

Executives Could Pay for Accounting R/restatements Under New SEC Clawback Rules

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On October 26, 2022, the Securities and Exchange Commission (“SEC”) adopted final rules¹ implementing the Dodd-Frank requirement for issuers to recover incentive-based compensation erroneously paid to current and former executive officers due to an accounting restatement (the “Clawback Rules”).² These rules were originally proposed in July of 2015, and subsequently reopened for comment in October 2021 and June 2022.³ Under the Clawback Rules, substantially all issuers⁴ (including FPIs, EGCs, SRCs, and controlled companies) will be required to implement and disclose “no fault” clawback policies that meet strict recovery standards for both “Big R” and “little r” restatements.⁵

The Clawback Rules require listing exchanges to adopt clawback standards that go into effect no later than fourth quarter 2023, with issuers required to implement policies within 60 days thereafter. Issuers should be prepared to have policies in effect no later than the fall of 2023.

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¹ SEC Release Nos. 33-11126; 34-96159 (October 26, 2022) available at <https://www.sec.gov/rules/final/2022/33-11126.pdf> (the “Release”).

² Release at 195.

³ Release at 7-8.

⁴ Release at 17-18.

⁵ Release at 87.



Compliance Overview

1. Applicability

With some minor exceptions,⁶ all listed issuers are required to adopt, disclose, and comply with a clawback policy, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and companies listing only debt or preferred securities.⁷ No scaled compliance or phase-in adjustments are permitted.

2. Timing

Issuers must adopt a recovery policy no later than 60 days following the date on which the listing standard adopted by their listing securities exchange becomes effective.⁸ The issuer's policy must apply to all "incentive-based compensation" received by executive officers on or after the effective date of the listing standard, and may apply to compensation already promised or granted pursuant to contracts already in place.⁹ Compliance with the disclosure requirements contained within the Clawback Rules is required in the first annual report or proxy information statement required to be filed after the effective date of the listing standards.¹⁰

Listing standards must be effective no later than one year following publication of the Clawback Rules in the Federal Register,¹¹ which generally occurs one to four weeks after adoption by the SEC. Stock exchanges are required to file proposed listing standards no later than 90 days following the Federal Register publication date.¹²

⁶ The rules exclude from coverage (i) securities issued by a listed fund, on the condition that such funds have not granted incentive-based compensation to any executive officer during any of the last three fiscal years (or since the initial listing, if shorter), (ii) unit investment trusts, and (iii) clearing agencies that issue only "securities futures products" and/or standardized options.

⁷ Release at 17-18.

⁸ § 240.10D-1(a)(3)(i).

3. Elements of the Clawback Rules

Triggering events and covered periods

Under the Clawback Rules, an issuer must recover erroneously paid incentive-based compensation whenever it is required to prepare an accounting restatement that corrects an error in a previously issued financial statement that is material to the previously issued financial statement, or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.¹³ As foreshadowed in the SEC's 2021 comment period, this includes both "Big R" and "little r" restatements.¹⁴ The Clawback Rules do not describe any type or characteristic of material errors, pointing instead to the extensive judicial and regulatory history of materiality determinations.

The Clawback Rules do indicate that the following changes would not trigger application of a clawback policy:

- retrospective application of a change in accounting principle;
- retrospective revision to a reportable segment due to a change in the structure of an issuer'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 (IFRS filers only); and

⁹ Release at 123-24. The SEC acknowledges the potential need to amend existing contracts to permit recoupment of previously-awarded incentive-based compensation, but does not address how compliance may be impacted by an issuer's need to obtain consent to do so. Release at 122.

¹⁰ Release at 106.

¹¹ § 240.10D-1(a)(2).

¹² § 240.10D-1(a)(2).

¹³ Release at 32.

¹⁴ Release at 33.

- retrospective revision for stock splits, stock dividends or other changes in capital structure.¹⁵

Incentive-based compensation received during the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement (the “Recovery Period”) is subject to clawback under the Clawback Rules. For purposes of the Clawback Rules, this date is defined as the earlier to occur of:

- the date the issuer¹⁶ concludes, or reasonably should have concluded, that it is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, or;
- the date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement¹⁷

Covered persons and covered compensation

The Clawback Rules apply only to incentive-based compensation received by a person (a) after beginning service as an executive officer, (b) who served as an executive officer at any time during the performance period applicable to the incentive-based compensation, (c) while the issuer has a class of securities listed on a national securities exchange, and (d) during the Recovery Period.¹⁸

The definition of “executive officer” for purposes of the Clawback Rules is modeled after the definition of “officer” under Section 16 of the Exchange Act and includes:

- the issuer’s president, principal financial officer, and principal accounting officer (or if

there is no such accounting officer, the controller),

- any vice-president of the issuer 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 issuer.

Executive officers of the issuer’s parent or subsidiaries are deemed executive officers of the issuer if they perform policy making functions for the issuer.¹⁹

“Incentive-based compensation” for purposes of the Clawback Rules is any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure.²⁰ Financial reporting measures consist of (a) stock price, (b) total shareholder return (“TSR”), (c) any other measures that are presented in accordance with the accounting principles used in preparing the issuer’s financial statements, and (d) any measures derived wholly or in part from these measures, including non-GAAP measures.²¹ Examples of financial reporting measures include revenues, net income, operating income, EBITDA, liquidity measures such as working capital or operating cash flow, earnings measures, sales per square foot or same store sales, and cost per employee.

Performance-based compensation that is granted, earned or vested based solely on the occurrence of strategic or operational goals, such as completing a merger, divestiture or restructuring plan, opening a specified number of stores, increase in market share, or obtaining regulatory approval of a product, is not subject to clawback under the Clawback Rules, nor are bonuses paid solely at the discretion of the

¹⁵ Release at 37-38.

¹⁶ For purposes of this provision, “issuer” means the 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.

¹⁷ § 240.10D-1(b)(1)(ii).

¹⁸ § 240.10D-1(b)(1)(i).

¹⁹ § 240.10D-1(d).

²⁰ § 240.10D-1(d). Compensation considered “incentive-based compensation,” includes (but is not limited to) non-equity incentive plan awards earned by satisfying a financial reporting measure performance goal; cash awards based on satisfaction of a financial reporting measure performance goal; and bonuses paid from a “bonus pool,” the size of which is determined based on satisfying a financial reporting measure performance goal. Release at 64.

²¹ § 240.10D-1(d).

compensation committee,²² bonuses paid upon satisfying subjective standards, or compensation subject solely to service-based vesting.²³

For purposes of the Clawback Rules, incentive-based compensation is deemed to be “received” in the issuer’s fiscal period during which the applicable financial reporting measure is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period.²⁴ If compensation is subject to multiple vesting conditions, the compensation is deemed received for purposes of the Clawback Rules when the relevant financial performance measure is met, even if the award remains unvested and subject to continued employment for a period of time.

Clawback calculation and recovery

Under the Clawback Rules, issuers must recover incentive-based compensation received by the executive officers during the relevant period in excess of the amount that otherwise would have been paid had the compensation amount been determined based on the accounting restatement.²⁵ Issuers must recalculate the applicable financial reporting measure using the restated financials, and then determine the appropriate amount of incentive-based compensation that would have been earned as a result. For incentive-based compensation earned based on a combination of financial reporting measures and compensation committee discretion, issuers must determine the portion of the incentive-based compensation attributable to the financial reporting measure,

recalculate based on the restatement, and may continue to include amounts paid due to compensation committee discretion if such discretion was permitted under the plan given the revised financial measures. All calculations must be done on a pre-tax basis, even if the executive officer would not be able to recover previously paid taxes (e.g., income taxes or employment taxes) from the applicable taxing authorities.²⁶

For incentive-based compensation based on TSR or stock price, where the amount of erroneously awarded compensation cannot be recalculated directly from the information in an accounting restatement, the amount of compensation clawed back must be based on a reasonable estimate of the effect of the accounting restatement on the applicable measure.²⁷ The issuer must maintain documentation of the determination of that reasonable estimate and provide it to the exchange.²⁸

The issuer must recover any excess incentive-based compensation received by an executive officer (regardless of fault or magnitude), except when pursuit of recovery would be impracticable or where recovery would affect the tax status of tax-qualified retirement plans. Under the Clawback Rules, the pursuit of recovery may only be deemed impracticable if (a) the direct cost paid to a third party of recovery would exceed the amount of recovery²⁹ or (b) the recovery would violate the issuer’s (and not the executive officer’s) home country law.³⁰

²² Note, however, that “bonus pools” determined based on financial performance but then allocated at the discretion of the compensation committee *are* covered by the Clawback Rules.

²³ Release at 65.

²⁴ § 240.10D-1(d). Ministerial acts or other conditions necessary to effect payment, such as calculating the amount earned or obtaining approval from the board of directors do not affect determination of the date received. Release at 69.

²⁵ Release at 75.

²⁶ Release at 77. There may be significant limitations to obtaining refunds under U.S. federal income tax rules, and state, local or non-U.S. tax rules may also be relevant.

²⁷ Release at 75.

²⁸ Release at 75.

²⁹ The Clawback Rules require the issuer to make a reasonable attempt to recover incentive-based compensation before concluding that it would be impracticable to do so. The issuer must document those attempts to recover and provide that documentation to the exchange. § 240.10D-1(b)(1)(iv)(A).

³⁰ § 240.10D-1(b)(1)(iv). For this second exception to apply, the home country law must have been adopted prior to the publication date of the Clawback Rules in the Federal Register. Only a home country rule in the issuer’s jurisdiction may support this exception, regardless of the jurisdiction in which the applicable executive officer is located. The issuer also must obtain an opinion of home

An issuer is not permitted to settle for less than the full amount of recovery unless the requirements for one of the above impracticability exceptions is met. The Clawback Rules do provide issuers with discretion to determine the means of recovery,³¹ but recovery must be pursued promptly.³²

Disclosure

The Clawback Rules require an issuer to file its clawback policy as an exhibit to its annual report on Form 10-K, 20-F, or 40-F, as applicable.³³ In addition, the Clawback Rules amend Item 402 of Regulation S-K to require issuers to disclose how they have applied their recovery policies, in connection with any restatement. This requirement applies if, at any time during or after its last completed fiscal year, the issuer was required to prepare an accounting restatement that required the recovery of incentive-based compensation or there was an outstanding balance as of the end of the last completed fiscal year of erroneously awarded incentive-based compensation to be recovered. In connection therewith, issuers will be required to provide the following information:³⁴

- The date of the required restatement and the aggregate dollar amount of excess incentive-based compensation attributable to the restatement (or if not yet determined, an explanation of the reason why) and the aggregate amount of compensation that remains outstanding and uncollected at the end of its last completed fiscal year.³⁵
- estimates used for determining excess incentive-based compensation if the financial reporting measure related to stock price or TSR and an explanation of the methodology used for such estimates;

- 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:
 - o the amount forgone;
 - o a brief description of the reason the issuer decided not to pursue recovery;
 - o the impracticability exception relied upon, if applicable and certain supporting information (e.g., types of direct costs, the home country law relied upon or a brief explanation of how the recovery would jeopardize the tax-qualified status of a tax-qualified retirement plan); and
- for each current or former named executive officer, the name and amount due from each person from whom, as of the end of the last completed fiscal year, excess incentive-based compensation had been outstanding for 180 days or longer.³⁶

In addition, any amounts recovered under a recovery policy must be reflected in the Summary Compensation Table to reduce the amount reported in the applicable column as well as the “total” column for the fiscal year in which the amount recovered initially was reported. Such amounts should also be identified by footnote.³⁷

Finally, the SEC has also mandated new “check box” disclosure on the cover page of an issuer’s annual report “to assure that issuers listed on different exchanges are subject to the same disclosure requirements regarding erroneously awarded compensation recovery policies.”³⁸ This disclosure must indicate separately (a) whether the previously issued financial statements in the filing include an

country counsel before it can conclude that it would be impracticable to recover. § 240.10D-1(b)(1)(iv)(B).

³¹ The SEC acknowledged potential means of recovery include canceling unrelated unvested compensation awards and offsets against other compensation including unpaid incentive-based compensation. Release at 96.

³² Release at 99.

³³ Release at 106.

³⁴ This disclosure is not required to be incorporated in the issuer’s Compensation Discussion & Analysis, nor would any recovery be required to be reported as a “related party transaction” pursuant to Item 404(a) of Regulation S-K.

³⁵ Release at 108.

³⁶ Form 20-F Item 6(F)(1).

³⁷ Release at 108.

³⁸ Release at 10.

error correction, and (b) whether any corrections are restatements that required a recovery analysis of incentive-based compensation received during the applicable fiscal year.³⁹

Indemnification and Insurance

Issuers are prohibited from insuring or indemnifying any executive officer against the loss of erroneous awarded incentive-based compensation as a result of the Clawback Rules.⁴⁰ Executive officers are permitted to purchase their own insurance, but the issuer cannot cover or reimburse the executive officers for the related premiums.⁴¹ The SEC did acknowledge in the Rule Release, however, that compensation packages for executive officers may change in composition and total amount to account for the change in risk due to this rule,⁴² and that if executive officers do purchase private insurance, that cost will likely be covered by these expected changes in compensation packages.⁴³

Enforcement

The Clawback Rules leave direct enforcement to the listing exchanges, requiring that they seek delisting for any issuers that fail to adopt and follow a recovery policy. The Clawback Rules likely will lead to an increase in shareholder derivative suits seeking to force companies to pursue clawback under their policies, or to compel the companies to adjust their calculation of the timing or amount of the clawback to increase the recovery. When similar shareholder suits were brought in Delaware courts in the past, they were evaluated under the deferential business judgment rule. The Clawback Rules curtail management and board discretion and may lead to different outcomes in such cases. The Clawback Rules do not, however, provide a mechanism for the SEC to directly compel an issuer to pursue recovery or adjust the amounts sought.

The SEC's Enforcement Division and plaintiffs' lawyers are likely to scrutinize the new required

disclosures for potential antifraud claims. Their focus likely will be on disclosures about how the company calculated the recoverable amount of incentive-based compensation—particularly for calculations that involve a degree of judgment, such as stock return based measures—and when the company decided, or reasonably should have decided, that it had to restate financials, which could also affect the amount sought. Even if the SEC or plaintiffs' firms identify arguably false or misleading disclosures, however, it may be difficult for them to establish that any errors were material and/or that they were not the result of a reasonable, good-faith effort.

Sarbanes-Oxley Section 304:

The new Clawback Rules do not affect Section 304 of the Sarbanes-Oxley Act, which remains in force. Section 304 states that if an issuer is required to prepare an accounting restatement “due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws,” then the CEO and the CFO of the issuer “shall reimburse” the issuer for any incentive-based or equity based compensation, or profits from trades in company stock, that the executive received in the 12-month period following the first filing or issuance of the financial document that was later restated.⁴⁴ This clawback provision applies to *any* incentive compensation or stock sale profits, whether or not tied to the restated financial metric. The SEC and several courts have taken the position that the “misconduct” at issue may be attributable to any employee, and need not have been the fault of the CEO or CFO.⁴⁵ The SEC also has taken the position that negligence suffices to establish misconduct. On the other

³⁹ Release at 10-11.

⁴⁰ Release at 118. We think it likely the SEC would take the position that this prohibition on indemnification would include a prohibition against providing tax gross ups for any associated tax overpayment.

⁴¹ Release at 119.

⁴² This expected shift is discussed in greater detail in the section, “Next Steps: How should issuers prepare to compensate executive officers?” of this memorandum.

⁴³ Release at 170.

⁴⁴ 15 U.S.C. § 7243.

⁴⁵ *SEC v. Jensen*, 835 F.3d 1100 (9th Cir. 2016).

hand, the Section 304 clawback provision applies only to “Big R” restatements. Issuers are also not required to pursue clawback under Section 304; instead the SEC may bring an action against the CEO or CFO to order reimbursement. The SEC has brought an increasing number of such actions in 2022.⁴⁶

Next Steps

1. How should issuers prepare for compliance?

Issuers should review any existing compensation recovery policies in place and evaluate their scope against the Clawback Rules. While many issuers already maintain clawback policies, frequently the individuals covered, the time period covered, the types of compensation covered and the discretion afforded to the applicable decision-making body may not align with the final Clawback Rules. Issuers who do not yet have clawback policies should begin to design and draft these policies, subject to modification in response to those adopted by the listing exchanges.

The Clawback Rules cover any incentive-based compensation earned on or after the effective date of the listing standard, which likely includes previously-granted incentive-based compensation. Issuers should review any current and former incentive-based compensation to ensure they retain the contractual ability to comply with the Clawback Rules should a restatement become necessary, and initiate discussions regarding compliance and appropriate amendments with executive officers if necessary.

Issuers should evaluate and document which executive officers will become subject to the Clawback Rules initially, and update at least annually. This is particularly important for former executive officers,

from whom it may be more challenging to recover, if necessary.

To facilitate enforcement, issuers should consider adopting broad-based offsetting provisions in their compensation arrangements that would permit an issuer to offset from future compensation the value of incentive-based compensation required to be recouped under the Clawback Rules.⁴⁷ This may be of particular importance for executive officers that are former employees receiving severance or other post-termination pay. Issuers could also consider imposing post-vesting holding periods for stock-based compensation to facilitate direct recovery. Issuers may want to implement recoveries, to the extent possible, against compensation that has not yet been taxed (e.g., unvested compensation or unexercised options), in order to mitigate the adverse effect of having recovery amounts determined on a pre-tax basis. Finally, issuers could consider requiring executive officers to purchase and pay for insurance products that would provide issuers with a source of funds in the event of a restatement requiring recoupment.

2. How should issuers prepare for challenges?

When attempting calculation of the recoverable amount under the Clawback Rules, issuers may benefit from consulting counsel who have experience with the Enforcement Division’s approach to similar calculations when it considers such issues as disgorgement or executive compensation clawbacks required under SOX Section 304. The SEC has used a number of techniques, often involving use of event studies, and issuers will have a strong defense that their calculations were reasonable and made in good faith if they resemble what the SEC would do in analogous situations. Similarly, issuers can insulate themselves from allegations that they misstated the timing of when they determined a restatement was

⁴⁶ For a more complete discussion of Section 304 and recent trends, see our article “SEC Accounting Enforcement Action Signals Heightened Focus on Individual Accountability and Puts Public Company Executives on Notice for Potential SOX 304 Reimbursement” available at <https://www.clearyenforcementwatch.com/2022/06/sec->

[accounting-enforcement-action-signals-heightened-focus-on-individual-accountability-and-puts-public-company-executives-on-notice-for-potential-sox-304-reimbursement/](https://www.clearyenforcementwatch.com/2022/06/sec-accounting-enforcement-action-signals-heightened-focus-on-individual-accountability-and-puts-public-company-executives-on-notice-for-potential-sox-304-reimbursement/).

⁴⁷ Issuers should be aware of, and ensure compliance with, any applicable state wage laws when structuring any such offset provisions.

necessary by following an orderly process and documenting it.

Issuers may also want to consider adopting a policy in advance, assigning responsibility for who will decide when a restatement is necessary—for instance, a working group consisting of the principal financial officer, principal accounting officer and controller, in consultation with the audit committee and any special committee⁴⁸—to avoid confusion about which stakeholders must reach consensus before it can be said that a restatement is necessary. In addition, issuers should consider requiring any such working group to periodically report to the board circumstances that the working group concluded would not lead to a restatement.

Finally, the Clawback Rules are likely to invite scrutiny of an issuer’s decision that no restatement of any kind is necessary in connection with errors, which likely will lead issuers and their auditors to create more fulsome documentation of their immateriality analysis around such errors, all of which could be discoverable in future litigation or investigations. The Enforcement Division has focused on auditors recently,⁴⁹ including by bringing enforcement actions against audit partners for failing to abide by professional standards, such as standards requiring adequate documentation of materiality analysis. Issuers may find their auditors taking more conservative positions and requiring more extensive documentation, even for immaterial errors.

3. How should issuers prepare to compensate executive officers?

One potential consequence of the Clawback Rules is a shift away from incentive-based compensation.⁵⁰ As the SEC acknowledges, executive officers may start to favor compensation that is not subject to potential recovery, base salary for example, over incentive-based compensation that is so subject.⁵¹ This preference from executive officers will need to be balanced by the potential of an opposing preference of issuers for incentive-based compensation, as the requirement of recovery lowers costs due to the ability to claw back any overpayment,⁵² as well as the strong preferences for performance-based compensation articulated by shareholders and proxy advisory firms. In addition to the change in composition of compensation packages, the total amount may also be impacted. Issuers may be faced with providing risk premiums to their executive officers due to the increase in risk and uncertainty the Clawback Rules bring to their compensation.⁵³ The SEC notes that the extent of an increase in total compensation depends on the conditions of the labor market for executive officers.⁵⁴ The SEC also referenced concerns that the rules create a disadvantage in recruiting executives for companies that fall within its scope as compared to those that do not.⁵⁵ Any changes to the type and amount of compensation offered to executives will need to address this issue and limit the disadvantage in order to ensure issuers remain competitive in a market for talent, while balancing the preferences of other constituencies.

⁴⁸ Such a special committee should include only independent directors.

⁴⁹ Details on this focus can be found in our article “SEC Imposes Penalties and Sweeping Independent Consultant on CohnReznick for Alleged Audit Failures in Case Underscoring SEC’s Focus on ‘Gatekeepers’” available at <https://www.clearyenforcementwatch.com/2022/06/sec-imposes-penalties-and-sweeping-independent-consultant-on-cohnreznick-for-alleged-audit-failures-in-case-underscoring-secs-focus-on-gatekeepers/#more-2709>.

⁵⁰ This similarly was a potential consequence to the elimination of the “qualified performance based compensation” exception under Section 162(m) of the Internal Revenue Code, though pressure from shareholders and proxy advisory firms have tended to stem any significant reduction in incentive-based pay.

⁵¹ Release at 159.

⁵² Release at 161.

⁵³ Release at 162.

⁵⁴ Release at 162.

⁵⁵ Release at 163.

4. A shift in thinking about performance milestones

The Clawback Rules may also possibly shift how issuers think about performance metrics and goals when constructing incentive-based compensation. There are concerns that the move away from incentive-based compensation will affect the alignment that such compensation creates between executive officers and shareholders.⁵⁶ If issuers want to address this, a shift in focus from financial-based performance metrics to compensation that is earned upon satisfaction of strategic and/or operational measures (e.g., opening a certain number of stores, increasing market share, or completing a project) could be a solution. These sorts of performance goals and metrics would not be viewed as incentive-based compensation within the Clawback Rules and thus, they would not be subject to recovery.⁵⁷ However, they would still serve to create alignment between executive officers and shareholders.⁵⁸

We will continue to monitor and report on developments, including actions taken by exchanges to implement the Clawback Rules. Please contact any of the authors or your regular Cleary Gottlieb contacts for further discussion or if you have questions.

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⁵⁶ Release at 160.

⁵⁷ Release at 64-65.

⁵⁸ Release at 65.