

SEC Finalizes Executive Pay Clawback Rules

On October 26, 2022, the SEC voted three to two to issue a [final rule](#) to complete mandates from the 2010 Dodd-Frank Act. New Rule 10D-1 addresses standards for exchange-listed companies for the recovery of erroneously awarded compensation to executive officers, known as a clawback policy. The executives covered are broad and include the issuer's president; principal financial officer; principal accounting officer; any vice president in charge of a principal business unit, division, or function; and any other officer who performs policymaking functions. Highlights include:

- National securities exchanges must establish listing standards that would require listed companies to adopt and comply with a compensation recovery policy. Noncompliance would result in delisting.
- Listed issuers are required to disclose any recovery of excess incentive-based compensation and file their clawback policy as an annual report exhibit.
- All issuers' annual reports will include a check box if the financial statements reflect an error correction to previously filed statements. Disclosure is required if the restatement required a recovery analysis and any actions taken related to its recovery policy.



I. Background

The SEC first issued a proposal in 2015 to fulfill its compensation recovery Dodd-Frank requirements. The comment period was reopened on October 14, 2021 and again on June 8, 2022. Since the first proposal, many more companies have adopted compensation recovery policies. Both the New York Stock Exchange and the Nasdaq already have compensation clawback policies. The final rule's economic analysis notes that approximately 46% of all filers currently disclose some form of an executive compensation recovery policy, although revisions are likely to be required to comply with Rule 10D-1.

Currently, the Sarbanes-Oxley Act¹ contains a recovery provision that is triggered when a restatement is the result of issuer misconduct. This provision applies only to CEOs and CFOs and the recovery amount is limited to compensation received in the 12-month period following the first public issuance or SEC filing of the improper financial statements. Rule 10D-1 covers

¹ Amounts compensation recovered under this SOX provision (Section 304) would be included under the Rule 10D-1 recovery policy. Recovery under 10D-1 would not preclude recovery under Section 304.

more executive officers, broadens triggering from misconduct to accounting misstatement, and expands the lookback period from one year to three years.

II. Exchange Requirements

Rule 10D-1 requires national securities exchanges to develop listing standards that would require their listed companies to adopt and comply with a compensation recovery policy for recovery of incentive-based compensation based on financial information required to be reported under the securities laws.

- The policy should be applicable to the issuers' executive officers, during the three completed fiscal years immediately preceding the date that the issuer is required to prepare an accounting restatement.
- Disclose those compensation recovery policies and tag the information in XBRL format.
- Recovery is required:
 - From current and former executive officers who received incentive-based compensation during the three fiscal years preceding the date on which the issuer is required to prepare an accounting restatement to correct a material error
 - On a “no fault” basis, without regard to misconduct or an executive officer’s responsibility for the misstated financial statements
 - The recovery amount is the incentive-based amount received by an executive that exceeds the amount that would have been received if the incentives were based on the restated financial statements
- Issuers must recover in compliance with their recovery policies, except to the extent that it would be impracticable.
- Issuers are prohibited from indemnifying current and former executive officers for loss of recoverable compensation.

Exchanges would be required to delist issuers that do not comply with the above disclosures.

Issuer & Security Scope Exceptions

The requirements would apply to all listed issuers and any security of an issuer, which would include not only common equity securities, but also debt and preferred securities with the following exceptions:

- Exchanges that only trade securities pursuant to unlisted trading privileges but do not list securities
- The listing of certain security futures products, standardized options, securities issued by unit investment trusts, and the securities issued by certain registered investment companies²

No exemption is provided for foreign private issuers, smaller reporting companies, emerging growth companies, or externally managed business development companies; therefore, these entities will be subject to these changes.

² Any security issued by a listed fund if the fund has not awarded incentive-based compensation to any current or former executive officer of the fund in any of the last three fiscal years or for a fund that has been listed for less than three fiscal years, since the initial listing

III. Listing Company Requirements

In addition to meeting the compensation recovery policy listing standards, the final rule also amends Item 402 of Regulation S-K, Form 40-F, and Form 20-F (and for listed funds, Form N-CSR) to include new disclosures. In a change from the proposal, the final rules will additionally require disclosure relating to an issuer's compensation recovery policy and recovery and additional check box disclosure on the cover of the Forms 10-K, 20-F, and 40-F.

Listed issuers could adopt policies more extensive than those called for by the listing standards if those policies at a minimum satisfied the listing standards. Exchanges and associations could adopt listing standards with requirements that are more extensive than those required in Rule 10D-1.

Disclosures

The following items, if applicable, would be required in Item 402 disclosure:

- The date on which the listed issuer was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (including how the recoverable amount was calculated) or, if the amount has not yet been determined, an explanation of the reasons and disclosure of the amount and related disclosures in the next filing
- The aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the issuer's last completed fiscal year
- If the financial reporting measure related to a stock price or total shareholder return³ (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
- If recovery would be impracticable, for each current and former named executive officer and for all other current and former executive officers as a group, disclose the amount of recovery forgone and a brief description of the reason the listed registrant decided in each case not to pursue recovery
- For each current and former named executive officer, disclose the amount of erroneously awarded compensation still owed that had been outstanding for 180 days or longer since the date the issuer determined the amount owed

If the impracticability exception was used for not pursuing recovery, the following details should be provided depending on which exception was used:

- 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
- A brief explanation of how the recovery policy would cause an otherwise tax-qualified retirement plan to fail to meet IRS requirements

In addition, the Summary Compensation Table should be adjusted for any amounts recovered pursuant to a listed issuer's compensation recovery policy by reducing the amount for the fiscal year in which the amount was initially reported and recasting the total column. Footnote identification is required for such adjustments.

³ The formula for calculating TSR is $\{ (\text{current price} - \text{purchase price}) + \text{dividends} \} \div \text{purchase price}$.

III. Definitions

A. Covered Officers

The SEC concluded that the Dodd-Frank requirements did not intend to limit recovery to officers at fault for accounting errors that led to a restatement or only to those directly responsible for financial statement preparation. The SEC believes the Dodd-Frank requirements were established not to punish wrongdoing but rather to require executive officers to return monies that rightfully belong to the issuer and shareholders.

The final rule defines in scope executive officers as the issuer's president; principal financial officer; principal accounting officer (or if there is none, 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 policymaking function; or any other person who performs similar policymaking functions for the issuer.

The final rule will only require recovery of incentive-based compensation received by a person after beginning service as an executive officer and if that person served as an executive officer at any time during the recovery period. Recovery of compensation received while an individual was serving in a nonexecutive capacity prior to becoming an executive officer will not be required. The recovery requirement also does not apply to an individual who is an executive officer at the time recovery is required if that individual was not an executive officer at any time during the period for which the incentive-based compensation is subject to recovery.

B. Accounting Restatements

Under the final rule, listed issuers must adopt and comply with a written compensation policy that is triggered if the issuer is required to prepare an accounting restatement⁴ that corrects an error⁵ in previously issued financial statements that is material to the previously issued financial statements, or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period. Under current GAAP, the following types of changes in an issuer's financial statements do not represent an error correction and would not trigger application of the compensation recovery policy:

- Retrospective application of a change in accounting principle
- Retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization
- Retrospective reclassification due to a discontinued operation
- Retrospective application of a change in reporting entity, such as from a reorganization of entities under common control
- Retrospective adjustment to provisional amounts in connection with a prior business combination (International Financial Reporting Standards filers only)

⁴ Under U.S. GAAP, a restatement is defined in Accounting Standards Codification (ASC) Topic 250, Accounting Changes and Error Corrections, as the process of revising previously issued financial statements to reflect the correction of an error in those financial statements.

⁵ Under GAAP, an error in previously issued financial statements is defined in ASC 250 as an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

- Retrospective revision for stock splits, reverse stock splits, stock dividends, or other changes in capital structure

Big “R” & Little “r” Restatements

A Big R restatement is one that corrects errors that are material to previously issued financial statements. A little r restatement is a restatement that corrects errors that are not material to previously issued financial statements but would result in a material misstatement if the errors were left uncorrected in the current report or the error correction was recognized in the current period. A little r restatement differs from a Big R restatement primarily in the reason for the error correction, the form and timing of reporting, and the disclosure required. A Big R restatement requires the issuer to file an Item 4.02 Form 8-K and amend its filings promptly to restate the previously issued financial statements. 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.

Both Big R and little r restatements are covered by the final rule.

C. Incentive-Based Compensation

The final rule uses a principles-based approach to define incentive-based compensation to be any compensation that is granted, earned, or vested based wholly or in part⁶ 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 measures. This would include non-GAAP financial measures. Financial reporting measures may or may not be included in SEC filings and may be presented outside the financial statements, such as in Management’s Discussion and Analysis or Results of Operations or in a performance graph. The final rule contains the following nonexhaustive list of examples of accounting-based metrics and performance measures:

- Revenues
- Net income
- Operating income
- Profitability of one or more reportable segments
- Financial ratios, *e.g.*, accounts receivable turnover and inventory turnover rates
- Net assets or net asset value per share, *e.g.*, for registered investment companies and business development companies that are subject to the rule
- Earnings before interest, taxes, depreciation, and amortization
- Funds from operations and adjusted funds from operations
- Liquidity measures, *e.g.*, working capital, operating cash flow
- Return measures, *e.g.*, return on invested capital, return on assets
- Earnings measures, *e.g.*, earnings per share
- Sales per square foot or same store sales, where sales are subject to an accounting restatement

⁶ Incentive-based compensation need not be based solely upon attainment of a financial reporting measure. An example of compensation that is based in part upon the attainment of a financial reporting measure would include an award in which 60% of the target amount is earned if a certain revenue level is achieved, and 40% of the target amount is earned if a certain number of new stores are opened. Similarly, an award for which the amount earned is based on attainment of a financial reporting measure but is subject to subsequent discretion by the compensation committee to either increase or decrease the amount would be based in part upon attainment of the financial reporting measure.

- Revenue per user, or average revenue per user, where revenue is subject to an accounting restatement
- Cost per employee, where cost is subject to an accounting restatement
- Any of such financial reporting measures relative to a peer group, where the issuer's financial reporting measure is subject to an accounting restatement
- Tax-basis income
- Stock price
- Total shareholder return

Specific examples of **incentive-based compensation** include, but are not limited to:

- 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 the satisfaction of a financial reporting measure performance goal
- Restricted stock, restricted stock units, performance share units, stock options, and stock appreciation rights that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal
- 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

Examples of **non-incentive-based compensation** include, but are not limited to:

- Salaries
- Bonuses paid solely at the discretion of the compensation committee or board that are not paid from a “bonus pool” that is determined by satisfying a financial reporting measure performance goal
- Bonuses paid solely upon satisfying one or more subjective standards, *e.g.*, demonstrated leadership, and/or completion of a specified employment period
- Non-equity incentive plan awards earned solely upon satisfying one or more strategic measures, *e.g.*, consummating a merger or divestiture, or operational measures, *e.g.*, opening a specified number of stores, completion of a project, or increase in market share
- Equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more nonfinancial reporting measures

D. Three-Year Look-Back Period

The three-year look-back period for the recovery policy will comprise the three completed **fiscal years** immediately preceding the date the issuer is required to prepare an accounting restatement for a given reporting period.

Under the recovery policy, incentive-based compensation is deemed to be received in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs after period end. Incentive-based compensation is subject to the issuer's recovery policy if it is received while the issuer has a class of securities listed on exchange.

The date of receipt of the compensation depends upon the terms of the award; for example:

- If the grant of an award is based—either wholly or in part—on satisfaction of a financial reporting measure performance goal, the award would be deemed received in the fiscal period when that measure was satisfied.

- If an equity award vests only upon satisfaction of a financial reporting measure performance condition, the award would be deemed received in the fiscal period when it vests.
- A non-equity incentive plan award would be deemed received in the fiscal year that the executive officer earns the award based on satisfaction of the relevant financial reporting measure performance goal, rather than a subsequent date on which the award was paid.
- A cash award earned upon satisfaction of a financial reporting measure performance goal is deemed received in the fiscal period when that measure is satisfied.

Administrative acts or other conditions necessary to effect issuance or payment, such as calculating the amount earned or obtaining the board of directors' approval, do not affect the determination of the date received.

Recovery Period Trigger Date

To avoid issuers delaying their restatement conclusions, the final rule defines the date on which an issuer is required to prepare an accounting restatement (trigger date) is the earlier of:

- The date the issuer's board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws
- The date a court, regulator, or other legally authorized body directs the issuer to prepare an accounting restatement

An issuer will not be able to delay or relieve itself from the obligation to recover erroneously awarded incentive-based compensation by delaying or failing to file restated financial statements.

E. Erroneously Awarded Compensation

The final rule defines erroneously awarded compensation as the amount of incentive-based compensation received by the executive officer 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. 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.

Issuers may adopt more extensive recovery policies, so long as those policies satisfy the rule minimum requirements.

The final rule contains the following examples:

- For cash awards, the erroneously awarded compensation is the difference between the amount of the cash award (whether payable as a lump sum or over time) that was received and the amount that should have been received applying the restated financial reporting measure.

- For cash awards paid from bonus pools, the erroneously awarded compensation is the pro rata portion of any deficiency that results from the aggregate bonus pool that is reduced based on applying the restated financial reporting measure.
- For equity awards, if the shares, options, or stock appreciation rights (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).

The issuer is required to disclose the amount of erroneously awarded compensation attributable to an accounting restatement, including an analysis of how the erroneously awarded compensation was calculated.

Impracticability Exception

An issuer must recover erroneously awarded compensation in compliance with its recovery policy, except to the extent that pursuit of recovery would be impracticable. An issuer would have to make reasonable attempts at recovery before concluding it would be impracticable. The issuer must document its recovery attempts, which must be provided to the exchange. There are three exceptions on mandated recovery:

- If the direct cost of recovery, *i.e.*, reasonable legal and consulting fees, exceeds the recovery amount
- The recovery would violate home country law. Such law must have been adopted in that country before this final rule is published in the **Federal Register**
- Recovery from a tax-qualified retirement plan. Erroneously awarded incentive-based compensation contributed to plans limited only to executive officers, supplemental executive retirement plan, or other nonqualified plans would still be subject to recovery

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.

IV. Indemnification & Insurance

Issuers would be prohibited from insuring or indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation. An issuer also would be prohibited from paying or reimbursing an executive officer for a third-party indemnification policy.

V. Effective Date & Transition

Each exchange will be required to file its proposed listing standards no later than 90 days following **Federal Register** publication. Listing standards must be effective no later than one year following **Federal Register** publication. Each issuer subject to such listing standards will be required to adopt a recovery policy no later than 60 days following the date on which the applicable listing standards become effective.

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. Disclosures required by the rule and

Item 402(w) in the applicable SEC filings are required on or after the date on which the exchanges' listing standards become effective.

The mandatory recovery policy will not apply to pre-existing compensation contract or arrangements, e.g., an incentive-based contract that existed before the effective date of Rule 10D-1 that was not received until after the effective date of the applicable listing standard.

Conclusion

Listed companies should carefully review any existing clawback policies. For more information, visit forvis.com.

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