

Executive Compensation and Employee Benefits Alert

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SEC Adopts Final Clawback Rules

November 8, 2022

On October 26, 2022, the U.S. Securities and Exchange Commission (SEC) adopted long-awaited **final rules** implementing the “clawback” provisions of Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rules, which add new Rule 10D-1 under the Securities Exchange Act of 1934 (Exchange Act), require stock exchanges to establish listing standards requiring listed issuers to:

- Adopt and comply with a written clawback policy, which provides for the recovery of “erroneously awarded” incentive-based compensation received by its current or former executive officers in the event the issuer is required to prepare an accounting restatement; and
- Disclose the clawback policy in accordance with SEC rules.

Affected Issuers; Timing

Given that incentive-based compensation is widely used as part of long-term compensation design, a substantial number of issuers will be affected by the final rules. Indeed, the final rules provide that the clawback requirements apply to all listed issuers, including foreign private issuers, smaller reporting companies, emerging growth companies, debt-only issuers and controlled companies, with only limited exceptions.¹

An issuer will be subject to delisting if it does not adopt and comply with its clawback policy. Issuers must adopt its clawback policy no later than 60 days following the date on which the applicable listing standard becomes effective; however, stock exchanges have 90 days following publication of the SEC’s final rules in the *Federal Register* to propose listing standards, which must be effective within one year following publication of the SEC’s final rules.

Accounting Restatement Trigger; No Fault Required

Under the final rules, the clawback requirement is a bright-line: Recovery is required if the issuer is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements, regardless of any fault or wrongdoing of the executive officer for the accounting errors. Recovery does not require adjudication of any misconduct, negligence, responsibility, or failure of supervision leading to the restatement. This scope may very well result in recovery

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from officers (but not rank-and-file employees) who did not play a role in an accounting error or in an issuer's financial reporting accuracy more generally.

Accounting restatements that trigger the clawback requirement include both "Big R" and "little r" restatements. In other words, the clawback is triggered in the event the issuer 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 known as "Big R" restatements), or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (commonly known as "little r" restatements). The final rules further clarify that no clawback analysis would be triggered when an error is immaterial to previously issued financial statements and the correction of the error in the current period financial statements (known as an "out-of-period adjustment") is also immaterial to the current period.

Clawback Requirements

If an issuer is required to prepare an accounting restatement, the final rules require an issuer to recover for the benefit of its shareholders, from any current or former executive officer, the amount of any incentive-based compensation that was erroneously awarded during the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement. Any recovery will be available for the issuer to return to investors or invest in productive assets to generate value for shareholders.

Who is an "executive officer"?

Conforming to Section 16 of the Exchange Act rules, "executive officers" include 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, including executive officers of a parent or subsidiary.

By contrast, Sarbanes-Oxley Act Section 304, which contains a recovery provision that is triggered when a restatement is the result of issuer misconduct, and which the SEC has enforced more rigorously under SEC Chairman Gensler's tenure, applies only to CEOs and CFOs. While CEOs and CFOs would not be subject to duplicative clawback, recovery under the SEC's final rules will not preclude enforcement under the Sarbanes-Oxley Act to the extent any applicable amounts have not been recovered.

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 three-year lookback period.

What constitutes "incentive-based compensation"?

Incentive-based compensation includes any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. "Financial reporting measures" are measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, and any measures derived wholly or in part from such

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financial information. This includes GAAP and non-GAAP measures, as well as stock price and Total Shareholder Return (TSR). Awards that vest solely based on continued employment (e.g., time-vesting) and were not granted based on a financial reporting measure would not be considered incentive-based compensation. Similarly, compensation subject to subjective performance criteria or strategic or operational measures would not be considered incentive-based compensation.

There is no phase-in for incentive compensation: the final rules capture incentive compensation whether received pursuant to a preexisting contract or arrangement, or one that is entered into after the effective date of the listing standard.

When is incentive-based compensation deemed “received”?

Incentive-based compensation will be deemed received in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award was attained, even if payment or grant occurs after the end of that period.

The date of receipt depends on the award terms. For example, if the grant of an award is based on satisfying a financial reporting measure, the award would be deemed received in the fiscal period when that measure was satisfied. Similarly, if an award is earned or vested upon satisfaction of a financial reporting measure, the award would be deemed received in the fiscal period when it is earned or vested, as applicable, even if paid or settled later.

What amount is considered “erroneously awarded”?

The amount “erroneously awarded” means the excess of the amount of incentive-based compensation the executive officer received over the amount the executive officer would have received had it been determined based on the accounting restatement, computed on a pre-tax basis.

For incentive-based compensation based on stock price or TSR, where the amount is not subject to mathematical recalculation, 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 and provide it to the stock exchange.

What if recovery is impracticable?

The final rules provide for 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 and provided the stock exchange with documentation of its attempts to recover;
- For foreign private issuers, recovery would violate home country laws that existed at the time of adoption of the rule, and the issuer provided the stock exchange an opinion of counsel to that effect; or
- Recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet certain qualification requirements of the Internal Revenue Code.

In order to mitigate potential conflicts of interest, any determination that recovery would be impracticable in any of these three circumstances must be made by the issuer's committee of independent directors that is responsible for executive compensation decisions. In the absence of a compensation committee, the determination must be made by a majority of the independent directors serving on the board.

No indemnification or “make whole.”

The final rules prohibit issuers from insuring or indemnifying any current or former executive officer against the loss of erroneously awarded compensation. While an executive officer may be able to purchase a third-party insurance policy to fund potential recovery, an issuer may not pay or reimburse the executive officer for premiums for such an insurance policy.

Disclosure Requirements

The final rules require all listed issuers to (i) file their written recovery policies as exhibits to their annual reports and (ii) disclose information about compliance and actions taken pursuant to its recovery policies, under new Item 402(w) to Regulation S-K.

Under new Item 402(w), if, during its last completed fiscal year, the issuer either was required to prepare a restatement that triggered a clawback requirement, or there was an outstanding balance of excess incentive-based compensation relating to a prior restatement, the issuer must disclose:

- The date on which the issuer was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (including an analysis of how the recoverable amount was calculated);
 - If the amount of erroneously awarded compensation is based on a stock price or TSR attributable to such accounting restatement, the estimates used and an explanation of the methodology;
 - If the clawback amount has not been determined yet, an explanation of the reasons why it has not been determined and subsequent disclosure in the next filing that is subject to Item 402 of Regulation S-K;
- The aggregate amount of erroneously awarded compensation unrecovered at the end of the last completed fiscal year;
- If the amount of erroneously awarded compensation for any current or former named executive officer remains unrecovered for 180 days or longer since the date the issuer determined the amount owed, the name of and amount due from such person at the end of the issuer's last completed fiscal year;
- If any erroneously awarded compensation was not recovered based on the impracticability exception, a brief description—for each individual named executive officer and for all other executive officers as a group—of the forgone recovery amount and the reasons the issuer has not pursued such recovery; and
- If, at any time during its last completed fiscal year, an issuer prepared an accounting restatement and concluded that recovery of erroneously awarded

compensation was not required pursuant to its recovery policy, a brief explanation of what resulted in this conclusion.

The new Item 402(w) disclosure 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. Disclosure under Item 402(w) would be included along with other executive compensation disclosure where Item 402 is required (*i.e.*, in proxy or information statements, or in annual reports on Forms 10-K), or analogous disclosure provisions in the forms applicable to listed funds and foreign private issuers.²

Effect on Summary Compensation Table. The final rules require that any “clawed back” amounts reduce the amount reported in the applicable column of the Summary Compensation Table, as well as the “total” column, for the fiscal year in which the amount recovered initially was reported, and be identified by footnote.

“Check Boxes” for Financial Statement Errors. Listed issuers must check boxes on their annual reports (on the cover pages of Form 10-K, Form 20-F and Form 40-F) to indicate (a) whether the included financial statements reflect correction of an error to previously issued financial statements and (b) whether any of those corrections are restatements that required a clawback analysis during the fiscal year.

Interactive Data. The final rules require listed issuers to tag the compensation recovery disclosures in interactive data format (XBRL).

What Companies Should Do Now

Listed companies do not need to adopt a Rule 10D-1 clawback policy until the listing standards implementing the final rules are proposed by the stock exchanges and become effective. However, companies can prepare now by taking the following steps:

- Review any existing clawback policies and consider what changes may be required under the final rules. Consider whether to modify existing clawback policies to align the scope with Rule 10D-1, or maintain multiple clawback policies with varying scope.
- Review existing incentive compensation plans and arrangements to determine whether such compensation would, in any part, relate to “financial reporting measures” under SEC rules. Consider whether, in view of the company’s overall long-term compensation design and risk analysis, it would be appropriate to use other performance criteria (such as ESG-related goals or strategic or operational measures), or to add, or change the weighing of, compensation based on other measures.
- Consider whether it is necessary to add a clawback provision in any incentive compensation plans or agreements to support contractual enforcement of the clawback, including on a retroactive basis.
- Review analysis of the company’s executive officer list to confirm who would be subject to the clawback requirements under the final rules.

¹ The final rules do not apply to certain securities futures products, standardized options or securities issued by listed funds where the funds have not awarded incentive compensation to any executive officers in the past three years.

² The analogous disclosure provisions are: (i) for listed funds, annual reports on Form N-CSR and in proxy statements and information statements relating to the election of directors, (ii) for foreign private issuers, annual reports on Form 20-F, and (iii) for multijurisdictional disclosure system filers, annual reports on Form 40-F.

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