

Client Alert

The New Clawback Rules: What You Need to Know

EXEQUITY

Independent Board and
Management Advisors

On October 26, 2022, the SEC issued its final clawback rules (recovery of erroneously awarded incentive compensation) under Section 954 of the Dodd-Frank Act.¹ These rules were published in the *Federal Register* on November 28, 2022.² Consequently, the SEC must approve the listing exchanges' new listing standards implementing these requirements by November 28, 2023.

The NYSE and Nasdaq filed their clawback listing standards with the SEC on February 22, 2023, which the SEC shows as received March 7, 2023.³ The SEC must allow for a comment period and then can act to approve these listing standards. Once these new listing standards are adopted by the SEC (which has to occur before November 28, 2023), a public company subject to these listing standards will have 60 days to adopt a compliant clawback policy. Failure to do so can lead to the company being delisted.

The remainder of this **Client Alert** summarizes the key requirements of the new clawback rules and what they will require public companies to do going forward.

Which companies must adopt a compliant clawback policy?	Companies with securities listed on national securities exchanges or associations must adopt written clawback policies that are compliant with the final rules that their national listing exchange or association promulgates.
When must companies adopt a compliant clawback policy?	Compliant clawback policies must be adopted within 60 days after the exchange/association rules become effective, which must occur no later than November 28, 2023.

¹ See SEC [Press Release 2022-192, SEC Adopts Compensation Recovery Listing Standards and Disclosure Rules](#) (October 26, 2022), and SEC [Release Nos.33-11126; 34-96159, Listing Standards for Recovery of Erroneously Awarded Compensation](#) (October 26, 2022).

² See *Federal Register* 87 FR 73076 (November 28, 2022), available at <https://www.federalregister.gov/documents/2022/11/28/2022-23757/listing-standards-for-recovery-of-erroneously-awarded-compensation>.

³ See SEC Release No. 34-97055, available at [Notice of Filing of Proposed Rule Change to Adopt New Section 303A.14 of the NYSE Listed Company Manual to Establish Listing Standards Related to Recovery of Erroneously Awarded Incentive-Based Executive Compensation](#), and SEC Release No. 34-97060, available at [34-97060.pdf \(sec.gov\)](#).

What must a clawback policy cover?	A clawback policy must require the recovery of erroneously awarded compensation received by current or former executive officers in the event a company is required to prepare an accounting restatement due to its material noncompliance with any financial reporting requirements under the securities laws during the three completed fiscal year periods preceding the date on which the company is required to prepare an accounting restatement.
What compensation is erroneously awarded compensation subject to clawback?	Erroneously awarded compensation potentially includes any incentive compensation received within the three completed fiscal year periods prior to the date of the accounting restatement. Erroneously awarded compensation is 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.
When is incentive-based compensation deemed received?	Incentive-based compensation is deemed received in the company'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.
What is incentive-based compensation?	Incentive-based compensation is any compensation that is granted, earned, or vested based wholly or in part upon attainment of a financial reporting measure.
Could a company have to claw back more than just incentive-based compensation under the rules?	Yes. The SEC issued guidance indicating that the rules are intended to apply broadly. Consequently, if a plan takes into account incentive-based compensation, a company will be expected to claw back the amount contributed to the notional account based on erroneously awarded compensation and any earnings accrued to date on that notional amount. ⁴
What is a financial reporting measure?	A financial reporting measure is a measure that is determined and presented in accordance with the accounting principles used in preparing a company's financial statements, any measures derived wholly or in part from such measures, and stock price and total shareholder return. While the provision of stock price and total shareholder return as examples is helpful, we believe the SEC may need to provide further guidance on how companies determine the incentive compensation when a financial reporting measure is based on stock price or total shareholder return. Note that the SEC indicated that a financial reporting measure need not be presented within the financial statements or included in a filing with the SEC.
Who must be covered?	Both current and former executive officers.
Who is an executive officer?	An "executive officer" is a company's president, principal financial officer, principal accounting officer (or if there is no such 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 company.
What types of accounting restatements must trigger a clawback policy?	Both "Big R" and "little r" accounting restatements must trigger the clawback policy.
What is a "Big R" accounting restatement?	A "Big R" restatement is a material noncompliance that results from an error that is material to "previously issued" financial statements.

⁴ Question 121H.04, Section 12H: Requirements Under Section 10D-1—Listing standards relating to recovery of erroneously awarded compensation, Exchange Act Rules, Questions and Answers of General Applicability (January 27, 2023), available at <https://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps>.

<p>What is a “little r” accounting restatement?</p>	<p>A “little r” restatement results from the material noncompliance from an error that is material to the “current” period if left uncorrected or if the correction were only recorded in the current period. Due to the materiality of the impact the error would have on the “current” period, previously issued financial statements must be revised to correct the error even though the error was not material to previously issued financial statements.</p>
<p>What types of accounting restatements will <u>not</u> trigger a clawback?</p>	<p>The SEC did state the following changes to a company’s financial statements do not represent error corrections, and therefore would not trigger application of a company’s clawback policy under the listing standards:</p> <ul style="list-style-type: none"> • Retrospective application of a change in accounting principle; • Retrospective revision to reportable segment information due to change in the structure of a company’s internal organization; • Retrospective reclassification due to a discontinued operation; • Retrospective application of a change in reporting entity, such as from a reorganization of entities under common control; • Retrospective adjustment to provisional amounts in connection with a prior business combination (International Financial Reporting Standards filers only); and • Retrospective revision for stock splits, reverse stock splits, stock dividends or other changes in capital structure.
<p>Are there any exemptions?</p>	<p>Yes. The final rules provide that recovering erroneously awarded compensation does not need to be done if impracticable to do so as determined by independent directors. But there are only three limited cases where enforcing a clawback policy would be impracticable:</p> <ol style="list-style-type: none"> 1) if the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered, 2) if the recovery would violate home country law, or 3) if the recovery would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees, to fail to meet the requirements of Internal Revenue Code Sections 401(a)(13) or 411(a). <p>Before relying on the expense to collect exemption, a company must first make a reasonable attempt to recover the erroneously awarded compensation and document such reasonable efforts, which would then be provided to the exchange or association.</p> <p>Before a company can rely on the home country law prohibition exemption, it must obtain an opinion of home country counsel, acceptable to the national exchange or association, that recovery would result in such a violation, and then supply the opinion to the exchange or association.</p>
<p>What disclosures are now required?</p>	<ul style="list-style-type: none"> • A company’s written clawback policy must be filed as an exhibit to the annual report (Form 10-K). • New checkboxes were added to the annual reports (Form 10-K) to indicate whether financial statements reflect correction of an error to previously issued financial statements and whether any of those error corrections are restatements that require a recovery analysis. • Disclosure of any actions taken pursuant to a clawback policy, including unrecovered amount balances by executive.

What must be disclosed if a restatement occurs?

New Item 402(w) of Regulation S-K requires that if during the last completed fiscal year either a restatement that required recovery of erroneously awarded compensation pursuant to the clawback policy was completed or there was an outstanding balance of erroneously awarded compensation from the application of the policy to a prior restatement, a company must provide:

- For each restatement:
 - The date the company was required to prepare an accounting restatement;
 - The aggregate dollar amount of erroneously awarded compensation attributable to such restatement, including an analysis of how the amount was calculated;
 - The estimates and methodology that were used in determining the erroneously awarded compensation attributable to such accounting restatement if the financial reporting measure related to a stock price or total shareholder return metric;
 - The aggregate dollar amount of excess incentive-based 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 reason(s), and disclose the information required above in the next filing required to include Item 402 of Regulation S-K disclosures.
- If recovery would be impracticable, for each such individual covered by the clawback, set out the name and amount forgone and a brief description of the reason the company decided in each case not to pursue recovery.
- The name of each individual from whom, as of the end of the last completed fiscal year, erroneously awarded compensation had been outstanding for 180 days or longer since the date the company determined the amount the individual owed, and the dollar amount of outstanding excess incentive-based compensation due from each such individual.
- If the company was required to prepare an accounting restatement during or after its last completed fiscal year, and the company concluded that recovery of erroneously awarded compensation was not required pursuant to its required clawback policy, a brief explanation of why application of the clawback policy resulted in this conclusion.
- The disclosures required by new Item 402(w) shall be in the same format as the rest of the disclosure required to be provided pursuant to Item 402 and be electronically formatted using XBRL.

Can a company indemnify executives against clawback losses?

No. The final rules prohibit companies from indemnifying any executive officer or former executive officer against loss of erroneously awarded compensation.

Next Steps

Given that listing standards by the national securities exchanges and associations still need to be published in the *Federal Register* and receive comments before the SEC can approve them, companies may want to tee-up working on ensuring their current clawback policy is compliant. For many companies who have either not adopted a clawback policy or delayed reviewing their existing policy until final rules were approved, they should also consider whether their final clawback policy should be narrowly tailored to simply comply with the new rules, or if they prefer a more expansive clawback. For example, many

companies already have current clawback policies that cover more than current and former executive officers and also cover actions or behaviors that do not require financial restatements such as violations of the company's code of conduct.

Companies will not have all that much leeway in application of the clawback policy if a Big R or little r accounting restatement occurs, unless they conclude that the restatement would not have caused a difference in the payout of incentive-based compensation subject to the clawback policy as a result of the restatement occurring. The three exemptions provided by the SEC will be determined on a facts and circumstances basis, so companies generally should expect to have to apply their clawback policy and recover compensation in the majority of cases when a Big R or little r accounting restatement occurs if they conclude there would have been a difference in applicable incentive-based compensation.



If you have any questions about this **Client Alert**, please contact Ed Hauder ((847) 996-3990 or Edward.Hauder@exqty.com) or any of the following:

Ben Burney	(847) 996-3970	Ben.Burney@exqty.com
Steven Dolan	(949) 748-6132	Steven.Dolan@exqty.com
Chris Fischer	(847) 996-3972	Chris.Fischer@exqty.com
Robbi Fox	(847) 996-3978	Robbi.Fox@exqty.com
Mark Gordon	(925) 478-8294	Mark.Gordon@exqty.com
Stacey Joy	(847) 996-3969	Stacey.Joy@exqty.com
Jesse Meschuk	(949) 748-6776	Jesse.Meschuk@exqty.com
Chad Mitchell	(949) 748-6169	Chad.Mitchell@exqty.com
Jeff Pullen	(847) 996-3967	Jeff.Pullen@exqty.com
Dianna Purcell	(718) 273-7444	Dianna.Purcell@exqty.com
Bob Reilley	(856) 206-9852	Bob.Reilley@exqty.com
Mike Sorensen	(847) 996-3996	Mike.Sorensen@exqty.com
Ross Zimmerman	(847) 996-3999	Ross.Zimmerman@exqty.com

Headquarters • 1870 West Winchester Road, Suite 141 • Libertyville, IL 60048

East Region • 309 Fellowship Road, Suite 200 • Mt. Laurel, NJ 08054

West Region • 2 Park Plaza, Suite 820 • Irvine, CA 92614

www.exqty.com

You are receiving this **Client Alert** as a client or friend of Exequity LLP. This **Client Alert** provides general information and not legal advice or opinions on specific facts. If you did not receive this directly from us and you would like to be sure you will receive future **Client Alerts** and our other publications, please click on the following link to add yourself to our subscription list: <http://www.exqty.com/References/Subscribe.aspx>. If you want to unsubscribe from our list, please click on "Manage Subscription" at the bottom of the e-mail sent to you.