were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), and the SEC initially proposed rules to implement the mandate in July 2015. However, final executive compensation clawback rules were not adopted until after the SEC reopened the comment period for the proposed rules in October 2021 and again in June 2022.

The final rules add Rule 10D-1 under the Securities Exchange Act of 1934, which requires exchanges to adopt the new listing standards relating to clawback policies that will apply to all listed issuers, with few exceptions. A listed company will be subject to delisting if it does not adopt and comply with a compensation recovery policy that meets the requirements of the applicable listing standards. In addition, as part of the new rulemaking, the SEC adopted amendments to Item 402 of Regulation S-K, Form 40-F, and Form 20-F to include new disclosure requirements related to the required clawback policies.

The new rules were just recently published in the Federal Register and will become effective on January 27, 2023. But this does not mean public companies must have the required clawback policies in place by that date. Rather, the new rules first require the national securities exchanges to propose listing standards implementing the new rules by February 26, 2023, and those listing standards will need to be effective no later than November 28, 2023. A listed issuer will then only have 60 days to adopt a recovery policy after the applicable listing standards become effective. Therefore, if an exchange’s listing standards become effective at the latest possible date of November 28, 2023, then the listed issuer must have its new clawback policy in place no later than January 27, 2024. This compliance date may be earlier if the exchanges’ listing standards become effective earlier in 2023. Thereafter, each listed issuer will be required to comply with its clawback policy, as well as the new disclosure requirements in its proxy and information statements and annual reports filed on or after it adopts its clawback policy, which for most issuers will be in 2024.

Broad Definition of “Accounting Restatements”

Under the final rules, listed issuers are required to adopt and comply with a written compensation recovery policy that will be triggered if the listed company is required to prepare an accounting restatement that either: (1) corrects an error in previously issued financial statements that is material to the previously issued financial statements (often referred to as “Big R” restatements), or (2) that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (often referred to as “little r” restatements).

A “Big R” restatement is what first comes to mind when thinking about accounting restatements. A “Big R” accounting restatement requires a public company to file an Item 4.02 Form 8-K within four business days and to amend its SEC filings promptly to restate the previously issued financial statements because those financial statements can no longer be relied upon by users. However, 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. While the initial error for a “little r” restatement may not have been material to previously issued financial statements, it may become material due to its cumulative effect over multiple reporting periods. In this case, a material adjustment to the current period that relates to an error from previously issued financial statements would cause the current period financial statements to be materially misstated. Thus, the SEC has taken the position that “little r” restatements are indeed accounting restatements and were intended to be covered by the Dodd-Frank Act clawback rule mandate.

While the proposed clawback rules from 2015 focused exclusively on “Big R” restatements, the final clawback rules adopted by the SEC in 2022 reflect a much more expansive definition of accounting restatements that could trigger a required clawback when a company makes a “little r” restatement.

Incentive-Based Compensation under Clawback Policies

Under the final rules, the recoverable amount required under a clawback policy is the amount of incentive-based compensation received by a current or former executive officer in excess of the amount that otherwise would have been received had it been determined based on the restated financial measures, without regard to any taxes paid.

The rules define “incentive-based compensation” to be any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure. In the adopting rule release, the SEC provided the following examples of incentive-based compensation (which is not an exhaustive list):

- 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.

In addition, “financial reporting measures” are defined as measures that are determined and presented in accordance with the accounting principles used in preparing the listed company’s financial statements, and any measures derived wholly or in part from such measures, including non-GAAP financial measures.

In the adopting rule release, the SEC argued that, “absent recovery of such compensation, executive officers would still be in a position to benefit from accounting errors, undermining their incentives to ensure reliable financial reporting.”

Definition of Executive Officer

The final clawback rules define an “executive officer” as any one of the following: the 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 (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 company. Executive officers of a company’s parent(s) or subsidiaries are deemed executive officers of the company if they perform such policy making functions for the company.

The new rules do not limit the scope of recovery under executive compensation clawback policies to those officers who may be “at fault” for accounting errors that led to a restatement, nor to those who are directly responsible for the preparation of the financial statements.

The final rule will only require recovery of incentive-based compensation received by a person (1) after beginning service as an executive officer, and (2) if that person served as an executive officer at any time during the recovery period. However, if the person served as an executive officer during the recovery period triggered by the accounting restatement and later leaves the company, that person’s incentive-based compensation remains subject to clawback even though the person is not with the company at the time of the restatement.

Exceptions to Recovery

The new listing standards will require a listed company to recover erroneously awarded compensation, subject to limited impracticability exceptions available only in circumstances where:

- direct expenses paid to third parties to assist in enforcing the policy would exceed the amount to be recovered and the issuer has made a reasonable attempt to recover;
- recovery would violate home country law that existed at the time of adoption of the rule, and the issuer provides an opinion of counsel to that effect to the exchange; or
- recovery would likely cause an otherwise tax-qualified

retirement plan to fail to meet the requirements of the Internal Revenue Code.

Absent any of these exceptions, a listed company will be required to seek recovery for such erroneously awarded incentive-based compensation.

New Disclosure Requirements

Under the final rules, a listed issuer must file its policy as an exhibit to its annual report and disclose how it has applied the policy, including, as relevant:

- the date it 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 total shareholder return);
- the aggregate amount that remains outstanding and any outstanding amounts due from any current or former named executive officer for 180 days or more; and
- details regarding any reliance on the impracticability exceptions.

In addition, the SEC amended the cover page of Form 10-K, Form 20-F, and Form 40-F to add check boxes that indicate separately (1) whether the financial statements of the registrant included in the filing reflect correction of an error to previously issued financial statements, and (2) 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. In the final rule release, the SEC notes that, "particularly as it relates to "little r" restatements which typically are not disclosed or reported as prominently as "Big R" restatements, the check boxes provide greater transparency around such restatements and easier identification for investors of those that triggered a compensation recovery analysis."

In addition, listed companies will be required to use Inline XBRL to tag their compensation recovery disclosure.

Practical Considerations

The new clawback rules are likely to have important practical impacts on public companies. First, because the final rules include "little r" restatements as clawback triggers, companies that discover accounting errors may now have an incentive not to revise their financial statements at all as a result of the error and rather rely on "out-of-period adjustments" to correct the error, if that can be justified. Just as the inclusion of "Big R" restatements as clawback triggers may have encouraged companies (rightly or wrongly) to undertake more "little r" restatements over the past several years, so too the inclusion of "little r" restatements as clawback triggers in the final rules may encourage companies to justify making more out-of-period adjustments to avoid a clawback. If this happens, this may result in riskier accounting practices and reduce the quality of financial statements produced by public companies.

Second, companies likely will be required to spend more time and resources analyzing the effect of an accounting error and its ramifications on potential executive compensation clawbacks, particularly because “little r” restatements are now included as clawback triggers. Companies discovering accounting errors now must take a more critical look at the extent of the error, whether it requires revisions to the financial statements, and quantifying the effect on incentive-based compensation, even for small accounting errors. This will require the finance and accounting departments of public companies to implement additional controls and procedures to address these matters.

Finally, the expansive nature of the final clawback rules may prompt public companies to reassess the design of their executive compensation programs, particularly with respect to the performance-based compensation element of executives’ pay packages. If clawbacks of incentive-based compensation are more likely to occur as a result of the new clawback rules, then companies (and the executives who run them) may decide it would be better from a talent-retention perspective to shift more of the executives’ compensation to time-based awards or even base salary. If executive compensation begins to become decoupled from company performance metrics, this may have the unintended effect of reducing alignment of executive pay packages with the interests of shareholders.

To obtain more information about the final rules, please contact the Barnes & Thornburg attorney with whom you work or David Hooper at 317-231-7333 or david.hooper@btlaw.com or Isabelle Dinerman at 404-264-4097 or isabelle.dinerman@btlaw.com.

© 2022 Barnes & Thornburg LLP. All Rights Reserved. This page, and all information on it, is proprietary and the property of Barnes & Thornburg LLP. It may not be reproduced, in any form, without the express written consent of Barnes & Thornburg LLP.

This Barnes & Thornburg LLP publication should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult your own lawyer on any specific legal questions you may have concerning your situation.