In depth

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SEC adopts executive incentive compensation clawback rules

What's inside

At a glance

A 2022 SEC rule directs US securities exchanges to establish standards that require a listed issuer to have a written policy for the recovery of incentive-based compensation received by current and former executive officers in the event of a required accounting restatement. A listed issuer will need to file its recovery policy as an exhibit to its annual report and to provide other disclosures.

The securities exchanges have issued listing standards that will become effective for issuers on October 2, 2023. An affected issuer would have until December 1, 2023 to adopt a recovery policy that complies with the standards. The policy, however, must be applied to erroneously awarded compensation received on or after October 2, 2023.

This *In depth* provides questions and answers that detail some of the key provisions of the new rule and related amendments. It was updated on September 20, 2023 to reflect the issuance of the final listing standards by the exchanges and the effective dates. Transition guidance and more details on the disclosure requirements were also added.

Key provisions

In October 2022, the SEC adopted new Exchange Act Rule 10D-1 (the "new rule") directing US securities exchanges to establish standards that require a listed issuer to develop and implement a written policy for the recovery of erroneously awarded incentive-based compensation received by current and former executive officers in the event of a required accounting restatement. The new rule and related amendments also require a listed issuer to file its recovery policy as an exhibit to its annual report and to provide other disclosures. The new rule, which was proposed in 2015 and reopened for comment in 2021 and 2022, is intended to implement the requirements of Section 954 of the Dodd-Frank Act.

1. What types of accounting restatements would trigger a requirement to perform a compensation recovery analysis?

A compensation recovery analysis would be triggered if an issuer is required to prepare an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement under the securities laws, including any interim financial reporting requirements. As stated in the new rule, this would include any required accounting restatement:

1. to correct an error in previously issued financial statements that is material to the previously issued financial statements, or
2. that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.

The SEC's adopting release describes the restatements referred to in (1) above as "Big R" restatements and those in (2) above as "little r" restatements. The inclusion of a "little r" restatement as a trigger represents an important change from the original proposal. After seeking public feedback, the SEC concluded that the phrase "accounting restatement due to material noncompliance" can be read to include a restatement required due to an error that is material to the current period financial statements if left uncorrected or if the correction were recorded only in the current period. Out-of-period adjustments and other changes to prior financial statements that are not the result of an error, such as changes relating to the adoption of a new accounting standard and changes solely to conform prior period(s) presentation to current period presentation, would not be considered accounting restatements due to material noncompliance and should not trigger recovery analysis.

When assessing whether an error is material to the financial statements, the release also highlights the importance of a thorough and well-documented materiality analysis that considers relevant qualitative and quantitative factors.

2. What compensation would be subject to recovery?

Issuers will be required to recover **erroneously awarded incentive-based compensation** (see Question 3) **received** (see Question 5) by **executive officers** (see Question 6) during the applicable **look-back period** (see Question 7).

> **Erroneously awarded incentive-based compensation**
> The amount of incentive-based compensation received that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts.

Erroneously awarded incentive-based compensation is computed on a pre-tax basis (i.e., without regard to taxes paid by the executive officer).

The SEC's adopting release provides examples of how to determine erroneously awarded incentive-based compensation, including bonuses paid from bonus pools and certain equity awards. The SEC also noted that if compensation that would be recovered under the new rule has already been recovered under other recovery obligations or provisions (e.g., Section 304 of the Sarbanes-Oxley Act), then it would be appropriate to credit the amount already recovered against amounts otherwise recoverable under the new rule.

3. What is incentive-based compensation for purposes of the new rule?

Incentive-based compensation

Any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure

See Question 4 for the definition of a financial reporting measure.

The SEC's adopting release includes the following as examples of incentive-based compensation:

- 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;
- 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; and
- 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.

The adopting release also provides examples of compensation that is not considered incentive-based compensation for purposes of the new rule.

4. What is a financial reporting measure for purposes of the new rule?

Financial reporting measure

A measure that is 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

Non-GAAP financial measures, stock price, and total shareholder return (TSR) are among the metrics and measures considered to be financial reporting measures. The adopting release contains additional examples of financial reporting measures. Also, a financial reporting measure could be presented outside the financial statements. It is not limited to information included in an SEC filing.

The SEC indicated that it included stock price and TSR as financial reporting measures "because improper accounting affects such measures and in turn results in excess compensation." It also noted the potential difficulty, complexity, and subjectivity associated with trying to determine the impact of an accounting error on stock price or TSR. Accordingly, an issuer is permitted to use reasonable estimates (with appropriate documentation) when determining the impact of a restatement on stock price or TSR. The adopting release notes, however, that it is less likely that a "little r" restatement will be associated with significant stock price reaction and, therefore, recovery of incentive-based compensation tied to stock price or TSR is expected to be relatively small and infrequent as a result of "little r" restatements.

5. When is incentive-based compensation considered received for purposes of the new rule?

For purposes of the new rule, incentive-based compensation is considered to be received "in the issuer's fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period."

Incentive-based compensation would be subject to recovery even if received in connection with a contract or arrangement entered into before the effective date of the new listing standards. To provide a transition period, however, an issuer's recovery policy would only apply to incentive-based compensation received on or after the effective date of the relevant exchange's new listing standards (i.e., October 2, 2023).

6. Who is considered an executive officer for purposes of the recovery analysis?

The new rule contains a broad definition of the term executive officer, which aligns with the definition of "officer" under Exchange Act Rule 16a-1 or "Section 16 officers." This definition is more inclusive than definitions of "executive officer" used in other SEC rules (e.g., Exchange Act Rule 3b-7) and specifically includes the principal financial officer and principal accounting officer. The new rule defines "executive officer" (in part).

Executive officer (partial definition)

…the issuer's president, principal financial officer, principal accounting officer (or the controller if there is no principal accounting officer), any vice-president in charge of a principal business unit, division, or function (such as sales, administration, or finance), any other officer or other person who performs a policy-making function

The definition of an executive officer does not consider whether a person was involved with the preparation of the financial statements or contributed to the error.

The recovery analysis would generally be required to cover any person who served as an executive officer at any time during the incentive compensation performance period.

7. What is the applicable look-back period for purposes of the recovery analysis?

The new rule requires recovery of erroneously awarded incentive-based compensation received during the three completed fiscal years immediately preceding the date that the issuer is required to prepare an accounting restatement. An issuer's obligation to recover erroneously awarded compensation is not dependent on if or when the restated financial statements are filed.

As detailed in the new rule, the date that an issuer is required to prepare an accounting restatement is the earlier of:

1. 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; or

2. The date a court, regulator, or other legally authorized body directs the issuer to prepare an accounting restatement.

For example, if an issuer with a calendar year-end concludes in November 2027 that a triggering accounting restatement is required and files restated financial statements in January 2028, the recovery policy would apply to compensation received in the years ended December 31, 2026, 2025, and 2024.

The new rule also contains provisions that address how to determine the look-back period in the event of a change in fiscal year-end.

Since the recovery policy is only required to apply to incentive-based compensation received on or after October 2, 2023 (as discussed in Question 5), the look-back period for triggering accounting restatements in the initial years (e.g., 2024, 2025, and 2026) may be less than the three completed fiscal years immediately preceding the restatement.

In addition, since the recovery policy is required to apply only to incentive-based compensation received while the issuer has a class of securities registered on a national securities exchange, newly public companies will only be required to look back to the later of October 2, 2023 or the date the issuer registered a class of securities on a national securities exchange.

8. Can the board exercise discretion with respect to pursuing recovery?

The new rule stipulates that an issuer must recover erroneously awarded compensation in compliance with its recovery policy unless (1) one of three specific conditions is present and (2) the issuer's committee of independent directors responsible for executive compensation decisions, or in the absence of such a committee, a majority of the independent directors serving on the board, has determined that recovery would be impracticable. The three conditions are:

1. direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered (applicable only after making a reasonable attempt to recover);
2. recovery would violate home country law that existed before November 28, 2022 (an issuer must obtain a legal opinion in support of this condition); or
3. recovery would likely cause certain tax-qualified retirement plans to not meet the relevant legal requirements.

Although the new rule requires issuers to recover erroneously awarded incentive-based compensation "reasonably promptly," it provides boards and issuers with discretion regarding the means of recovery (e.g., a payment plan). The adopting release contains considerations for boards in exercising this discretion.

The new rule specifically notes that issuers are not permitted to indemnify any current or former executive officer against the loss of erroneously awarded compensation. The SEC has also indicated that issuers are prohibited from paying or reimbursing the executive officer for premiums for third-party insurance purchased to fund potential recovery obligations.

9. What new disclosures are required by the new rule and related amendments?

The new rule and related amendments include new disclosure requirements, including requiring an issuer to file its recovery policy as an exhibit to its annual report and establishing new cover page disclosures on Forms 10-K, 20-F, and 40-F indicating (1) whether the financial statements included in the filing reflect the correction of an error and (2) whether the error correction required an incentive compensation recovery analysis.

Detailed disclosures related to the application of the recovery policy are required, including when an issuer concluded that an accounting restatement did not result in the need for recovery. Under these requirements, the issuer will be required to disclose in Part III of the Form 10-K:

- the date on which the accounting restatement was required to be prepared
- the aggregate dollar amount of erroneously awarded compensation
- how the amount was calculated (including how the amount has been estimated if the financial reporting measure is based on stock price or total shareholder return)
- the aggregate dollar amount of erroneously awarded compensation outstanding at the end of the most recently completed fiscal year
- whether any erroneously awarded compensation has not yet been determined and the reasons the amount has not yet been determined. In addition, the next filing required to include the information required by Item 402 of Regulation S-K (e.g., Forms 10-K, S-1, S-4) must include disclosures of the missing information.
- for any erroneously awarded compensation that has been outstanding for 180 days or longer since the determination of the clawback amount, the name of each executive officer and the amount outstanding
- for any recovery that is determined to be impracticable in accordance with the rule, the name of each executive officer for which recovery is not being pursued and the amount of erroneously awarded compensation for each such executive officer (individually and in the aggregate across all executive officers), and a description of the reasons the issuer is not seeking recovery
- for any recovery analysis that results in a determination that there was no erroneously awarded compensation required under the issuer's policy, a brief explanation of the rationale for this conclusion

The new disclosures are detailed in Item 402(w) of Regulation S-K, Item 6.F of Form 20-F, paragraph (19) to General Instruction B of Form 40-F, and Item 18 of Form N-CSR.

Required disclosures will be subject to Inline XBRL reporting and tagging requirements.

10. Is the new rule applicable to Emerging Growth Companies, Smaller Reporting Companies, and Foreign Private Issuers?

Yes. The new rule does, however, provide for certain limited exceptions (e.g., the listing of certain security futures products, certain standardized options, and certain securities issued by unit investment trusts and registered investment companies) as described in Exchange Act Rule 10D-1(c).

11. What are some of the accounting considerations relating to clawbacks of share-based compensation arrangements?

A clawback is considered a contingent event under ASC 718, *Compensation – Stock Compensation*. A clawback is accounted for when a compensation recovery event occurs.

The general model in ASC 718 states that a clawback is recognized when the consideration is received (i.e., returned to the company). The issuer would record a credit in the income statement up to the original expense recorded for an equity-classified stock award and a credit to additional paid in capital for the fair value of the consideration received in excess of that amount. If the original grant was a liability award, similar accounting would apply such that the maximum amount recorded in income would be equal to the final measurement of expense for the award, with the excess, if any, recorded as a credit to additional paid-in capital. Because clawbacks are considered contingent events, there is no "day-one" impact on the measurement of a stock-based compensation award.

To establish a grant date for accounting purposes, the presence of any clawback features should be clear and objective such that a mutual understanding is established between the issuer and the executive officer as to the key terms and conditions governing vesting of the award. Additionally, there should not be significant discretion by the issuer regarding enforcement of the clawback. We generally expect that plans designed to conform closely to the new rule will not result in a problem establishing a grant date, as the new rule provides for objective clawback triggers and very limited exceptions for impracticability of enforcement. It continues to be important, however, to evaluate other clawback triggers (e.g., non-competes, non-solicitation clauses) to ensure a grant date has been established.

As noted, the new rule permits issuers flexibility as to the means of recovery. If a clawback entails cancellation or modification of unrelated stock-based compensation awards that would otherwise not have been affected by the restatement, different accounting may apply.

Effective date

The securities exchanges have issued listing standards that will become effective for issuers on October 2, 2023 and incentive-based compensation received on or after that date would be subject to recovery in the event of a required accounting revision or restatement. Affected issuers would have until December 1, 2023 to adopt a recovery policy that complies with the standards.

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