

Updates to SEC's Executive Pay Clawback Rules

In 2022, the SEC issued a [final rule](#) creating standards for exchange-listed companies for the recovery of erroneously awarded executive compensation, known as a clawback policy. The New York Stock Exchange (NYSE)¹ and the Nasdaq Stock Market (Nasdaq)² filed their proposed listed standards with the SEC on February 22, 2023. Comments are due 21 days after **Federal Register** publication. In January, the SEC added four questions on the rule to its Compliance & Disclosure Interpretation (C&DI) on application of this final rule.



I. Background

Currently, SOX³ 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 more executive officers, broadens triggering from misconduct to accounting misstatement, and expands the look-back period from one year to three years. For a comprehensive review of the final rule, see **FORsights**TM article, "[SEC Finalizes Executive Pay Clawback Rules](#)."

II. Exchange Proposals

The exchanges' respective proposals closely follow the SEC's final rule. Once the proposals are finalized, listed issuers must adopt compliant policies within 60 days following the exchange rule's effective date. A company's policy may be more—but not less—extensive than the final listing requirements.

The clawback requirement of each exchange's proposed listing standard applies to executive officers and is modeled on the definition of "officer" under §16 of the Exchange Act, including both current and former executive officers. Recovery would only apply to incentive-based compensation received by a person:

- After beginning service as an executive officer
- If that person served as an executive officer at any time during the recovery period

¹ <https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-filings/2023/SR-NYSE-2023-12.pdf>

² <https://listingcenter.nasdaq.com/assets/rulebook/NASDAQ/filings/SR-NASDAQ-2023-005.pdf>

³ 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 §304.

- While the issuer has a class of securities listed on a national securities exchange or a national securities association

The clawback requirements would apply to incentive-based compensation, which is defined to mean any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure. Financial reporting measure is defined as comprising measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, and any measures that are derived wholly or in part from such measures. Stock price and total shareholder return also are financial reporting measures.

The SEC final rule includes both big R and little r restatements.⁴ The NYSE and Nasdaq proposals contain similar language that the clawback requirement is triggered "in the event 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, including any required accounting restatement to correct an error 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."

Issuers must recover in compliance with their recovery policies, except to the extent that it would be impracticable. Under the exchange proposals, the determination that a clawback is impracticable also must be made by either:

- The issuer's committee of independent directors responsible for executive compensation decisions, or
- The issuer's Compensation Committee or in the absence of such a committee, a majority of the independent directors serving on the board

Issuers are prohibited from indemnifying current and former executive officers for loss of recoverable compensation.

Under the NYSE proposal, if a listed issuer has not recovered erroneously awarded compensation as required by its clawback policy "reasonably promptly," trading in all listed securities of the issuer would be immediately suspended and NYSE would immediately commence delisting procedures for all listed securities.

Under the Nasdaq proposal, an issuer would be subject to delisting if it does not adopt a compliant compensation policy or fails to disclose the policy or follow the policy's recovery provisions. A company that failed to comply would be required to submit a plan to regain compliance.

Issuer & Security Scope Exceptions

NYSE's and Nasdaq's respective proposed listing standards generally apply to all listed issuers, including emerging growth companies, smaller reporting companies, foreign private issuers, and controlled companies, without regard to the type of security issued, subject to the following limited exemptions.

⁴ 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.

NYSE exceptions:

- A security futures product cleared by a clearing agency that is registered pursuant to §17A of the *Securities Exchange Act of 1934* or that is exempt from the registration requirements of §17A
- A standardized option issued by a registered clearing agency
- Any security issued by a unit investment trust (UIT)
- Any security issued by a management company, that is registered under §8 of the *Investment Company Act of 1940*, if such management company has not awarded incentive-based compensation to any executive officer of the company in any of the last three fiscal years, or for a company that has been listed for less than three fiscal years, since the company's listing

Nasdaq exceptions include any security issued by a UIT and any security issued by a management company, as defined above.

III. SEC Clarifications

The final SEC rule added a “check the box” on certain forms to indicate if the form includes the correction of an error in previously issued financial statements and a related recovery analysis. The boxes were added effective January 27, 2023, but the SEC does not expect compliance with the disclosure requirements until companies are required to have a clawback policy under the applicable exchange listing standards.

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 C&DI clarifies that individualized disclosure is required about executive officers for whom the issuer otherwise provides individualized compensation disclosure in the filing and clarified disclosures for foreign private issuers.

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 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 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 or operating cash flow
- Return measures, *e.g.*, return on invested capital or 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
- 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

The C&DI clarifies that this rule is intended to apply broadly. For plans that take into account incentive-based compensation, *e.g.*, long-term disability plans, life insurance plans, and supplemental executive retirement plans, an issuer would be expected to claw back the amount contributed to the notional account based on erroneously awarded incentive-based compensation and any earnings accrued to date on that notional amount.

Conclusion

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

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