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LEGAL UPDATES AND NEWS

SEC Adopts Final Rules on Incentive Compensation Clawbacks

Seven years after releasing the proposed rules, the Securities and Exchange Commission (the "SEC") on October 26, 2022, pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), adopted final rules directing the national securities exchanges to establish listing standards that require issuers, including emerging growth companies and smaller reporting companies, to develop, implement and disclose clawback policies for recovering erroneously paid incentive-based compensation provided to their current and former executive officers. These clawback policies will, with limited exceptions, require a listed company to recover incentive-based compensation that executives received as a result of erroneous financial results during a three-year look-back period if the listed company is required to prepare an "accounting restatement." Failure to comply with these new requirements will subject listed companies to delisting.

Stock exchanges will be required to propose new listing standards no later than 90 days after the final rules are published in the Federal Register, and such listing standards are to become effective no later than one year after the final rules are published in the Federal Register. Listed companies will then be required to have a compliant clawback policy no later than 60 days after the listing standards take effect.

General Requirements for a Clawback Policy and Its Implementation

Each public company, including emerging growth companies and smaller reporting companies, must develop and maintain a written clawback policy that provides for recoupment of incentive compensation (both cash and equity) erroneously paid to executives if (i) the incentive compensation was calculated based on financial statements that were required to be restated due to material noncompliance with financial reporting requirements, without regard to any fault or misconduct, and (ii) that noncompliance resulted in overpayment of the incentive compensation within the three fiscal years preceding the date the restatement was required.

The types of accounting restatements covered by the SEC's rules are fairly broad and exceed what was included in the 2015 proposal. Clawbacks are triggered irrespective of wrongdoing or misconduct – i.e., an honest accounting error can trigger a clawback. In addition to restatements to amend previously issued financial statements to correct errors that are material to such financial statements, a clawback would also be triggered by "little r" restatements, which do not involve restating previously issued financial statements. "Little r" restatements are those restatements that correct errors that are not material to previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period.

The term “executive officer” for purposes of the rules is based on the “officer” definition in Section 16 of the Securities Exchange Act of 1934 and includes the issuer’s *current and former* executives who served in a Section 16 position during the relevant lookback period and whose compensation was based on the erroneously reported financial information. The SEC broadly defines “incentive compensation” to include any compensation that is determined based on financial reporting measures (including GAAP and non-GAAP measures) and compensation that is granted or vests based on stock price or total shareholder return (“TSR”). The SEC opted for this broad principles-based definition in an effort to ensure the rules will capture new forms of compensation that are developed and new measures of performance upon which compensation may be based.

Under the final rules, the incentive compensation required to be clawed back would be the amount in excess of what would have been received based on the accounting restatement determined on a pre-tax basis. The SEC acknowledged the potential difficulty in terms of determining the amount to be recovered when the relevant financial reporting measure relates to stock price or TSR measures, and issuers will be permitted to use reasonable estimates to determine the impact of a restatement on stock price and TSR. Incentive compensation received in the three fiscal years preceding the date on which the accounting restatement is required to be prepared are subject to clawback. An issuer will be required to recover erroneously awarded incentive compensation except to the extent that pursuit of recovery would be impractical because it would impose undue costs on the company or its shareholders. This determination must be made by the company’s compensation committee or, in the absence of a compensation committee, a majority of its independent directors.

Disclosure Requirements

The new rules require several new disclosures in the Form 10-K and proxy statement. In the Form 10-K, two new checkboxes will be added to the cover page for issuers to indicate if they have had a restatement requiring a clawback. In addition, issuers’ clawback policies must be filed as an exhibit to Form 10-K. For compensation reporting in proxy statements and Form 10-K, the SEC has amended its rules to require additional disclosures when the issuer is required to prepare an accounting restatement that triggers a clawback. Issuers are required to disclose the aggregate amount of recoverable compensation and any amounts that remain unrecovered for more than 180 days. Recovered compensation amounts will also be reflected in the Summary Compensation Table by reducing the amount reported in the applicable column for the fiscal year in which such compensation was initially reported. As with other recent disclosure rulemaking, the new disclosures must be tagged using inline XBRL.

Penalty for Non-Compliance

A listed company will become subject to delisting if it fails to adopt a clawback policy, fails to enforce its clawback policy or fails to make the required clawback disclosures.

Dodd-Frank Clawbacks and SOX Clawbacks

The new clawback rules from the SEC are in addition to the current clawback rules that were implemented by the SEC pursuant to the Sarbanes-Oxley Act of 2002 ("SOX"), which remain in effect. The following table summarizes the differences between the new Dodd-Frank-based clawback requirements and the already-in-place SOX clawback:

	SOX Section 304	**Dodd-Frank Section 954**
Trigger	Any misconduct that requires a restatement of any financial report that is required under securities laws	An accounting restatement (including a "little r" restatement) that is due to material noncompliance with reporting requirements under securities laws
Which Executives	CEO and CFO only	All current and former executive officers
Compensation Clawed-bank	Bonus or other incentive-based or equity-based compensation (full amount of the compensation, not just the excess over what would have been paid); and in addition to compensation, the recovery of profits of certain sales of securities	Incentive-based compensation in excess of what would have been paid under the accounting restatement (pre-tax)
Lookback Period	The 12-month period following the first to occur of the first public issuance or filing with the SEC of the financial document that gives rise to the restatement	Three-year period preceding the date the company is required to prepare the accounting restatement

Expected Timing and Next Steps

Stock exchanges are required to propose new listing standards no later than 90 days after the final rules are published in the Federal Register, and such listing standards are to be effective no later than one year after the final rules are published in the Federal Register. Within 60 days after the listing standards are effective, listed companies must adopt a compliant clawback policy and disclose the clawback policy in their annual reports. The clawback policy must apply to all applicable incentive compensation that is "received" after the listing standard effective date (regardless of whether the incentive compensation is the subject of a contract or arrangement that

existed prior to the effective date of the rule). Given this timeline, it is likely that companies will be required to implement clawback policies by the end of 2023 or early 2024, and 2023 financial statements may be affected by the new disclosure requirements.

Issuers should start planning for the adoption of a clawback policy that satisfies the listing standards to be adopted by the national exchanges. While the national exchanges have yet to institute their own final rules to implement the SEC's new requirements, issuers should now have sufficient information regarding the clawback policy requirements to begin thinking about the scope and implications of such policies but should remain aware that there could be additional considerations based on the standards adopted by the exchanges. Topics for consideration may include the procedural and technical requirements for implementing the new clawback requirements (including how companies should measure a financial restatement's impact on TSR and stock price metrics and how to collect on a clawback when an executive has already been paid the compensation and paid tax on the compensation), the impact on any existing clawback policies or compensation agreements, the impact on issuer controls around financial reporting and restatement determinations, pay program designs and governance around executive compensation more broadly.

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