SEC adopts executive incentive compensation clawback rules

At a glance

A new SEC rule directs US securities exchanges to establish standards that require listed issuers 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. Listed issuers will need to file their recovery policy as an exhibit to their annual report and to provide other disclosures.

The listing standards must be effective no later than one year after publication of the final rules in the Federal Register. Affected issuers will be required to adopt a recovery policy no later than 60 days after the listing standards become effective.

On October 26, the SEC adopted new Exchange Act Rule 10D-1 (the “new rule”) directing US securities exchanges to establish standards that require listed issuers 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 listed issuers to file their recovery policy as an exhibit to their 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.

This In depth provides questions and answers that detail some of the key provisions of the new rule and related amendments.

Key provisions

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

A compensation recovery analysis would be triggered in the event that 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. As detailed in the new rule, this would include any required accounting restatement:

   i. to correct an error in previously issued financial statements that is material to the previously issued financial statements, or

   ii. 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 (i) as “Big R” restatements and those in (ii) as “little r” restatements. The inclusion of these “little r” restatements 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. The SEC’s adopting release makes it clear, however, that out-of-period adjustments are not restatements and should not trigger a recovery analysis.

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). The new rule defines erroneously awarded incentive-based compensation as “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 in the case of 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?**

The new rule defines incentive-based compensation as “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:

i. 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;

ii. 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

iii. 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 SEC’s 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?

As defined in the new rule, a financial reporting measure is “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 SEC’s adopting release contains additional examples of financial reporting measures. Note that a financial reporting measure could be presented outside the financial statements. They are 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 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.

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 is more inclusive than definitions of the same term used in other SEC rules (e.g., Exchange Act Rule 3b-7)). Under the new rule, the term executive officer is defined (in part) as:

“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 take into account 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.

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

The new rule stipulates that issuers must recover erroneously awarded compensation in compliance with their recovery policy unless one of three specific conditions is present and 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 made a determination that recovery would be impracticable. The three conditions identified in the new rule are:

i. 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);

ii. recovery would violate home country law that existed before the publication of the new rule in the Federal Register (an issuer must obtain a legal opinion in support of this condition); or

iii. 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,” the new rule provides boards and issuers with discretion regarding the means of recovery (e.g., a payment plan). The SEC’s 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 a number of new disclosure requirements, including requiring issuers to file their recovery policy as an exhibit to their annual reports and establishing new cover page disclosures on Forms 10-K, 20-F, and 40-F indicating whether the financial statements included in the filing reflect the correction of an error and whether the error correction required an incentive compensation recovery analysis.

Detailed disclosures relating to the application of the recovery policy are required, including when an issuer concluded that an accounting restatement did not trigger the need for recovery. 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 some general exemptions (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. Clawbacks are 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. To the extent 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.

In order to establish a grant date for accounting purposes, it is important that the presence of any clawback features is 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 the 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 above, the new rule permits issuers flexibility as to the means of recovery. To the extent 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. The facts and circumstances regarding the adjustment should be evaluated to determine the appropriate accounting.

**Effective date**

The new rule and related amendments will become effective 60 days after publication in the Federal Register. The exchanges must file proposed listing standards to implement the SEC’s directive no later than 90 days after the final rules are published in the Federal Register, and those listing standards must be effective no later than one year after that publication date. Affected issuers will be required to adopt a recovery policy no later than 60 days after the listing standards become effective.