SEC Adopts Compensation Recovery ("Clawback") Policy and Disclosure Rules

On August 26, 2022, the SEC adopted final rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act requiring the Commission and the national securities exchanges to prohibit the listing of companies that do not adopt, disclose, and enforce a compensation recovery ("clawback") policy that applies to incentive-based compensation provided to their current and former executive officers. This action completes the SEC's rule-making under the Dodd-Frank Act, a process which began over 12 years ago with the enactment of the Act.

This Thoughtful Pay Alert summarizes the key aspects of the final rules and provides our initial observations about the likely impact of this new disclosure and corporate governance requirement on technology and life sciences companies.

Four Things Technology and Life Sciences Companies Should Know about the SEC's Final Rules on the New Clawback Requirement

- **General Requirement:** Companies listed on a national securities exchange will have 60 days from the date the SEC approves the applicable listing standard to adopt a compliant clawback policy
- **Policy Features:** The clawback policy will be required to:

- Apply to current and former executive officers (essentially, Section 16 officers)
- Apply to any accounting restatement resulting from a material error – misconduct not required
- Apply to incentive compensation (including performance-based stock options) if earned based on attainment of financial reporting measures
- Does not apply to base salaries, bonuses paid solely upon satisfying one or more subjective standards and/or completion of a specified employment period, or equity awards where vesting is contingent solely upon completion of a specified employment period
- Recover excess compensation received during the three completed fiscal years preceding the date that the restatement is required

- **Required Disclosure:** Listed companies will be required to file their clawback policy with their Form 10-K and disclose the details about the recovery of any excess compensation in their proxy statement
- **Implementation and Effective Date:** Compliance with the final rules will involve a multi-step process:

- The final rule will become effective 60 days after publication in the Federal Register (which is expected to occur later this month)
- The national securities exchanges will have 90 days from the date of such publication to submit a proposed listing standard to the SEC for approval and one year from the date of such publication to have the listing standard approved
- Listed companies will have 60 days from the date the SEC approves the new listing standard to adopt a compliant clawback policy
- **Thus, each listed company will likely need to have a compliant clawback policy in place before the end of 2023**
- **We recommend that technology and life sciences companies contact their legal counsel to review their current clawback policies and begin thinking about whether they will need to amend their existing policy or adopt a new policy to meet the anticipated listing standard requirements**

Background

To enhance the oversight of executive compensation programs, Section 954 of the Dodd-Frank Act added new Section 10D to the Securities Exchange Act of 1934. Section 10D requires the SEC to direct the national securities exchanges to prohibit the listing of any company that has not developed and adopted a policy providing that:

- if the company is required to prepare an accounting restatement due to noncompliance with any financial reporting requirement under the securities laws,
- the company will recover from any of its current or former executive officers
- who received incentive-based compensation (including performance-based stock options) during the three-year period preceding the date the company is required to prepare the accounting restatement based on the erroneous data

- the amount in excess of what would have been paid to the executive officer under the accounting restatement.

On July 1, 2015, the SEC proposed rules to begin the implementation of Section 10D. However, no further action was taken for the next six years. In October 2021 and again in June 2022, the SEC reopened the comment period on the proposed rules to solicit input on a series of questions about possible changes to the proposed rules, including the expansion of the type of financial restatements that would trigger a compensation recovery analysis

Clawback Policy Requirement

Rather than leave the substantive rulemaking to the national securities exchanges, the final rules set forth the specific terms of the required clawback policy that must be contained in the exchanges' listing standards. Generally, the clawback policy must provide that, in the event a company is required to prepare an accounting restatement due to its material non-compliance with any financial reporting requirement under the federal securities laws, the company will reasonably promptly recover (on a pre-tax basis) the amount of incentive-based compensation received by its current or former executive officers in excess of the amount of incentive-based compensation that would have been received had such compensation been determined based on the restated amount.

Executives Subject to Clawback Policy

The clawback policy must apply to a listed company's current and former "executive officers," who are defined to include its president, principal financial officer, principal accounting officer (or if there is none, the controller), any vice-president in charge of a principal business unit, division, or function (such as sales administration or finance), any other officer who performs a policy-making function, and any other person who performs similar policy-making functions for the company. In addition, executive officers of the company's parent or subsidiaries would be deemed executive officers of the company if they perform such policy making functions for the company.

The clawback policy will only require recovery of incentive-based compensation received by an individual after beginning service as an executive officer and if that individual served as an executive officer at any time during the recovery period.

Observations. The required listing standard will define the term "executive officer" in a manner modeled after the definition of the term "officer" as used for purposes of Section 16 of the Exchange Act. Further, the clawback policy will apply to any individual who served as an executive officer and received incentive-based compensation at any time during the three-year period preceding the date of the financial restatement. However, in a change from the proposed rules, this will not include incentive-based compensation derived from an award authorized before the individual became an executive officer.

Since the clawback policy is to be applied broadly – and without regard to individual "fault" or "misconduct," a potentially large number of individuals will be subject to the policy, possibly reshaping how a compensation committee considers the design and mix of the compensation arrangements for its executive officers. This could involve the use of more non-financial performance measures in incentive-based compensation plans and/or the re-weighting of the mix of equity awards between performance-based and time-based awards. In addition, listed companies will need to develop a means for tracking former employees who served as an executive officer and received incentive-based compensation to be able to enforce their clawback policy in the event of a subsequent financial restatement.

Accounting Restatement Trigger

In a significant change from the proposed rules, the clawback policy must provide for recovery of erroneously awarded compensation in the event a company is required to prepare an accounting restatement due to its material non-compliance with any financial reporting requirement under the federal securities laws, including a required accounting restatement:

- to correct an error in previously issued financial statements that is material to such financial statements (a so-called "Big R" restatement); or

- to correct an error in previously issued financial statements that is not material to such financial statements, but which would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (a so-called "little r" restatement).

Observations. The expansion of the definition of the type of accounting restatements that will trigger a clawback analysis likely increases the number of accounting restatements that will need to be scrutinized to determine whether recovery of incentive-based compensation will be required. While not all of these "little r" restatements will result in triggering a company's clawback policy, it is clear that some will, thereby requiring companies to consider the possible application of their clawback policy any time an error in previously issued financial statements is flagged

Further, unlike similar policies (such as the compensation recovery required by Section 304 of the Sarbanes-Oxley Act), the required clawback will be triggered on a "no fault" basis – that is, the sole trigger for a clawback will be an accounting restatement. Recovery will not be based on the finding of any misconduct or even an executive officer being found responsible for the accounting error leading to the financial statement.

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Three-Year Recovery Period

The clawback policy must apply to all excess incentive-based compensation received during the three completed fiscal years preceding the date upon which a listed company is required to prepare an accounting restatement. This date is to be the earlier to occur of the date:

- the board of directors, a committee of the board, or the officer or officers authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that its previously issued financial statements contain an error; or
- a court, regulator or other legally authorized body directs the company to restate its previously issued financial statements to correct a material error.

The required listing standard will also specify how the three-year "look-back" period is to be measured, providing that this period comprise the three completed fiscal years immediately preceding the date a company is required to complete an accounting restatement. For example, if a company with a calendar year fiscal year concludes in November 2023 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2024, the clawback policy will apply to incentive-based compensation received in 2020, 2021, and 2022.

Finally, the required listing standard will provide that incentive-based compensation is to be deemed "received" in the fiscal period during which the financial reporting measure specified in the incentive-based compensation is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period. In addition, an award that is subject to a financial reporting measure and a service-based vesting condition (such as a performance-based equity award with a time-based vesting "tail") is considered received when the financial reporting measure is achieved, even if the award continues to be subject to the time-based vesting condition.

Observations. In the case of a listed company's decision to conduct a restatement, the date of this decision will be determined objectively; that is, the appropriate date for measuring the three-year "look-back" period will be the date when a reasonable company, based on the facts available, would have concluded that the previously issued financial statements contained an error. Generally, it is expected that this date will coincide with the date upon which the company is obligated to file a current form on Form 8-K notifying investors that its previously issued financial statements may no longer be relied upon.

Compensation Subject to Recovery

The clawback policy will apply to any "incentive-based compensation," defined as "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure." This definition encompasses both cash and equity, including stock options and other equity awards whose grant or vesting is based, in whole or in part, upon the attainment of any measure based upon or derived from financial reporting measures.

For purposes of the required listing standard, a "financial reporting measure" will be defined as:

- any measure that is determined and presented in accordance with the accounting principles used in preparing the company's financial statements;
- any measure derived, in whole or in part, from such financial information;
- stock price; and
- total shareholder return ("TSR").

The inclusion of "stock price" as a financial reporting measure will introduce several challenges in determining excess incentive-based compensation because of the complexities involved in determining the impact of accounting errors on stock price movement. In recognition of these potential issues, the required listing standard permits companies to use reasonable estimates to assess the effect of an accounting restatement on stock price and TSR and require that these estimates be disclosed.

Observations. Based on this definition, compensation subject to the clawback policy will include (but not be limited to):

- non-equity incentive plan awards that are earned based, in whole or in part, on satisfying a financial reporting measure performance goal;
- bonuses paid from a "bonus pool," the size of which is determined based, in whole or in part, on satisfying a financial reporting measure performance goal;
- other cash awards based on satisfaction of a financial reporting measure performance goal;
- restricted stock, restricted stock units, performance share units, stock options, and stock appreciation rights that are granted or become vested based, in whole or in part, on satisfying a financial reporting measure performance goal;
- proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based, in whole or in part, on satisfying a financial reporting measure performance goal.

For most technology and life sciences companies, the clawback policy will apply to restricted stock or restricted stock unit ("RSU") awards with vesting based on financial performance, RSU awards with vesting tied to relative TSR performance,

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and RSU awards with vesting tied to the achievement of future stock price goals.

Compensation that will not be considered "incentive-based compensation" will include:

- annual base salary;
- bonuses paid solely at the discretion of the board of directors or compensation committee that are not paid from a "bonus pool" that is determined by satisfying a financial reporting measure performance goal;
- bonuses paid solely upon satisfying one or more subjective standards (such as demonstrated leadership) and/or completion of a specified employment period;
- non-equity incentive plan awards earned solely upon satisfying one or more strategic measures (such as consummating a merger or divestiture), or operational measures (such as opening a specified number of stores, completion of a project, increase in market share);
- equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more nonfinancial reporting measures (such as strategic measures or operational measures; and
- compensation paid solely on a discretionary basis.

Determination of Excess Compensation

The clawback policy must require that recoverable compensation is to be calculated as "the amount of incentive-based compensation received by the 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." Applying this approach, following an accounting restatement a listed company will:

- recalculate the applicable financial reporting measure and the amount of incentive-based compensation based thereon; and
- then determine whether, based on that financial reporting measure as calculated relying on the original financial statements and taking into account any discretion that the compensation committee had applied to reduce the amount originally received, the executive officer received a greater amount of incentive-based compensation than would have been received applying the recalculated financial reporting measure.

The recoverable compensation is to be calculated on a pre-tax basis.

For incentive-based compensation based on stock price or TSR, where the amount of excess compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the recoverable amount may be determined based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. For these measures, the company will be required to maintain documentation of the determination of that reasonable estimate and provide such documentation to the relevant exchange.

Consistent with the statute, the required listing standard will provide that recovery of any excess incentive-based compensation is to be mandatory. Nonetheless, recovery will be considered "impracticable" and, thus, not be required if:

- the direct costs of enforcing recovery would exceed the recoverable amount;
- recovery would violate the company's home country law; or
- recovery would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees of the company, to fail to meet applicable federal income tax laws and the regulations thereunder.

Before relying on the first exception, a company will first need to make a reasonable attempt to recover that incentive-based compensation. In addition, the company will be required to document its attempts to recover, provide that documentation to its exchange, and disclose in its proxy statement why it determined not to pursue recovery. Similarly, before concluding that it would be impracticable to recover the compensation because doing so would violate home country law, the company first will need to obtain an opinion of home country counsel that recovery would result in such a violation.

Observations. While the determination of recoverable compensation to cash awards is likely, in most instances, to be fairly straightforward, the determination for equity awards will involve different, and potentially more challenging, considerations. As the SEC notes, in the case of equity awards:

- if the shares, stock options, or SARs are held at the time of recovery, the recoverable amount will be the number of shares received in excess of the number that should have been received applying the restated financial reporting measure;
- if the stock options or SARs have been exercised and the underlying shares are still held, the recoverable amount will be the number of shares underlying the excess options or SARs applying the restated financial reporting measures; and

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- if the shares have been sold, the recoverable amount will be the sale proceeds received with respect to the excess number of shares (less any exercise price paid to purchase the shares).

The complexity of these computations will be compounded where the relevant financial reporting measure is based on stock price or TSR. As previously noted, the challenges inherent in estimating the effect of a financial restatement on stock price will likely necessitate that most companies incur the cost and uncertainties of undertaking an analysis requiring significant technical expertise and specialized knowledge. We would not be surprised to see these challenges taken into consideration when designing an incentive compensation program and, as a practical matter, when assessing the feasibility of seeking recovery of excess incentive-based compensation from executive officers.

Filing and Disclosure Requirements

In addition to adopting and enforcing a compliant clawback policy, each listed company will be required to do the following:

- file its clawback policy as an exhibit to its annual report on Form 10-K;
- add checkboxes to the cover page of its annual report on Form 10-K, one to indicate whether the financial statements included in the report reflect the correction of an error to previously issued financial statements and one to indicate whether any of the error corrections require a recovery analysis under the company's clawback policy; and
- disclose in its proxy statement how they have applied their clawback policy if, at any time during the last completed fiscal year, either:
    - a financial restatement that triggered the clawback policy was completed; or
    - there was an outstanding balance of excess incentive-based compensation from the application of the policy to a prior restatement.

Content of Required Disclosure

Where a listed company completes the financial restatement that triggered the clawback policy, it will be required to disclose the following details about the pending recovery:

- the date on which the company was required to prepare the restatement;
- the aggregate dollar amount of excess incentive-based compensation attributable to the restatement (including an analysis of how the recoverable amount was calculated);
- if the incentive-based compensation was determined based on a stock price or TSR-related financial reporting measure, the estimates used to determine the excess incentive-based compensation attributable to the restatement (and an explanation of the methodology used to calculate such estimates);
- the aggregate dollar amount of such excess incentive-based compensation that remains outstanding at the end of its last completed fiscal year;
- if the aggregate dollar amount of erroneously awarded compensation has not yet been determined, disclose this fact, disclose the reasons, and include the previous information in the next filing required to include Item 402 compensation information
- if recovery would be impracticable, for each current and former named executive officer and for all other current and former executive officers as a group, disclose the amount of recovery and forgone and a brief description of the reason the company decided not to pursue recovery; and
- for each current or former named executive officer, the amounts of incentive-based compensation that are subject to clawback that are still outstanding for more than 180 days since the date the company determined the recoverable amount.

Location of Required Disclosure

Since the clawback policy must apply to all executive officers, not just named executive officers, this information is part of a separate disclosure requirement, and not part of the Compensation Discussion and Analysis. The SEC has noted, however, that inclusion in the CD&A will be permitted as part the listed company's compensation recovery policy disclosure.

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SEC Adopts New Rules for "Pay Versus Performance" Disclosure Requirement (Continued)

Impact on Subsequent Summary Compensation Table Disclosure

To the extent that excess incentive-based compensation is recovered, the amount subsequently reported in the Summary Compensation Table for the fiscal year in which the amount recovered initially was reported (if subject to disclosure), is to be reduced by the recovered amount, and be identified as subject to clawback by footnote.

Disclosure to be Provided in Interactive Form

Companies will be required to tag the new disclosure of any specific data points included within the clawback disclosures, as well as block text tagging of those disclosures, in an interactive data format using Inline eXtensible Business Reporting Language ("XBRL").

Other Aspects of Proposed Rules

Companies Subject to Listing Standard

The required listing standard will apply to any company listed on a national securities exchange, including smaller reporting companies, emerging growth companies, foreign private issuers, and controlled companies. Only registered investment companies will be exempt from the requirement.

Securities Subject to Clawback Policy

The required listing standard will apply to all of a listed company's listed securities, including common equity securities, debt securities, and preferred securities. Only security futures products, standardized options, and the securities of certain registered investment companies will be exempt from the requirement.

Indemnification and Insurance

The required listing standard will prohibit a listed company from indemnifying any current or former executive officer against the loss of excess incentive-based compensation. Further, while an executive officer may be able to purchase an insurance policy to fund potential recovery obligations, a listed company will also be prohibited from paying or reimbursing the executive officer for premiums for such a policy.

Consequences of Non-Compliance

Noncompliance with the applicable listing standard, the SEC's disclosure rules, or a company's own compensation recovery policy will subject the company to delisting.

Concurrent Application with Section 304 of the Sarbanes-Oxley Act

Given the overlapping scope of the two provisions, there may be circumstances in which both the required listing standard and Section 304 of the Sarbanes-Oxley Act could apply to the same incentive-based compensation. The SEC notes that the required listing standards will not alter or otherwise affect decisions under Section 304 as to when reimbursement is required. Thus, if an executive officer makes reimbursement under Section 304, this amount should be credited to the extent that a clawback policy requires repayment of the same compensation. Further, recovery under a clawback policy will not preclude recovery under Section 304 to the extent any applicable amounts have not been repaid to the listed company.

Transition and Effective Date

The final rules require the national securities exchanges to:

- submit their proposed listing standards to the SEC within 90 days of the date that the final rules are published in the Federal Register, and
- have their listing standards become effective no later than one year after the date that the final rules are published in the Federal Register.

Thereafter, each listed company will have 60 days from the date the applicable listing standard becomes effective to adopt a compliant clawback policy.

The required clawback policy must apply to any incentive-based compensation that is received by a current or former executive officer on or after the effective date of the applicable listing standard, even if the compensation was received pursuant to an award granted before adoption of the required clawback policy.

Need Assistance?

Compensia has extensive experience in helping companies understand how the corporate governance and executive compensation-related disclosure provisions of the Dodd-Frank Act will affect the design, operation, and disclosure of their executive compensation program. If you would like assistance in analyzing how the final rules are likely to impact your executive compensation program and disclosure, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Mark A. Borges.

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