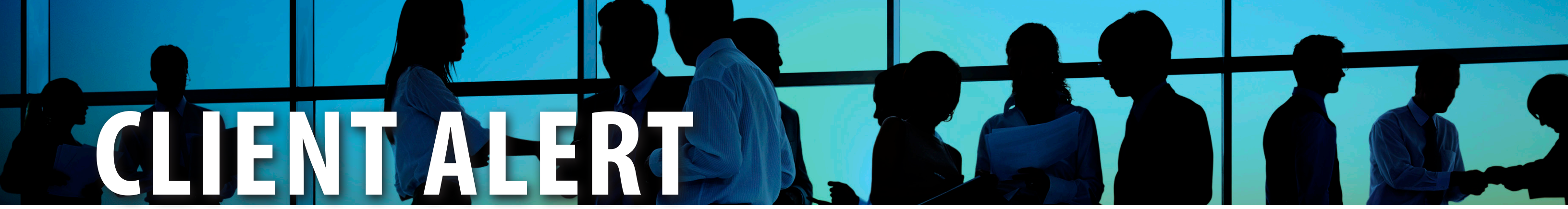


CLIENT ALERT

May 2023

FRAMEWORK OF DODD-FRANK ACT "CLAWBACK" POLICY (FINALLY) COMING INTO FOCUS

by Cynthia A. Moore

As directed by the Securities and Exchange Commission ("SEC"), the NYSE and Nasdaq have issued proposed listing standards related to the recovery of erroneously awarded executive compensation, commonly referred to as the "clawback" rules. The proposed listing standards closely follow the SEC's Rule 10D-1 issued under the Securities Exchange Act of 1934 (the "Exchange Act") in October 2022.

Background

The Dodd-Frank Act of 2010 added Section 10D to the Exchange Act, which required issuers to develop a recovery policy providing:

- for disclosure of the issuer's policy on incentive-based compensation that is based on financial information that is required to be reported under the securities laws; and
- that, if the issuer is required to prepare an accounting restatement due to material noncompliance with a financial reporting requirement under the securities laws, the issuer will recover from any executive officer who received incentive-based compensation (including stock options) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the account restatement.

The SEC issued a proposed rule under Section 10D on July 1, 2015, which languished until the SEC re-opened the comment period on October 14, 2021, and again on June 8, 2022. After consideration of the comments received, the final rule was published in the Federal Register on November 28, 2022.

Which Issuers Must Adopt a Clawback Policy?

All issuers with listed securities must adopt a clawback policy, including emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies. There are limited exceptions for the listing of:

- A security futures product cleared by a clearing agency registered under Section 17A of the Exchange Act;
- A standardized option issued by a clearing agency that is registered under Section 17A of the Exchange Act;
- Any security issued by a unit investment trust; and
- A security issued by a management company that is registered under Section 8 of the Investment Company Act of 1940, if the management company has not awarded incentive-based compensation to any executive officer in the last three fiscal years.

What is the Deadline for Adopting a Clawback Policy?

Each national securities exchange was required to issue a proposed listing standard implementing Rule 10D-1 by February 27, 2023, and both the NYSE and Nasdaq filed their proposed rules with the SEC on February 22, 2023. On April 24, 2023, the SEC published notices extending the period for consideration of the proposed rules from April 27, 2023 to June 11, 2023. On or before that date, the SEC will approve or disapprove, or institute proceedings to disapprove, the proposed rules. Each issuer must adopt its clawback policy within 60 days after the effective date of the listing standard. If the listing standards are approved by the SEC on June 11, 2023, the clawback policy must be adopted by August 10, 2023. It is possible that the deadline could be further extended, but under the SEC's final rule, the listing standards must be effective no later than November 28, 2023

What is the Consequences if the Issuer Fails to Adopt a Clawback Policy?

Any new securities will not qualify to be listed, and any securities that are listed are subject to delisting.

Which Executive Officers Must be Subject to the Clawback Policy?

The executive officers that must be covered by the issuer's clawback policy include, at a minimum, the following officers:

- President;
- Principal financial officer;
- Principal accounting officer (or if no accounting officer, the controller);
- Any vice president in charge of a principal business unit, division or function;
- Any other officer who performs a policy-making function; or
- Any other person who performs similar policy-making functions for the issuer.

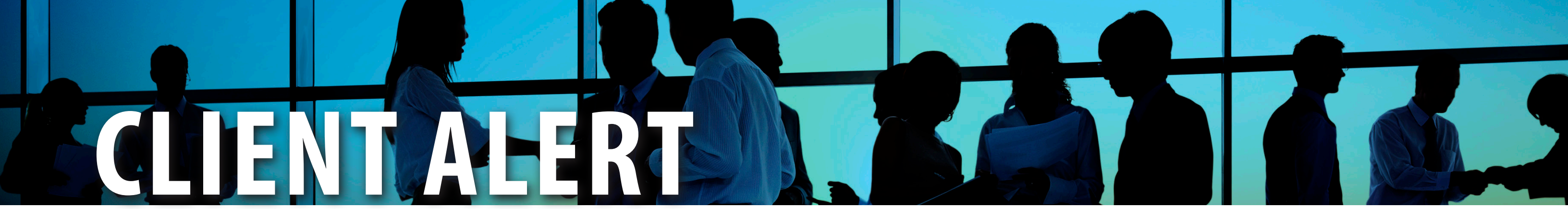
The policy is not limited to officers who are "at fault" or who are involved in the preparation of the financial statements.

What Types of Restatements Trigger Recovery of Erroneously Paid Compensation?

Rule 10D-1 and the proposed listing standards require recovery under the issuer's clawback policy to be triggered if there is:

- an accounting restatement that corrects an error in the previously issued financial statement (a "Big R" restatement); or
- an accounting restatement that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (a "little r" restatement.)

In the SEC's view, both types of restatements address material noncompliance of the issuer with financial reporting requirements, as provided in the statutory language.



What is the Recovery Period?

Erroneously paid compensation must be recovered in the three-year period preceding the date on which the issuer is required to prepare an accounting restatement. This period is measured from the earliest of:

- the date the Board of Directors, a Board committee, or authorized officer concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement; or
- the date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.

Is Recovery Limited to Current Executive Officers? Is Incentive-Based Compensation Subject to Recovery if it was Awarded to an Individual who was not an Executive Officer at the Time of Award?

The statute requires recovery from any current or former executive officer. Rule 10D-1 requires 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.

Therefore, incentive-based compensation paid to a former executive officer during the 3-year recovery period is subject to recovery.

Similarly, an award of incentive-based compensation granted to an individual before he/she becomes an executive officer is subject to the recovery policy, if the incentive-based compensation was received by the individual at any time during the recovery period after beginning service as an executive officer.

What Type of "Incentive-Based Compensation" is Subject to Recovery?

Rule 10D-1 and the proposed listing standards define "incentive-based compensation" as any compensation that is granted, earned or vested based wholly or in part on 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 includes GAAP and non-GAAP measures, as well as other measures, metrics and ratios. It also includes stock price and total shareholder return ("TSR").

Examples of financial reporting measures include:

- Revenue
- Net income
- Operating income
- Profitability
- Financial ratios
- Net assets or net asset value per share
- EBITDA
- Return measures (i.e., return on invested capital, return on assets)

Examples of "incentive-based compensation" include:

- Non-equity incentive plan awards that are earned based on satisfying a financial reporting measure performance goal;
- Bonuses paid from a "bonus pool," the size of which is determined 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 that are granted or become vested 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 on satisfying a financial reporting measure performance goal.

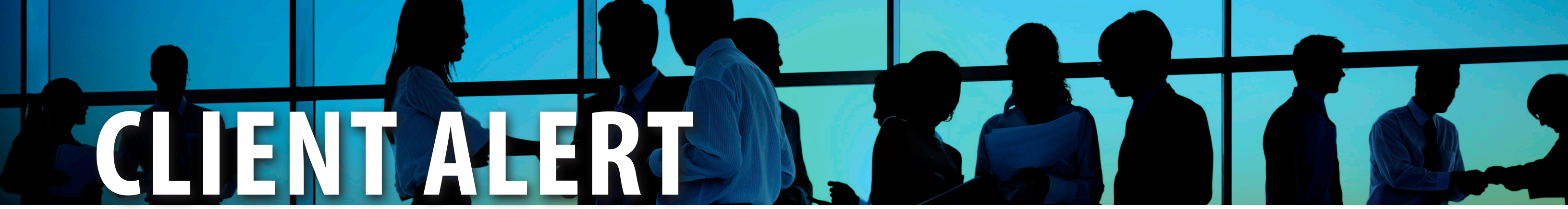
Examples of compensation that is not "incentive-based compensation" for this purpose include:

- Salaries
- Discretionary bonuses
- Non-equity plan awards earned solely upon satisfying one or more strategic measures (such as consummation of a merger) or operational measures (such as opening a specific number of stores); and
- Equity awards for which the grant is not contingent on achieving a financial reporting measure performance goal and vesting is contingent solely on completion of a specified employment period (i.e., subject to time-based vesting) and/or attaining one or more non-financial reporting measures.

When is Compensation Deemed "Received" for Purposes of the 3-Year Recovery Period?

Incentive-based compensation is deemed to be received for purposes of the recovery period in the fiscal period during which the financial reporting measure applicable to the award is attained, even if the payment or grant occurs after that period. The date of receipt of the compensation will depend on the terms of the award. For example:

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



Compensation is deemed received when the financial reporting measure is satisfied, even if the award is subject to further vesting conditions. For example, assume the financial reporting measure performance goal related to a performance share grant is met at the end of the 2022-2024 performance period. The compensation is deemed to be received in 2024 even if the award is not vested and paid until the end of the first quarter of 2025.

The three-year look-back period for the recovery policy will be the three fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement. From an administrative standpoint, this rule is easier to apply than a rolling 36-month period preceding the date that a restatement is required. As an example, if a calendar year issuer concludes in October 2024 that an accounting restatement is required, the recovery policy would apply to incentive-based compensation received in 2021, 2022 and 2023. This is the case even if the restatement is not completed and filed with the SEC until January 2025.

How is "Erroneously Awarded" Compensation Calculated?

Under Section 10D(2)(b), the issuer's recovery policy must apply to the amount of incentive-based compensation received "in excess of what would have been paid to the executive officer under the accounting restatement." Rule 10D-1 and the proposed listing standards provide that the excess compensation is determined under the financial reporting measures, as determined under the accounting restatement, without regard to any taxes paid by the executive officer.

In general, the process for determining the excess amount would be to:

> (1) recalculate the applicable financial reporting measure and the amount of incentive-based compensation that should have been paid under the accounting restatement;
>
> (2) compare this amount to the incentive-based compensation as calculated under the original financial statements (ignoring any discretionary payments); and
>
> (3) If the payment in step (2) is greater than the payment in step (1), the excess is the amount subject to recovery.

The SEC provided the following examples of how the excess would be calculated:

- For cash awards, the erroneously awarded compensation is the difference between the amount of the cash award (whether payable as a lump sum or in installments) 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.

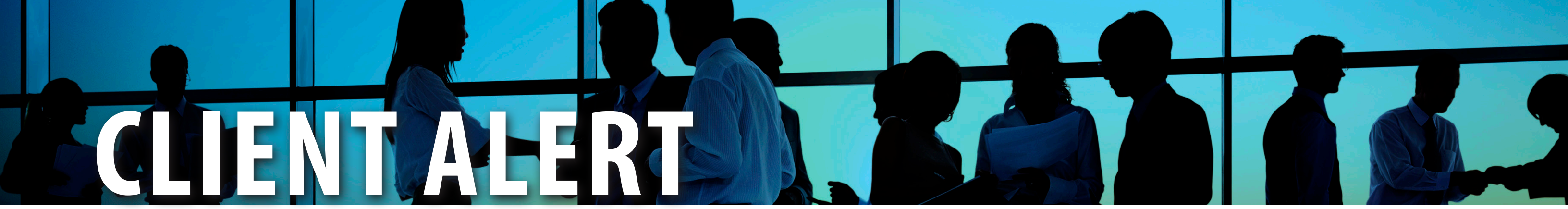
For incentive-based compensation based on TSR or stock price, where the amount of erroneously paid compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the amount must be based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. The issuer must maintain documentation of that reasonable estimate and the documentation must be provided to the exchange. The SEC acknowledges that there are a number of possible methods with different levels of complexity that may be used in preparing the estimate, and the issuer has the flexibility to use the appropriate measure.

The final rule provides that the erroneously awarded compensation must be calculated without regard to any tax liabilities that may have been incurred or paid by the executive officer to ensure that the issuer recovers the full amount of the incentive-based compensation that was erroneously awarded. In the SEC's view, this approach simplifies the recovery process for the issuer and aligns with the policy underlying Section 10D.

Can the Board use Discretion Not to Pursue Recovery?

A Board may decline to pursue recovery only if the independent compensation committee, or a majority of the independent directors, have determined that recovery is impracticable, under one of the following limited exceptions:

> (1) The direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered. Before reaching this conclusion, the issuer must make a reasonable attempt to recover the erroneously paid compensation, document the attempt, and provide that documentation to the exchange.
>
> (2) Recovery would violate home country law where that law was adopted before November 28, 2022. As a condition to relying on the exception, the issuer must obtain an opinion of home country counsel, acceptable to the exchange, that recovery would violate such law, and must provide the opinion to the exchange.
>
> (3) Recovery would likely cause a broad-based tax-qualified retirement plan to fail to meet the "anti-alienation" rule of Section



401(a)(13) of the Internal Revenue Code ("IRC") or the vesting requirements under IRC Section 411(a). For example, if an executive officer deferred a portion of an erroneously awarded bonus to a 401(k) plan, that deferral generally would not be allowed to be removed from the plan under the anti-alienation rule.

May a Board Exercise Discretion in the Manner of Recovery of Erroneously Awarded Compensation?

Yes. The SEC recognizes that different means of recovery may be appropriate in different circumstances. In all events, the issuer should seek to recover the erroneous payment "reasonably promptly." As an example, it may be appropriate to allow an executive officer to repay the erroneous payment over time in a deferred payment plan that does not cause financial hardship to the executive. Issuers could also consider more proactive means of recovery, such as holding back a portion of incentive-based compensation until the three-year recovery period has lapsed; paying incentive-based compensation in installments rather than in a lump sum (subject to compliance with IRC Section 409A) and/or requiring that executive officers hold a portion of any equity awards for some period post-acquisition to facilitate recoupment.

May an Issuer Indemnify its Executive Officers Against any Erroneously Awarded Compensation?

No. Issuers may not indemnify or insure any executive officer against the loss of erroneously awarded compensation. Issuers may also not reimburse an executive officer for the cost of individual insurance purchased by the officer to protect him/her from any such risk. Further, the issuer may not make an award of equity or cash that is a disguised reimbursement of the amount of erroneously awarded compensation.

Is the Issuer's Clawback Policy Required to be Filed with the SEC?

Yes. The clawback policy must be filed as an exhibit to Form 10-K.

Must other Disclosures be made if the Issuer Prepares an Accounting Restatement and Pursues Recovery of Erroneously Awarded Compensation from Executive Officers?

Yes. Regulation S-K Item 402 is amended to add new paragraph (w), which requires proxy statement disclosure if the issuer prepares an accounting restatement that triggers recovery under the issuer's clawback policy in the last completed fiscal year, or there was an outstanding balance of erroneously awarded compensation as of the end of the last completed fiscal year. The issuer must disclose, for each restatement, the following information:

- The date on which the issuer was required to prepare an accounting restatement;
- The aggregate dollar amount of erroneously awarded compensation attributable to the accounting restatement, including an analysis of how the amount was calculated;
- If the financial reporting measure related to a stock price or TSR, the estimates that were used in determining the erroneously awarded compensation attributable to such accounting restatement and an explanation of the methodology used for such estimates;
- The aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed fiscal year; and
- If the aggregate dollar amount of erroneously awarded compensation has not yet been determined, disclose this fact, explain the reasons and disclose the information set forth above in the next filing that is required to include disclosure pursuant to Item 402 of Regulation S-K.

Additionally, 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 foregone and a brief description of the reason the issuer decided in each case not to pursue recovery.

As of the end of the last completed fiscal year, if erroneously awarded compensation has been outstanding for 180 days or longer since the date the issuer determined the amount the individual owed, the issuer must disclose the dollar amount of outstanding erroneously awarded compensation due from each current and former named executive officer.

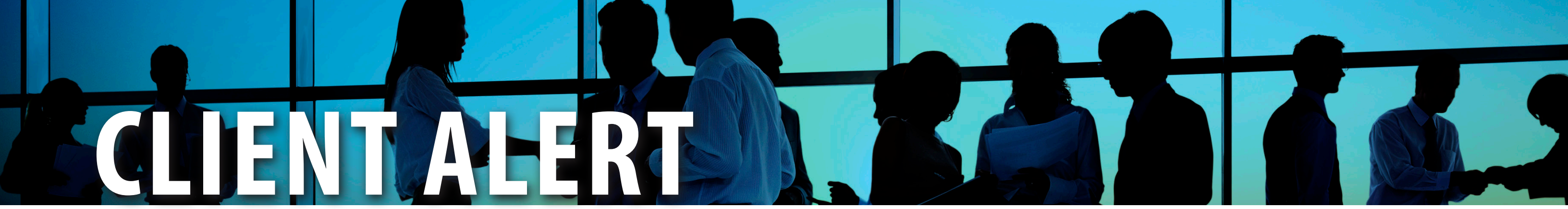
If at any during or after its last completed fiscal year the issuer was required to prepare an accounting restatement and the issuer concluded that recovery of erroneously awarded compensation was not required pursuant to the issuer's clawback policy, the issuer must briefly explain why application of the clawback policy resulted in this conclusion.

Finally, two new checkboxes will be added to Form 10-K where the issuer will need to indicate:

- Whether the issuer's financial statements included in the filing reflect the correction of an error to previously issued financial statements; and
- Whether any of those error corrections are restatements that require a recovery analysis of incentive-based compensation received by any of the issuer's executive officers during the relevant recovery period.

How does the Clawback Policy Required by Section 10D Compare to the Sarbanes-Oxley Clawback Provision?

Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX 304") permits the SEC to order the disgorgement of bonuses and incentive-based compensation earned by the CEO and CFO in the year following the filing of any financial statement that the issuer is required to restate because of misconduct, and the reimbursement of those funds to the issuer. SOX 304 provides:



> If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for—
>
> (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and
>
> (2) any profits realized from the sale of securities of the issuer during that 12-month period.

Section 10D is significantly broader than SOX 304 in that it:

- applies to any executive officer and is not limited to the CEO and CFO;
- requires recovery regardless of fault, whereas SOX 304 requires "misconduct";
- has a 3-year retroactive recovery period, rather than a 12-month post-filing recovery period; and
- requires the issuer to affirmatively act to recover erroneously awarded compensation, whereas the SEC is the entity empowered to pursue repayment under SOX 304.

In the adopting release to Rule 10D-1, the SEC states that to the extent the application of Rule 10D-1 would provide for recovery of incentive-based compensation that the issuer recovers pursuant to SOX 304 or other recovery obligations, it would be appropriate for the amount the executive officer has already reimbursed the issuer to be credited to the required recovery under the issuer's Rule 10D-1 clawback policy. The SEC notes, however, that recovery under Rule 10D-1 does not preclude recovery under SOX 304, to the extent any applicable amounts have not been reimbursed to the issuer.

Action Items

Now that the Rule 10D-1 has been issued in final form and the exchanges' proposed listing standards have been issued which largely track the Rule, an issuer may begin to formulate the required clawback policy, and consider how it may impact executive compensation programs, both in terms of awards and potential recovery actions.

The clawback policy should incorporate the major components of the Rule and the proposed listing standards, including:

- The entity or person(s) with authority to enforce the clawback policy, for example, the Compensation Committee;
- Identification of the affected executive officers;
- Identifying the action triggering a recovery (an accounting restatement);
- Listing the types of incentive-based compensation subject to recovery;
- Defining the amount subject to recovery;
- Outline potential recoupment methods; and
- Prohibiting indemnification of any executive officer for any erroneously awarded compensation.

The issuer should ensure that all plans and agreements awarding incentive-based compensation reference the issuer's clawback policy under Section 10D-1 and the listing standards, and any other applicable recovery policies, and make sure that executive officers are aware of the consequences associated with an accounting restatement.

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