



On October 26, 2022, the U.S. Securities and Exchange Commission (SEC) adopted final rules implementing Section 954 of the Dodd-Frank Act. The final rules were published in the *Federal Register* on November 28, 2022.

New Rule 10D-1 directs the national securities exchanges to establish listing standards requiring companies to adopt, enforce, and disclose policies for the recovery or clawback of excess incentive-based compensation from current and former executive officers in the event of an accounting restatement, regardless of whether the executive was at fault and without regard to any taxes paid or incurred by the executive. Companies who fail to comply with the new rules are subject to delisting.

## Key Points

- **Affected issuers.** The new rules apply broadly to all listed companies, including smaller reporting companies, emerging growth companies, controlled companies, debt-only issuers, and foreign private issuers, with only limited exceptions.
- **Timing.** The national securities exchanges must propose listing standards within 90 days of the final rules' publication in the *Federal Register*, and the listing standards must become effective within one year after the publication date. Companies must adopt a compliant clawback policy within 60 days from when the listing standards become effective.

Publication of the final rules in the *Federal Register* on November 28, 2022, results in the following timeline for implementation of the clawback rules:

- February 26, 2023: Deadline for the stock exchanges to propose listing standards.
- November 28, 2023: Latest date by which the stock exchanges' final listing standards must become effective.
- January 27, 2024: Latest possible deadline for companies to adopt a clawback policy. (This deadline could be much earlier, for example if the effective date of the final listing standards was July 1, 2023, the deadline for companies to adopt a clawback policy would be August 30, 2023.)

Required disclosures must appear in the first annual report or proxy or information statement required to be filed after the effective date of the listing standards.

- **Executive officers covered.** The Rule 10D-1 definition of executive officer includes all Section 16 officers, not just the "named executive officers" whose compensation is required to be disclosed in the proxy statement. Recovery is required for incentive-based compensation received by an individual (1) after beginning service as an executive officer and (2) if the individual served as an executive officer at any time during the clawback recovery period.
- **Restatement triggers.** In an expansion from the proposed rules, the clawback requirement covers not only "Big R" accounting restatements that correct an error that is material to previously issued financial statements and are required to be reported in an 8-K filing, but also "little r" restatements that correct an error that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.
- **Incentive-Based compensation covered.** Rule 10D-1 broadly construes incentive-based compensation to include any compensation that is granted, earned, or vested based wholly or in part on the attainment of any financial reporting measure, including stock price or total shareholder return. Although this definition does not apply to time-based awards such as stock options and restricted stock units that vest solely based on continued employment, it would apply if such awards were granted based on the attainment of previously specified financial reporting measures.
- **Amount recoverable.** Companies would have to recover the amount of incentive-based compensation that is erroneously "received" during the three-year period preceding the date the company is required to prepare an accounting restatement. Compensation is deemed "received" in the fiscal period during which the financial reporting measure is attained, even if the award is paid after the fiscal period or subject to further time vesting. The clawback policy would apply to awards granted before the effective date of the listing standards to the extent that they are earned or vested based on the attainment of performance measures attained after the effective date.

- **Limited exceptions; no indemnification.** Recovery of erroneously awarded compensation is mandated with only three narrow exceptions: (1) The direct expenses paid to third parties would exceed the amount to be recovered, (2) recovery would likely cause disqualification of a tax-qualified retirement plan, or (3) recovery would violate home country law. Companies are prohibited from indemnifying or insuring executive officers.
- **New disclosures.** Companies would be required to file their clawback policies as an exhibit to the Form 10-K and include two new check boxes on the Form 10-K cover page indicating whether the filing contains the correction of an error to previously issued financial statements and whether any of those corrections involved a restatement that triggered a clawback analysis.

Companies would also be required to provide certain proxy statement disclosures if there was a restatement that required a clawback during the last fiscal year or if there was an outstanding balance of unrecovered excess incentive-based compensation relating to a prior restatement. Companies will be required to use Inline XBRL to tag these disclosures.

The full text of the adopting release for the final rules is available [here](#) and the fact sheet is available [here](#). The following is a discussion of the significant provisions of the new rules (noting that the exchanges may adopt listing standards that are more extensive than Rule 10D-1) and steps companies can take now.

## Covered Companies and Individuals

### Which Companies Must Adopt a Clawback Policy?

The final rules apply to all companies with a class of securities listed on a national securities exchange, including smaller reporting companies, emerging growth companies, controlled companies, foreign private issuers, and companies with listed debt whose stock is not listed. The rules exclude only certain security futures products, standardized options, securities issued by unit investment trusts, and the securities of certain registered investment companies.

### Which Officers Must the Clawback Policy Cover?

The final rules require the clawback policy to cover all current and former "executive officers," regardless of their responsibility for or involvement in the actions that led to the restatement.

The definition of "executive officer" is modeled on the definition of "officers" under Section 16 of the Exchange Act, which covers a broader group than the "named executive officers" whose compensation is described in the company's proxy statement. Consistent with the Section 16 definition, executive officers will include the company's president, principal financial officer, principal accounting officer (or, if none, the controller), any vice president of the company in charge of a principal business unit, division or function, any other officer who performs a policymaking function, or any other person who performs similar policymaking functions for the company. Executive officers of parent or subsidiary companies would also be considered "executive officers" to the extent they perform policymaking functions for the company. The adopting release also provides that the definition includes, at a minimum, any person identified as an executive officer in the company's Form 10-K pursuant to Item 401(b) of Regulation S-K.

The clawback policy will only require recovery of incentive-based compensation "received" by a person (1) after beginning service as an executive officer and (2) if that person served as an executive officer at any time during the recovery period. Thus, recovery of compensation received while the individual was serving in a nonexecutive role prior to becoming an executive officer will not be required. Compensation "received" during the recovery period by former executive officers is also subject to clawback.

## **Triggering Restatements**

### **Which Types of Restatements Will Trigger Application of the Clawback Policy?**

Rule 10D-1 requires a clawback of incentive-based compensation if the company 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 (a "Big R" restatement, which requires a company to file an Item 4.02 Form 8-K and amend its filings to restate the previously issued financials) or
- Corrects an error that is not material to previously issued financial statements, but that would result in a material misstatement if the error was left uncorrected in the current report or the error correction was recognized in the current period (a "little r" restatement, where a Form 8-K is not triggered and the company may make any corrections the next time it files the earlier financials).

The rules do not give a prescribed definition of what would constitute a material error—instead pointing to existing guidance, literature, and definitions. The SEC notes that materiality would be determined based on facts and circumstances, both quantitative and qualitative, and that whether the misstatement has the effect of increasing management's compensation is a qualitative factor that should be considered when making a materiality determination.

The adopting release identifies changes to financial statements that would not constitute a restatement triggering a clawback, including an out-of-period adjustment—a situation where the correction of an error is recorded in the current financials but the error is immaterial to both the previous and current financials. The clawback policy also would not be triggered by changes to prior period financial statements that do not arise due to error corrections, such as retrospective revisions to financial statements due to changes in accounting principles, reportable segment information, or reclassification due to a discontinued operation.

### **When Is a Company "Required" To Prepare a Restatement?**

Rule 10D-1 requires recovery of incentive-based compensation received during the three completed fiscal years immediately preceding the date that the company is required to prepare an accounting restatement. The date on which a company is *required* to prepare an accounting restatement is the earlier to occur of:

- The date the issuer's board of directors (or committee thereof) or an authorized officer concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement due to material noncompliance by the company with any financial reporting requirement under the securities laws, or
- The date a court, regulator or other legally authorized body directs the company to prepare an accounting restatement.

## **Covered Incentive Compensation**

### **What Types of Incentive Compensation Are Covered?**

Companies must recover all "incentive-based compensation," defined as any compensation, including cash and equity, 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 the issuer's financial statements and any measures derived wholly or in part from such financial reporting measures. Additionally, Rule 10D-1 specifically includes stock price and total shareholder return (TSR) as financial reporting measures.

The adopting release includes examples of compensation that would not constitute incentive-based compensation, including salaries, discretionary compensation if not paid as part of a bonus pool that is based wholly or in part on attainment of a financial reporting measure, bonuses based on subjective standards, cash incentive plan awards earned solely upon satisfying strategic or operational measures, and equity awards, such as stock options and restricted stock units, where the grant is not contingent upon the attainment of any financial reporting measure and where vesting is contingent solely upon completion of a specified employment period and/or attaining nonfinancial reporting measures.

### **What Are Considered Financial Reporting Measures?**

Financial reporting measures need not be included in a filing with the SEC, and may be presented outside the financial statements, such as in the Management's Discussion and Analysis (MD&A) appearing in the company's periodic reports or the performance graph required by Item 201(c) of Regulation S-K. Below are nonexclusive lists of measures that would and would not be considered financial reporting measures for purposes of the new rules:

#### **Examples of Financial Reporting Measures**

- Revenues
- Net Income
- Operating Income
- Profitability of Reporting Segment
- Financial Ratios (e.g., Accounts Receivable or Inventory Turnover)
- Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)
- Net Assets or Net Asset Value per Share
- Funds From Operations
- Liquidity Measures
- Return Measures
- Earnings Measures
- Sales per Square Foot or Same Stores Sales
- Revenue per User
- Cost per Employee
- Any Financial Reporting Measures Relative to Peer Group
- Tax Basis Income

#### **Examples of Not Financial Reporting Measures**

- Consummating a Merger or Divestiture
- Opening Target Number of Stores
- Obtaining Regulatory Approval of a Product
- Completing a Restructuring or Financing
- Employment
- Subjective Criteria Such as Leadership
- Market Share
- Customer Satisfaction

### **What Time Period Must the Clawback Policy Cover?**

The clawback policy applies to any excess incentive-based compensation *received* by a current or former executive officer during the three immediately completed fiscal years preceding the date on which a company is required to prepare an accounting restatement. The adopting release provides an example of the timing for the look-back period: if a company with a calendar fiscal year concludes in November 2024 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2025, the three-year look-back period would apply to compensation received in 2021, 2022, and 2023.

### **When Is Compensation Deemed to Be "Received"?**

Compensation is deemed to have been *received* in the fiscal period during which the financial reporting measure is attained, even if the actual payment or grant of the compensation occurs in a subsequent fiscal period. Awards subject to a financial performance measure that is followed by a service-based vesting requirement would similarly be deemed *received* when the performance measure was attained, even if the award remains subject to service-based vesting.

### **Enforcing the Clawback Policy**

#### **How Do Companies Determine Excess Incentive-Based Compensation?**

The recoverable amount of incentive-based compensation is "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." Companies must calculate the recoverable amount on a pre-tax basis.

For equity awards, if an executive officer holds the shares, options, or restricted stock units (RSUs) at the time of recovery, the recoverable amount would be the excess number received. If the executive officer has exercised options or received shares in settlement of RSUs and still holds the shares, the recoverable amount would be the excess number of shares underlying the options (less the exercise price paid) or the RSUs. If the executive officer has already sold the shares, the recoverable amount would be the sale proceeds received with respect to the excess shares. For incentive-based compensation based on stock price or total shareholder return for which it may be difficult to calculate the impact of a restatement, companies may use a reasonable documented estimate of the effect of the accounting restatement on the stock price or total shareholder return to calculate the recoverable amount, which estimate would likely be prepared by a third-party provider. Documentation of the

estimate must be provided to the exchange on which the company's securities are listed.

### **How Would Companies Recover the Excess Incentive?Based Compensation?**

The new rules do not prescribe a means for companies to recover excess incentive?based compensation—leaving it instead to each company to determine the most appropriate means.

### **By What Deadline Will Companies Need To Recover Excess Incentive?Based Compensation?**

The new rules do not specify a time by which the company must recover the excess compensation. However, the SEC cautions that companies should recover excess incentive?based compensation "reasonably promptly," as undue delay would constitute noncompliance with a company's policy.

### **Do Companies Have Discretion on Whether To Seek Recovery?**

Companies generally do not have discretion on whether to seek recovery. Companies may forego recovery of erroneously paid incentive?based compensation only in these three limited circumstances:

- **If costs of recovery would exceed amounts recoverable.** Companies are not required to seek recovery if the direct costs of recovery paid to a third party to enforce the policy would exceed the recoverable amounts. To satisfy this exception, the company must first make a reasonable attempt to recover the compensation and provide documentation of that attempt to the exchange on which it is listed.
- **If recovery would disqualify a tax?qualified retirement plan.** Companies are not required to seek recovery from broad?based tax?qualified retirement plans such as 401(k) plans if such recovery would likely cause the plans to fail to meet the statutory requirements for tax exemption. Note that amounts contributed to nonqualified plans limited to executive officers, such as nonqualified deferred compensation plans and supplemental executive retirement plans and benefits therefrom, would be subject to clawback.
- **If recovery would violate home country law.** Companies are not required to seek recovery if the recovery would violate home country law. Under this exception, the company must first obtain an opinion of home country counsel that recovery would result in such a violation.

### **May Companies Indemnify or Insure Executive Officers for Recovered Compensation?**

Companies are prohibited from indemnifying, directly or indirectly, any current or former executive officer against the loss of erroneously paid incentive compensation. An executive officer may purchase an insurance policy to fund recovery obligations, but companies may not pay (or reimburse the premiums) for such policies.

### **Interaction With the Clawback Requirement Under Section 304 of the Sarbanes?Oxley Act of 2002 (SOX).**

Section 304 of SOX requires a company's chief executive officer and chief financial officer to reimburse the company for certain compensation received if the company is required to restate financial statements due to material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws. Any amounts recovered under Section 304 of SOX would be credited toward any amounts recoverable under the new rules.

## **New Disclosure Requirements**

The new rules require companies to file their clawback policies and disclose certain information about those policies and their application in SEC filings. Compliance with the disclosure requirements 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.

### **What Must Companies Disclose in Their Annual Reports?**

Companies must file their clawback policy as an exhibit to their annual report on Form 10?K, Form 20?F, or Form 40?F.

These forms have been amended to include two new checkboxes on the cover pages. One checkbox is to indicate whether the financial statements reflect a correction of an error to previously issued financial statements. The other is to indicate whether any correction involved a restatement that required a compensation recovery analysis under the company's clawback policy.

### **What Must Companies Disclose in Their Proxy and Information Statements?**

**Additional Item 402 disclosure.** New Item 402(w) of Regulation S?K requires disclosure in proxy and information statements if, at any time during or after the company's last completed fiscal year, the company either (1) was required to prepare an accounting restatement that required a clawback under the company's clawback policy or (2) there was an outstanding balance of unrecovered excess incentive?based compensation relating to a prior restatement. In either of these circumstances, the company would be required to disclose the following information:

- The date on which the company was required to prepare an accounting restatement.
- The aggregate dollar amount of excess incentive?based compensation attributable to the restatement and an analysis of how the recoverable amount was calculated and, if the dollar amount has not yet been determined, a disclosure that explains the reasons and a disclosure in the next filing subject to Item 402 that discloses the determined amount and related disclosures.
- If the financial reporting measure that was restated related to stock price or total shareholder return, the estimates used to determine the erroneously awarded compensation attributable to the restatement and an explanation of the methodology used for the estimates.
- The aggregate dollar amount of excess incentive?based compensation that remains outstanding at the end of the last completed fiscal year.
- If recovery is impracticable under the exceptions above, for each current and former named executive officer and for all other current and former executive officers as a group, the amount of recovery forgone and a brief description of the reason not to pursue recovery, including the specific exception on which the company is relying.
- For each current and former named executive officer, the amount of erroneously awarded compensation still owed that had been outstanding for 180 days or longer since the date the company determined the amount owed.

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

**Location of the disclosure.** The new 402(w) disclosures are not required to be included in the Compensation Discussion and Analysis (CD&A) of the proxy statement. If the disclosure is located outside the CD&A, it will not be incorporated by reference into other SEC filings and will not be captured as part of the compensation



committee report.

**XBRL.** The new rules require the Item 402(w) disclosure to be tagged using Inline XBRL format.

**Summary Compensation Table.** Under a new instruction to Item 402(c) of Regulation S-K, if recovered amounts reduce amounts previously reported in the Summary Compensation Table, the amount must be deducted from the applicable column and total column for the year in which the recovered amount was originally reported, and this amount must be identified in a footnote to the table.

### **What Consequences Would Companies Face for Noncompliance?**

Companies will face delisting for failure to do any of the following:

- Adopt a clawback policy meeting the applicable listing standards.
- Comply with the policy's recovery provisions.
- Provide the required disclosure in accordance with SEC rules.

### **Department of Justice Focus on Clawbacks**

There has been increasing interest in clawback policies as a tool to manage general compliance practices and deter/punish misconduct, even outside the context of a financial restatement and not limited to executive officers. A recent U.S. Department of Justice (DOJ) memorandum indicates that in criminal enforcement actions for corporate misconduct, one of the factors the DOJ will now consider in deciding whether and how to resolve a criminal investigation is whether a company's compensation programs "incorporate elements such as compensation clawback provisions that enable penalties to be levied against current or former employees, executives or directors whose direct or supervisory actions or omissions contributed to criminal conduct" and whether following discovery the company has enforced these provisions. The DOJ is expected to issue further guidance on how it will reward companies that develop and apply compensation clawback policies.

### **Practical Tips**

#### **What Steps Should Companies Take Now?**

Companies should consider taking the following actions now in preparation for the new listing standards, noting that the exchanges may adopt listing standards that are more extensive than Rule 10D-1:

- **Review executive officer determinations.** Because all Section 16 officers and any other person identified as an executive officer in the company's proxy statement or annual report will now be subject to potential clawback, companies should take a fresh look at their executive officer determinations to make sure that all individuals are properly classified. The determinations should be documented and updated at least annually.
- **Review existing clawback policies.** Companies with existing clawback policies should evaluate their scope against the mandates of the new rules and determine whether to integrate the new requirements into

existing policies or adopt a separate stock exchange-compliant policy.

- **Consider broader clawback policy.** In light of the DOJ's focus on clawbacks in enforcement actions, companies that have not already done so may want to take this opportunity to consider a separate discretionary clawback policy that includes material misconduct or violation of the company's code of conduct as clawback triggers.
- **Review existing incentive-based compensation programs.** Companies should evaluate their existing compensation programs to identify various elements potentially subject to clawback and consider whether to adjust performance metrics or the mix of incentive and nonincentive-based compensation.
- **Update existing plans and agreements.** To the extent they have not already done so, companies should incorporate language in incentive compensation plans and award agreements that specifically subjects incentive compensation awards to the company's clawback policy.
- **Update internal processes.** Companies should consider what internal processes and disclosure controls and procedures should be put in place to ensure compliance with the new rules.

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