

Client Alert

November 2022

Absorbing and Reacting to the SEC's New Clawback Rules

The Securities and Exchange Commission (the "SEC") on October 26, 2022, adopted new executive compensation "clawback" rules, thus fulfilling its 2010 mandate under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The purpose of this alert is to briefly summarize the rules and some related considerations and highlight next steps that issuers should be considering as they plan to comply with the new rules. A more detailed summary of the rules are set forth in Exhibit A and the adopting release and a related fact sheet are available [here](#).

What Happened?

As required by Dodd-Frank, the SEC adopted new Rule 10D-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), detailing the circumstances under which generally all listed issuers (including EGCs and SRCs) must recover (i.e., "clawback") incentive-based compensation that was erroneously received by current and former executive officers, but only to the extent such incentive-based compensation was based upon a misstated financial performance measure (including, for these purposes, stock price and total shareholder return) during the prior three fiscal years.

National stock exchanges (i.e., Nasdaq and the NYSE) will now be required to establish listing standards requiring listed issuers to adopt and comply with written clawback policies meeting the standards specified by Rule 10D-1.

Under corresponding amendments to other SEC rules under the Exchange Act, listed issuers will, once the applicable listing standards become effective, be required to file their clawback policies as exhibits to their annual reports and provide new disclosures about such policies and their implementation and effects in their annual reports on Form 10-K and proxy statements.

What Compensation is Covered?

Under any clawback policy that complies with the new rules, if an issuer is required to prepare a financial restatement, then such issuer must seek recoupment of any incentive-based compensation that its executive officers "received" during the prior three fiscal years, but only to the extent such incentive-based compensation received is in excess of what the executive officer would have received had the financial error not occurred.

Compensation is deemed “received” in the fiscal period during which the relevant goal related to the applicable financial reporting measure is satisfied, even if payment or grant occurs after the end of that period.

Current and former executive officers who erroneously received incentive-based compensation within the three fiscal years preceding a financial restatement must be subject to the clawback policy.

What Triggers a Clawback?

Notably, unlike many existing clawback policies that only apply to officers who actually engaged in fraud or misconduct related to financial statements and provide issuers with some degree of discretion in determining when and whether to pursue enforcement, the new rules generally require (subject to very limited exceptions) issuers to clawback compensation erroneously received by any executive officer in connection with any “Little r” restatements (i.e., financial restatements that are not deemed material errors and do not require a full restatement of previously issued financial statements), as well as “Big R” restatements (i.e., financial restatements that are deemed material errors and do require a full restatement of previously issued financial statements as well as immediate Form 8-K disclosure to the effect that the previously issued financial statements can no longer be relied upon). The rules were adopted by a 3-2 vote, and the relatively unexpected inclusion of “Little r” restatements was one element of the rules as adopted that generated dissent from the two Republican SEC commissioners as well as other stakeholders.

What is the Deadline to Comply with the New Rules?

The exact date an issuer must comply with the new rules is not currently known because the stock exchanges have not yet published listing standards (i.e., the listing standards could provide for an effective date up to one year after the new rules are published in the Federal Register, and an issuer would then have up to 60 days to implement a compliant clawback policy).

Accordingly, listed issuers probably have at least a year to adopt a new clawback policy. Moreover, a number of interpretive questions remain under the SEC’s new rules, and it remains to be seen whether future SEC guidance or additional specificity that may be embodied in the listing standards actually adopted by the exchanges resolve these issues. It is also uncertain how courts will interpret these provisions in the event an affected executive challenges a clawback demand in the future. Nevertheless, given the detailed nature of the SEC’s final rules, issuers can begin preparing now with reasonable certainty regarding their new obligations and any issuer adopting a “wait-and-see” approach should be ready to move quickly.

What Are Next Steps?

Even before the actual compliance deadline is known, issuers should consider one or more of the following action items (presented in no particular order):

1. Review the issuer's current clawback policy (if any) to determine whether changes will likely be required. At a minimum, an issuer's Board of Directors will likely desire an update on what the impact of the new rules could and will be.

2. Review existing contractual arrangements to determine whether compliance with the issuer's soon-to-be implemented (or revised) clawback policy would create any conflicts with existing contracts such as executive employment agreements, equity incentive awards, indemnification agreements, etc. To this point, keep in mind that the requirement to comply with the new clawback rules is a stock exchange listing requirement and failure to comply could result in delisting. It very well could be that an issuer has a contractual arrangement with a covered executive that would be violated if the issuer attempted to clawback incentive compensation. As a result, and to avoid any future tug-a-war where an issuer has to choose between potential delisting and a breach of contract with an executive, the issuer should evaluate and analyze every contract where a conflict or interpretive question would arise. The Board of Directors (or the Compensation Committee) should then review and discuss the results of this analysis, and deliberate as to what, if any, actions could and should be taken by the issuer in order to address any actual or potential issues.
3. With respect to vesting schedules, revisit any situation where the issuer incorporates a financial performance-based measure as a modifier to an otherwise non-financial performance-based measure. By way of example, assume the issuer has a human capital measure as the primary performance-based measure (e.g., safety, social goals, etc.) and then applies a financial performance-based measure (e.g., EBITDA, shareholder return, etc.) as an up or down modifier to any payout. Consideration should be given to whether or not the financial performance-based modifier should be eliminated.
4. In designing severance pay, consider whether performance-based incentive pay should instead be denominated as a flat dollar amount. By way of example, it is a common pay practice to have incentive bonuses paid to a terminated executive only to the extent the performance goal underlying such bonus would have been achieved. One way to avoid having such payment be subject to any future clawback is to have the payment be a flat dollar amount (e.g., the target amount is paid irrespective of what performance level is achieved).
5. Relatedly, separation agreements and any mutual releases should incorporate the possibility of the clawback policy being implemented.
6. Determine whether any executive officers reside in California. To this point, California Labor Code Section 221 provides in part that it is "unlawful for any employer to collect or receive from an employee any part of wages . . . paid . . . to said employee." Whether California law would prohibit an issuer from enforcing a clawback policy under the new rules is not yet known. It is unclear whether the SEC has authority to preempt state or foreign law on this issue.
7. Should a claims procedure be set forth in the clawback policy that provides an executive with a procedure within which he or she could contest a clawback? How should amounts subject to clawback actually be clawed back?

Given the impending potential for increased consequences from and scrutiny of financial reporting errors, revisit internal controls of the issuer and consider whether the issuer needs to bolster its financial reporting function capabilities, including from a human capital perspective.

Exhibit A
Overview of New Clawback Rules

<p>Background</p>	<ul style="list-style-type: none"> • In 2010, Dodd-Frank added Section 10D to the Exchange Act, requiring the SEC to direct the national securities exchanges to establish listing standards that require issuers to develop and implement a clawback policy, which: <ul style="list-style-type: none"> ○ must provide that, in the event the issuer is required to prepare an accounting restatement, the issuer will recover incentive-based compensation paid to its current and certain former executive officers, if such payment was based on any misstated financial reporting measure; and ○ must apply to compensation received during the three-year period preceding the date the issuer is required to prepare the accounting restatement. • In July 2015, the SEC proposed rules and rule amendments to implement the recovery of erroneously awarded compensation requirement. • In October 2021 and again in June 2022, the SEC reopened the comment period for the 2015 proposed rules to allow additional comments to address requirements the SEC was considering in connection with the proposed rule.
<p>New Clawback Rule Framework</p>	<ul style="list-style-type: none"> • New Rule 10D-1 requires exchanges to adopt listing standards that will require each listed issuer to adopt a compensation recovery policy, comply with that policy, and provide the required compensation recovery policy disclosures. • An issuer will be subject to delisting if it does not adopt and comply with a compensation recovery policy that meets the requirements of the listing standards. • The new rules amended Item 402 of Regulation S-K, Form 10-K and other forms to include new disclosure requirements related to the required policies, including a requirement that a listed issuer must file its policy as an exhibit to its annual report and disclose on an annual basis how it has applied the policy and related matters (see below for more details).
<p>Issuers Covered</p>	<ul style="list-style-type: none"> • Rule 10D-1 generally applies to all listed issuers, including smaller reporting companies, emerging growth companies, foreign private issuers, controlled companies and issuers of debt and non-equity securities. • The only exempted issuers under the final rules are issuers of security futures products, standardized options, unit investment trust securities and certain registered investment company securities.
<p>Effective Date</p>	<ul style="list-style-type: none"> • The final rules will become effective 60 days following publication of the adopting release in the Federal Register. • Exchanges will be required to file proposed listing standards no later than 90 days following publication of the release in the Federal Register, and the listing standards must be effective no later than one year following the date the adopting release is published in the Federal Register. Issuers subject to the listing standards will then be required to adopt a clawback policy no later than 60 days following the date on which the applicable listing standards become effective, and the issuer will thereafter be required to comply with related disclosure requirements.

<p>Clawback Trigger</p>	<ul style="list-style-type: none"> • Restatements triggering clawback of incentive compensation may include both “Big R” and “Little r” restatements. <ul style="list-style-type: none"> ○ “Big R” restatements are those that correct errors that are material to previously issued financial statements and require Form 8-K disclosure. “Big R” restatements can only be corrected by restating previously issued financial statements. ○ “Little r” restatements are those that correct errors that are not material to previously issued financial statements, but would result in a material misstatement if (i) the errors were left uncorrected in the current report or (ii) the error correction was recognized in the current period. “Little r” restatements can be corrected in subsequent financial statements. <p>Notably, and in a departure from some current clawback policies there is no misconduct requirement and misstated metrical that are not “financial” are not required to be covered.</p>
<p>Fiscal Periods Covered</p>	<ul style="list-style-type: none"> • An issuer must clawback incentive compensation erroneously paid during the three completed fiscal years immediately preceding the date on which the issuer is required to prepare an accounting restatement to correct an error that is material to previously issued financial statements, which will be deemed to be the earlier of: <ul style="list-style-type: none"> ○ the date the issuer’s board of directors (or committee thereof) 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 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 restatement.
<p>Executive Officers Subject to Clawback</p>	<ul style="list-style-type: none"> • Any executive officer (whether or not currently an executive officer) who received compensation after beginning service as an executive officer who served as an executive officer at any time during the performance period for the relevant incentive-based compensation. • The term “executive officers” in the new rules uses substantially the same definition used to determine an issuer’s “officers” under Section 16 of the Exchange Act, which includes: <ul style="list-style-type: none"> ○ an issuer’s president, principal financial officer, 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 (such as sales, administration, or finance); and ○ any other officer (or person) who performs a policy-making function for the issuer.
<p>Compensation Subject to Clawback</p>	<ul style="list-style-type: none"> • A compliant clawback policy must provide that, if the issuer has an accounting restatement within the fiscal years covered (see above), then the issuer must recover from its current and former executive officers any incentive-based compensation that was erroneously received by them as a result of the misstated financial reporting measure. More specifically: <ul style="list-style-type: none"> ○ The amount that is required to be clawed back is any excess over the amount that would have been received had the attainment of the financial

	<p>reporting measure been determined based on the restated (correct) amounts.</p> <ul style="list-style-type: none"> ○ The amount must be computed without regard to any taxes paid. ● Compensation is deemed “received” in the fiscal period during which the relevant goal related to the applicable financial reporting measure is satisfied, even if payment or grant occurs after the end of that period. ● Incentive-based compensation earned prior to the period that an executive officer served in that capacity or prior to the effectiveness of the applicable listing standard is not subject to clawback. <ul style="list-style-type: none"> ○ Sometimes determining the proper amount to recover can be difficult since the amount in question might not be subject to mathematical calculation (e.g., stock price metrics and TSR metrics). In such situations, the SEC allows issuers to apply reasonable estimates, provided the issuer maintains documentation of such determination and provides the same to the applicable listing agency.
<p>Types of Incentive Compensation Covered</p>	<ul style="list-style-type: none"> ● The new rules define “incentive-based compensation” to be “any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure.” <ul style="list-style-type: none"> ○ “Financial reporting measures” includes both GAAP and non-GAAP financial measures, and also includes measures linked to stock price and total shareholder return (TSR). ● Examples of “incentive-based compensation” include, but are not limited to: <ul style="list-style-type: none"> ○ non-equity incentive plan awards that are earned 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; ○ 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 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. ● Examples of compensation that is not “incentive-based compensation” for purposes of the final rules include, but are not limited to: <ul style="list-style-type: none"> ○ salaries; ○ bonuses paid solely at the discretion of the compensation committee or board 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 (e.g., demonstrated leadership) and/or completion of a specified employment period;

	<ul style="list-style-type: none"> ○ non-equity incentive plan awards earned solely upon satisfying one or more strategic measures (e.g., consummating a merger or divestiture), or operational measures (e.g., opening a specified number of stores, completion of a project, increase in market share); and ○ 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 (e.g., discretionary grants of time-vesting restricted stock, restricted stock units, stock options or stock appreciation rights).
<p>Limited Exceptions to Mandatory Clawback</p>	<ul style="list-style-type: none"> ● Under the new rules an issuer has only limited discretion of whether to enforce a clawback of compensation that is otherwise triggered under the policy, including when: <ul style="list-style-type: none"> ○ direct expenses paid to third parties to assist in enforcing the policy would exceed the amount to be recovered and the issuer has otherwise made a reasonable attempt to recover; ○ recovery would violate home country law that existed at the time of the new rules being published in the Federal Register, and the issuer provides an opinion of counsel to that effect to the exchange; or ○ recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.
<p>Disclosure Requirements</p>	<ul style="list-style-type: none"> ● Issuers must file their clawback policy as an exhibit to their annual report. ● Issuers must disclose in their annual report and in any proxy or information statement that calls for disclosure pursuant to Item 402 of Regulation S-K, how they have applied their clawback policy, including, as relevant: <ul style="list-style-type: none"> ○ the date the issuer was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (including the estimates used in calculating the recoverable amount in the case of awards based on stock price or TSR); ○ the aggregate amount of erroneously awarded incentive compensation that remains outstanding and any outstanding amounts due from any current or former named executive officer for 180 days or more, separately identified for each individual (or, if the amount of such erroneously awarded incentive compensation has not yet been determined as of the time of the report, disclosure of this fact and an explanation of the reasons why); and ○ details regarding any reliance on the limited exceptions described above to not pursue a recovery. ● Inline XBRL tagging requirements apply to related disclosures in an annual report or proxy or information statement required pursuant to Item 402 of Regulation S-K. ● A new instruction to the Summary Compensation Table requires disclosure of any amounts recovered pursuant to an issuer’s clawback policy 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, and be identified by footnote.

	<ul style="list-style-type: none">• The new rules amend the cover pages of the annual reports on Form 10-K, Form 20-F and Form 40-F to add check boxes that indicate:<ul style="list-style-type: none">○ whether the financial statements of the registrant included in the filing reflect correction of an error to previously issued financial statements; and○ whether any of those error corrections are restatements that required a recovery analysis of incentive compensation received by any of the registrant's executive officers during the relevant recovery period under the new rule.
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