"Clawbacks: Navigating the Process After a Restatement"

Wednesday, April 17, 2024

Course Materials

“Clawbacks: Navigating the Process After a Restatement”

Wednesday, April 17, 2024

2 to 3 p.m. Eastern [archive and transcript to follow]

You’ve had a restatement. What now? For companies that find themselves in mandatory clawback territory, running a thoughtful, thorough and organized process will be key to managing the myriad of risks that can arise when implementing your clawback policy. This critical webcast will discuss the essential steps to complete the process of clawing back erroneously paid incentive compensation following a restatement.

Join our panelists:

- **Richard Luss**, Senior Economist, WTW
- **Ron Mueller**, Partner, Gibson, Dunn & Crutcher LLP
- **Steve Seelig**, Senior Director – Executive Compensation, WTW
- **Maj Vaseghi**, Partner, Latham & Watkins LLP

This program will cover:

- Coordinating with the Audit Committee
- Engaging the Right External Advisors & Internal Resources
- What is an Event Study? How Does it Work?
- Sources of Clawed Back Compensation & High-Level Tax Implications
- Planning the First Special Meeting of the Compensation Committee
- Communications with Impacted Executives
- Managing Litigation Risk
- Support & Documentation

“Clawbacks: Navigating the Process After a Restatement”

Course Outline/Notes

1. Coordinating with the Audit Committee

2. Engaging the Right External Advisors & Internal Resources

3. What is an Event Study? How Does it Work?

4. Sources of Clawed Back Compensation & High-Level Tax Implications

5. Planning the First Special Meeting of the Compensation Committee

6. Communications with Impacted Executives

7. Managing Litigation Risk

8. Support & Documentation

“Clawbacks: Navigating the Process After a Restatement”

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You've had a restatement: What now?

A primer for Dodd-Frank clawback compliance

By Steve Seelig (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Steve%20Seelig])**,**
Rich Luss (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Rich%20Luss]) **and**
Jamie Teo (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Jamie%20Teo]) **| December 4, 2023**

This article covers the essential steps required to complete the process of clawing back erroneously paid incentive compensation.

As of December 1, the public company you work at or with will have adopted a compliant Dodd-Frank clawback policy. Now the hard work begins to figure out exactly how the clawback process will work, from Board approval of the restatement to closing the books on the actual clawback of dollars needed to satisfy the requirements. With restatements, excluding those for special purpose acquisition companies, running at 5% per year, this will mean a significant number of companies will confront these issues. Are you ready?

This article covers the essential steps required to complete the process of clawing back erroneously paid incentive compensation. They are process-intensive and scalable to meet each company's unique circumstances.

Our primary advice is twofold:

1. Have in place a formal, written process of repeatable actions that can be quickly delegated, and
2. Adopt a timeline that will ensure those involved can help the company exercise the clawback "reasonably promptly," per the regulatory requirement mandate.

There's no need to panic; this planning work can take place in early 2024 because no clawback would arise for calendar-year companies until after the 2021 – 2023 long-term incentive plan and 2023 bonus plan are paid out in early 2024. Any restatement between now and then would not trigger a clawback but would instead influence the value of the payments calculated for any open compensation cycle.

We broke down the process into four essential steps, summarized below for the sake of brevity. For purposes of this article, we assume that the compensation committee is responsible for administering and enforcing the clawback.

Step 1: Make key process decisions up front. We foresee that soon after a restatement is announced, the committee would convene a special meeting to make key decisions about how the process will work and who will help assemble the needed data. We propose the following agenda items for that meeting:

- **Understand the potential impact on incentive compensation.** Management would provide a summary of the potential impact of the restatement on all elements of compensation.
- **Ensure data and documentation are readily available.** Understand who from management will provide the team charged with performing the calculations with access to financial data, compensation plans, meeting minutes and any other information needed to perform

calculations.

- **Determine if the clawback team is managed by external counsel using compensation experts.** Fundamentally, the committee must consider conflict-of-interest questions where management helps to determine clawback values. Our view is that the risk of this being an issue for shareholders diminishes when the sums involved are smaller, the calculation is simpler, and the assumptions or judgment calls needed to complete the calculation are fewer. The more there is at stake, the more likely that both shareholders and officers will quest results and ask about the source of funds, state legal authority and individual taxation; the more complicated the process of performing calculations becomes, the more plausible these objections will be.

  For these reasons, we foresee many situations where the committee would hire its own legal counsel and compensation experts to form the clawback team. To the extent it is available, preservation of attorney-client privilege in communications among the committee, the clawback team and the executive officer(s) also may be desirable.
- **Set forth expectations/timing for the clawback team.** We anticipate the following will be deliverables from the clawback team:
  - A complete Compensation Review Report that details all compensation potentially impacted
  - A Calculation Methodology Report that provides details on the methodology employed and the actual calculations
  - A presentation of the potential sources of funds to satisfy the clawback
  - A recommended proxy disclosure
- **Invoke recovery** Once the committee determines its approach, it must understand who has the legal authority to carry out the recovery and ensure the recovery is completed within a preset time frame.

Step 2: Perform the calculations. Each clawback team will need to accomplish the fundamental steps outlined in its listing exchange's manual to calculate the clawback. The process and dependencies set forth in Step 1 will help govern how the data and information change hands and who will be involved in each of the following sub-steps as the team looks back over the three completed fiscal years immediately preceding the year of the restatement (i.e., the lookback period):

1. Identify all individuals who were executive officers at any time during the lookback period.
2. Determine if incentive compensation was granted, paid or vested during the lookback period.
3. Calculate the extent to which incentive compensation must be clawed back.

While (A) is mostly straightforward, a lot more is involved in the next two steps.

- **Identifying incentive compensation:** Complications can arise when reviewing the documentation about how compensation levels were determined and pay was settled for each compensation element received during the lookback period. The first issue to address in Step (B) is identifying elements of compensation that are not obviously incentive compensation but that might still be affected by the restatement. Examples include salary increases based on prior year financial results or compensation deferred into a nonqualified plan based on a prior year bonus.

  The second issue involves looking at pay that is clearly incentive compensation (e.g., the annual bonus) and figuring out which portion might be attributable to non-financial performance, either based on a specific non-financial metric or at the committee's discretion. Making this determination would require looking at plan documents, grant agreements and the like plus reading committee reports and minutes to eliminate compensation not based on financial reporting measures. Where not enough documentation exists, the committee would likely err on the side of including that compensation in the clawback amount.
- **Calculating the clawback amount:** Much of the work in Step (C) will be straightforward math; in other instances, more powerful statistical tools may be required to calculate the value of incentive compensation that was erroneously paid. Complications arise when incentive compensation previously received was calculated based on stock price or total shareholder return performance that would be affected by a restated financial metric. The regulations outline the SEC's understanding that trying to determine what stock prices would have been had the restated financials been presented accurately for prior fiscal years is not a simple quantification exercise; rather, it requires companies to make a "reasonable estimate." This reasonable estimate may be determined using statistical tools such as an "event study."

  - **What is an event study?** An event study is a statistical method used in the fields of accounting, finance and economics to estimate the expected impact of specific actions or activities (an "event") over a specific period of time (the "event window") on the stock price returns of the firm involved.

    There are two types of event studies:

    1. The *multi-firm event study*, which looks at the average stock price movement of many firms that each experienced the same type of event (e.g., announcing a stock repurchase, being the target of a merger, announcing a restatement of earnings) over the same period of "event time" (i.e., time relative to when the event occurred as opposed to calendar time)
    2. The *single-firm event study*, which focuses on the shareholder returns for that organization relative to its specific event (i.e., the stock price movements from one week before to two weeks after the date that organization announced its restatement)

    While multi-firm event studies are more common in academic work, single-firm event studies have been recognized in securities fraud litigation in the Delaware Chancery as a preferred method for determining the impact of a particular event on share price.

- **Use of event studies:** The mechanics may be complicated to execute, but they are relatively straightforward to explain.
  - **Determine "normal" conditions.** An event study would first look at the correlation between share price movements of a company and a peer group over a period of time significantly before the restatement. This would establish a baseline of how the company share price moves relative to its peer group under what economists call normal conditions based on this "pre-event period."
  - **Determine the restatement's TSR impact.** The next step is to look at the company's shareholder returns and those of the firms ir peer group from just before to just after the restatement (i.e., the "event period"). The goal is to determine the "abnormal" impact on share prices due to the restatement, which is the difference between the actual shareholder returns during the restatement's event period and the returns that would have been expected under normal conditions compared with the peer group.
- **Determining if an event study is needed:** Not all stock plans or TSR-based plans will require the use of an event study for every restatement. The clawback team may need to conduct a lot of homework before the company can conclude one way or the other. The following table reflects the potential factors influencing this determination:

	Reasonable estimates may suffice	Event study needed
Inflection points in plan	Fewer hurdles and greater distance to next lowest hurdle	More hurdles and shorter distance to next lowest hurdle
Stock movement at restatement	Tepid movement when announced	Large share price change when announced
Market volatility	Lower volatility at original filing and restatement date	Higher volatility at original filing and restatement date
Proportion of pay affected	Lower percentage of incentive compensation	Lower percentage of incentive compensation
Magnitude of restatement	Lower value restated	Higher value restated
Cause of restatement	Change in accounting convention/audit firm	Systemic failure causing reputational harm

To give a flavor for how this would work, let's look at the inflection points in a performance share plan when compared with the magnitude of the restatement. Assume a plan has a relative TSR modifier in its formula that adjusts payout –25% at the 25th percentile, 0% at the 50th percentile and +25% at the 75th percentile. If original TSR when the financial statements were issued was just below the 75th percentile, unless the restatement had a significant effect on company share price when announced, the company might reasonably conclude that the recalculated share value would not cause the TSR modifier to fall below the 50th percentile. Under those facts, it might then be fair to find that a "reasonable estimate" would require no adjustment for share value changes. On the other hand, if the original TSR was slightly above the 75th percentile, that same adjustment might lead to the opposite conclusion. Note, an infinite number of variations could present themselves depending on each of the above factors.

After each of the above calculation steps are accomplished, the next issue will be to determine the optimal source of funds for the clawback.

Step 3: Determine the source of clawback funds. Some clawback policies are written narrowly so that the committee must send a demand letter to the officer for repayment, and only if there was a delay in responding would the committee seek other sources. Other policies are broadly written so that the committee has the sole discretion to determine if the source of funds would be direct repayment or recoupment from compensation still held by the company.

Our view is the committee should decide the source for funding the clawback after a discussion with the officer about his or her preferences. The executive's ability to repay the money directly rather than holding back other pay, and the tax considerations of doing so, would be the primary focus. Not only would this dialogue promote good will between the parties, but it would also expedite the committee's ability to act "reasonably promptly." These informal discussions are just that, as every policy we've seen makes clear that the committee has the sole discretion to determine the source of funds. Where a clawback must be applied to a former officer, unless funds remain held by the company, the committee might skip this step and simply issue a demand letter for the funds owed.

To prepare for this discussion, the committee should understand the extent to which an executive holds company shares, either on an after-tax basis or based on those still held by the company. This information should be readily available so the committee can determine whether the officer holds sufficient shares to satisfy the clawback while factoring in any company share ownership requirements or whether previously paid shares are still available to satisfy the clawback.

The committee also should understand the financial value available from each of the alternative sources listed below. Counsel must advise whether each of these would be permissible sources under state and federal law (including the tax code):

1. **Cancel in-flight cash or equity awards.** There are pros and cons when considering whether to cancel or reduce outstanding tranches of cash bonuses and long-term incentives. The company might find the cash bonus to be more accessible and easier to calculate and then simply cancel, while the officer might rather give up equity to be paid in the future than give up current cash. Determining which equity would

be cancelled, and at what point during a performance cycle, would require the committee to resolve some tough valuation questions. Nonetheless, the committee should understand potential approaches to determine the best source of funds from pending payments.

2. **Offset future cash or equity grants.** The preamble to the SEC regulations suggests this also could be a viable approach. Calculating how future payments will be reduced is relatively straightforward math and easy to determine. Executives may be more receptive to a reductio of future pay not yet granted. Of course, the rub here is that the committee would need to substantiate that it was reducing future pay i previously promised.
3. **Forfeit deferred compensation.** This one is a bit tricky due to the rules of 409A. While we read the regulations to permit a forfeiture of deferrals if the plan so specifies, we suspect most plans don't specify forfeitures can take place due to a clawback. That said, we anticipate most committees would amend plans soon to specify that future deferrals would be subject to a Dodd-Frank clawback. Tax advisors have a wide variety of views on this issue and should advise on the implications of forfeiting deferred compensation.

Whether or not the committee has a discussion with the officer, the goal of all this work is to permit the committee to determine the best source of funds so it can act "reasonably promptly" while balancing other considerations, such as maintaining a positive working relationship with the executive and the incentive effects on current and future short-term and long-term incentive grants. The committee can then present a potential source of funds determination to the officer along with the clawback calculations.

At the end of this step, the committee will need to authorize the appropriate company official to execute whichever action it determines is necessary to effectuate the clawback. This may be required even if a demand letter was sent mandating how the payment would be made if instead an alternative source of funds is identified.

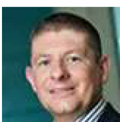
Step 4: Document calculations and processes. Each of the prior steps involves the clawback team documenting the process, decisions and calculation in a formal written report. This would include the details of the calculation, the event study (if needed), the assumptions and estimates made as part of the process, and how the source of funds issue was resolved. Our view is that this report would be preserved both to advise future restatement-related clawback actions and to serve as backup should the clawback action become the subject of shareholder lawsuits.

This report would then be the source for the Item 402(w) proxy disclosure that describes the relevant information requested in summary form. The report would also be the basis for amended Summary Compensation Table disclosures — and perhaps other tables within the tabular disclosures whose values may have changed. Similarly, these changes would also influence changes to the Item 402(v) Pay Versus Performance disclosures, both as the compensation actually paid and any previously disclosed performance metrics the restatement will have changed.

Authors

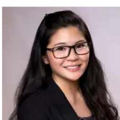
Steve Seelig (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Steve%20Seelig])
Senior Director, Executive Compensation

Email (mailto:steven.seelig@wtwco.com) **+1 703 258 7623** (tel:+1 703 258 7623)



Rich Luss
Senior Director in Research

Email (mailto:richard.luss@willistowerswatson.com)



Jamie Teo (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Jamie%20Teo])
Director, Talent and Rewards (New York)

Email (mailto:jamie.teo@willistowerswatson.com)

WEBCAST

Driving resilience: Executive compensation in a dynamic environment

December 14, 2023 - 1 p.m. ET

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4 steps for executing clawbacks after your restatement

By Steve Seelig (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Steve%20Seelig])**,**
Rich Luss (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Rich%20Luss]) **and**
Jamie Teo (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Jamie%20Teo]) **| March 6, 2024**

Learn the essentials steps for recouping erroneously paid incentive compensation.

Effective on October 2, 2023, restatements of companies' financial statements will trigger mandatory clawbacks of executives' incentive-based compensation payments. This article seeks to provide a step-by-step summary of how a company would claw back erroneously paid incentive compensation.

The process is detail-intensive but is scalable to meet every organization's unique circumstances. Our suggestion is to start is with:

- A formal, written process of repeatable actions that can be quickly delegated
- A timeline that ensures those involved can help the company exercise the clawback "reasonably promptly," per the U.S. Securities and Exchange Commission's (SECs) regulatory requirement.

After that, there are four essential steps every organization needs to follow, which fall under the assumption that the compensation committee is responsible for administering and enforcing the clawback.

Step 1: Make key process decisions up front

Soon after restatement, the compensation committee should convene a special meeting to decide how the process will work and who will help assemble the needed data. There are several agenda items to include in that meeting.

Potential impact on incentive pay

Management should be prepared to provide a summary of the potential impact of the restatement on all elements of incentive compensation.

Data and documentation

Identify who from management will provide the financial data, compensation plans, meeting minutes and any other relevant information to the team charged with performing the calculations.

Clawback team management

Fundamentally, the compensation committee must consider conflict-of-interest questions when management helps determine clawback values. This risk diminishes when clawback amounts are smaller – the calculation is simpler and there are fewer assumptions or judgment calls needed to complete the calculation.

However, when more money is at stake, it is more likely that both shareholders and officers will question the results and ask about the source of funds, state legal authority and individual taxation. Additionally, the calculations become more complicated, and that makes the objections more plausible.

For these reasons, the committee will hire its own legal counsel and compensation experts to form the clawback team. You also may want to preserve the attorney-client privilege in communications among the committee, the clawback team and executive officers as much as possible.

Expectations and timing

The clawback team's deliverables will include:

- A complete compensation review report that details all compensation potentially affected
- A calculation methodology report that provides details on the methodology employed as well as actual calculations
- A presentation of the potential sources of funds to satisfy the clawback
- A recommended proxy disclosure

A timeline for completion of each deliverable also should be established.

Recovery

After the committee determines the amounts subject to clawback, it must understand who has the legal authority within the company to carry out the recovery and ensure it is completed with a preset time frame.

Step 2: Perform the calculations

To calculate the clawback, the clawback team needs to execute the fundamental steps outlined in its listing exchange's manual. The process and dependencies established in Step 1 will help govern how the data and information changes hands. That process and those dependencies also will identify who is involved in the following list of to-dos for the three fiscal years completed immediately preceding the restatement (i.e., the lookback period):

- Identify everyone who was an executive officer any time during the lookback period
- Determine if incentive compensation was granted, paid or vested during the lookback period
- Calculate the extent to which incentive compensation must be clawed back

While identifying executive officers during the lookback period is mostly straightforward, determining incentive compensation grants and calculating how much must be clawed back are more complicated.

Determine incentive compensation

Complications can arise when reviewing the documentation about how compensation levels were determined, and pay was settled for each compensation element received during the lookback period. The first issue to address is identifying elements of compensation that aren't obviously incentive compensation but still might be affected by the restatement (https://www.wtwco.com/en-us/insights/2024/03/expose-your-executive-pay-plans-clawback-vulnerabilities) (e.g., salary increases based on prior-year financial results, compensation deferred into a nonqualified plan based on a prior-year bonus).

The second issue involves looking at pay that is clearly incentive compensation (e.g., annual bonus) and figuring out which portion might be attributable to non-financial performance, whether based on a specific non-financial metric or at the committee's discretion. Making this determination requires a review of plan documents, grant agreements and so on, plus reading committee reports and minutes to eliminate compensation not based on financial reporting measures. When there isn't enough documentation, the committee likely will err on the side of including that compensation in the clawback amount.

Calculate the clawback

Most of this work is straightforward math; however, in some cases powerful statistical tools may be required to calculate the value of erroneously paid incentive compensation. This work becomes complicated when incentive pay previously received was calculated based on stock price or total shareholder return performance that is affected by a restated financial metric.

The regulations outline the SEC's understanding that trying to determine what stock prices would have been if the restated financials had been presented accurately for prior fiscal years isn't a simple quantification exercise. Determining "what could have been" requires companies to make a reasonable estimate using a statistical tool like an event study, which is often used in accounting, finance and economics.

An event study estimates the expected impact of specific actions or activities (an event) over a specific time (the event window) on stock price returns. There are two types of event studies:

- **Multi-firm event study**: Looks at the average stock price movement of many firms that experienced the same type of event (e.g., announcing a stock repurchase, being the target of a merger, announcing an earnings restatement) over the same period of event time (i.e., time relative to when the event occurred vs. calendar time)
- **Single-firm event study**: Focuses on the shareholder returns for the company relative to its specific event (i.e., stock price movements from one week before to two weeks after the date that the organization announced its restatement)

While multi-firm event studies are more common in academic work, single-firm event studies have been recognized in securities fraud litigation in the Delaware Chancery as a preferred method for determining the impact of a particular event on share price.

Using event studies

The mechanics may be complicated to execute, but they're relatively straightforward to explain. An event study starts by looking at the correlation between share price movements of a company and a peer group over a period significantly before the restatement. This establishes a baseline of how the company share price moves relative to its peer group. This is what economists call normal conditions based on this pre-event period.

Next, look at the company's shareholder returns and those of peer-group firms from just before to just after the restatement (the event period). The goal is to determine the abnormal impact on share prices due to the restatement, which is the difference between the actual shareholder returns during the restatement's event period and the expected returns under normal conditions compared with the peer group.

It is important to note that not all stock plans or total shareholder return-based plans will require an event study for every restatement. The clawback team may need to conduct a lot of homework before the company knows one way or the other. There are several factors that will influence this determination (see Figure 1).

	Reasonable estimates may suffice	Event study needed
Inflection points in plan	Fewer hurdles and greater distance to next lowest hurdle	More hurdles and shorter distance to next lowest hurdle
Stock movement at restatement	Tepid movement when announced	Large share price change when announced
Market volatility	Lower volatility at original filing and restatement date	Higher volatility at original filing and restatement date
Proportion of pay affected	Lower percentage of incentive compensation	Lower percentage of incentive compensation
Magnitude of restatement	Lower value restated	Higher value restated
Cause of restatement	Change in accounting convention/audit firm	Systemic failure causing reputational harm

Figure 1. Inflection points in the plan, stock movement at retirement, market volatility, amount of pay affected, restatement magnitude and cause of restatement are factors to consider in deciding whether an event study is needed

Step 3: Determine the source of clawback funds

Some clawback policies are written narrowly so that the committee must send a demand letter to the officer for repayment. The committee would seek other funding sources only if the officer delays in responding. Other policies are so broad that the committee has the sole discretion to determine of the funds are received via direct repayment or recoupment from compensation still held by the company.

We recommend that the committee decide the clawback funding source after a discussion with the officer about their preferences. The executive's ability to repay the money directly rather than holding back other pay (and the tax considerations of doing so) is the primary focus. Not only does this promote good will, it also expedites the committee's ability to act reasonably promptly.

These informal discussions are just that, as every policy we've seen makes clear that the committee has the sole discretion to determine the fund source. When a clawback applies to a former officer, unless funds remain held by the company, the committee might skip this step and simply issue a demand letter for the funds owed.

To prepare for this discussion, the committee needs to understand the extent to which an executive holds company shares, either on an after-tax basis or based on those still held by the company. This information should be readily available so the committee can determine whether the officer holds sufficient shares to satisfy the clawback while factoring in any company share-ownership requirements or if previously paid shares are still available to satisfy the clawback.

The committee also should understand the financial value available from alternative sources. Counsel must advise whether these would be permissible sources under state and federal law (including the tax code):

- **Cancel in-flight cash or equity awards**. There are pros and cons when considering cancelling or reducing outstanding tranches of cash bonuses and long-term incentives (LTIs). The company might find the cash bonus to be more accessible and easier to calculate and then simply cancel, while the officer might prefer to forfeit equity to be paid in the future rather than give up current cash. Determining which equity would be cancelled and at when during the performance cycle requires the committee to resolve some tough valuation questions.
- **Offset future cash or equity payments**. The preamble to the SEC regulations suggests this also could be a viable approach. Calculating how future payments are reduced is relatively straightforward math. Executives may be more receptive to a reduction of future pay not yet granted. Of course, the rub here is that the committee would need to substantiate the reduction in future pay that was previously promised.
- **Forfeit deferred compensation**. Section 409A makes this a bit tricky. While the regulations permit a forfeiture of deferrals if the plan specifies, most plans don't specify that forfeitures can happen due to a clawback. We anticipate most committees have amended plans to specify that future deferrals would be subject to a clawback. Tax advisors have a variety of views on this and should advise on the implications of forfeiting deferred compensation.

Regardless of whether the committee talks with the officer, the goal is to permit the committee to determine the best source of funds so it can act reasonably promptly while balancing other considerations (e.g., maintaining a positive relationship with the executive, incentive effects on current and future short- and long-term incentive grants). The committee can then present a potential source of funds determination to the officer along with the clawback calculations.

At the end of this step, the committee needs to authorize the appropriate company official to effectuate the clawback. This may be required if a demand letter is sent mandating how the payment is to be made if an alternative source of funds is identified.

Step 4: Document calculations and processes

The first three steps involve the clawback team documenting the process, decisions and calculations in a formal written report that includes:

- Details of the calculation
- Event study (if needed)
- Assumptions and estimates made as part of the process
- How the source funds issue is resolved

This report – step 4 – should be preserved both to advise future restatement-related clawback actions and serve as a backup if the clawback action becomes the subject of shareholder lawsuits. The report also is:

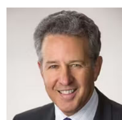
- The source for the Item 402(w) proxy disclosure that describes the relevant information requested in summary form
- The basis for amended summary compensation table disclosures
- Perhaps the basis for other tables within the tabular disclosures whose values may have changed

These changes also influence changes to the Item 402(v) pay versus performance disclosures, both as the compensation actually paid and any previously disclosed performance metrics the restatement changes.

Stay calm and claw back

Identifying how your company's clawback policy will work is no easy feat. However, maintaining a level head, having the right processes in place and collaborating with the right partners – both internally and externally – will get you from restatement to recoupment in this first year of mandatory disclosures.

Authors



Steve Seelig (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Steve%20Seelig])
Senior Director, Executive Compensation

Email (mailto:steven.seelig@wtwco.com) **+1 703 258 7623** (tel:+1 703 258 7623)

Rich Luss
Senior Director in Research

Email (mailto:richard.luss@willistowerswatson.com)

Jamie Teo (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Jamie%20Teo])
Director, Executive Compensation and Board Advisory (Seattle)

Email (mailto:jamie.teo@willistowerswatson.com)

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How companies will claw back executive incentive compensation

By Steve Seelig (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Steve%20Seelig])
and
William "Bill" Kalten (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[William%20%E2%80%9CBill%E2%80%9D%20Kalten])
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Mandatory clawbacks are here. Find out where organizations are starting from to recoup incentive-based pay.

While some organizations may be planning to rely on the compensation committee to deem executive incentive recoupment costs as "impracticable" so they can avoid enforcing now mandatory clawback regulations, this is not a get-out-of-jail-free card.

Companies must disclose why recoupment is impracticable, including details about how they calculated the amounts to be recouped. There is an overarching concern that shareholders, proxy advisors and the media will question the calculation that supports not seeking recoupment. We also anticipate that these same audiences will ask why the company did not have a mechanism in place to help ensure that officer-earned compensation is within reach.

Determining the source of funds to execute a clawback for current employees is straightforward: A ready source of funds exists based on future pay. The U.S. Securities and Exchange Commission (SEC) has said that, after a restatement, companies must act "reasonably promptly" to recoup funds, and that directors and officers who are charged with safeguarding the company's assets will pursue the most appropriate balance of cost and speed when deciding the right way to recover funds.

Until restatements happen, we will not know if companies adopted a hierarchy outlining the sources they will pursue first, but sources certainly do exist. It is just a matter of figuring out the "who" and "how."

For current officers

If officers must meet certain share ownership requirements either as shareholders or beneficial owners, companies could mandate in advance that those shares be the readiest source of a clawback, especially if they are still in the company's possession. The same could apply for shares not yet beneficially owned (e.g., performance shares that have not vested).

Clawback policies leave the decision as to source of funds up to the compensation committee. Nonetheless, we think that the committee should have at least an informal discussion as to the source current officers would prefer to use to fund the clawback, whether from future pay, existing stock holdings or ready cash. Not only may the officer not have after-tax funds available, they also may prefer to withhold from future pay if they determine the tax impacts to be beneficial. Having a meaningful discussion about the options will help the committee act as quickly as possible to recoup the required pay.

For former officers

Companies often do not have access to a ready source to fund a clawback after an officer leaves, but there are exceptions. Check to see if options remain outstanding or if full-value shares are not settled until a date after retirement (e.g., end of a performance period). It may be that existing deferral arrangements may delay payment until a future date.

In the U.S., it is rare for companies to hold back pay post-termination for its senior executives, except for non-qualified deferred compensation where payment is delayed for 6 months. We wonder if, after there are some high-profile cases where companies are unable to recoup funds from former officers, we might see a push from proxy advisors and shareholder advocates to create mandatory deferrals that are held back for a fixed time (e.g., two years) post-termination.

Remember 409A

Assuming a company wanted a mandatory deferral mechanism, section 409A of the Internal Revenue Code requires that deferrals be paid on a fixed-distribution date that applies to all officers. This could be as simple as holding part of an annual bonus to pay out at the end of year one, two or three for every executive regardless of whether they are still employed.

The goal is to try to match the total deferrals held by the company with the potential amount required to be clawed back. Companies need to make sure the deferrals are subject to a legally enforceable forfeiture provision in the case of a restatement. Using an existing deferral program may be difficult unless such a forfeiture provision already existed in anticipation of this year's mandatory rules.

The silver lining of mandatory deferrals

Current officers can also benefit if mandatory deferrals are the source of funds because much of the hierarchy of clawback sources goes away – the deferrals are the source. Deferrals also solve the problem of forcing officers who pay clawbacks with after-tax dollars being forced to claim a miscellaneous deduction or seek relief under the "claim of right" doctrine to recoup paid taxes. Deferrals are not taxed until they are distributed and, presumably, will not be taxed ever if the amount is forfeited because of a restatement.

Think through how this process will work

We expect that any company that issues a restatement this year (and for years to come) will be under intense scrutiny from shareholders and the regulators. Now is the time to consider exactly how the source of funds question will be answered and plan for how the committee will be best informed to work with officers to manage the process. Companies should not anticipate they should use the "impracticable" exception to explain why a clawback did not happen.

Authors

Steve Seelig (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[Steve%20Seelig])
Senior Director, Executive Compensation

Email (mailto:steven.seelig@wtwco.com) **+1 703 258 7623** (tel:+1 703 258 7623)

William "Bill" Kalten (https://www.wtwco.com/en-us/insights/all-insights#sort=%40fdate13762%20descending&f:@authors=[William%20%E2%80%9CBill%E2%80%9D%20Kalten])
Senior Director, Retirement and Executive Compensation

Email (mailto:william.kalten@wtwco.com) **+1 203 326 4625** (tel:+1 203 326 4625)

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SEC Clawback Rules: Practical Considerations and FAQs

The FAQs offer practical advice for listed companies implementing compliant policies.

Key Points:

- By December 1, 2023, all companies listed on the NYSE or Nasdaq must adopt clawback policies that comply with listing standards mandated by the SEC (the SEC Clawback Rules).
- This requirement to adopt new compliant clawback policies applies to all US-listed companies, including listed foreign private issuers (FPIs).

Adopting a Clawback Policy

1. When will companies need to publicly disclose their policies?

Companies must file their policy as an exhibit to their first annual report filed on or after December 1, 2023 (Form 10-K for US domestic issuers, Form 20-F for FPIs, Form 40-F for filers under the multi-jurisdictional disclosure system (MJDS), and Form N-CSR for registered management investment companies).

The SEC Staff has clarified that companies need not provide checkbox and other clawback-related disclosure "until they are *required to* have a recovery policy under the applicable listing standard" — that is, December 1, 2023, even though the rules and forms already include checkboxes and other disclosure requirements. See Compliance and Disclosure Interpretation (C&DI) 121H.01 (emphasis added).

We believe the guidance in C&DI 121H.01 resolves any ambiguity potentially arising under the SEC releases approving the Nasdaq and NYSE listing standards, in which the SEC provided that listed issuers must provide "the *required* disclosures in the applicable Commission filings on or after the effective date of October 2, 2023" (emphasis added). In particular, C&DI 121H.01 clarifies that compliance with the required disclosures, including the exhibit filing, is not expected until December 1, 2023, when the recovery policy becomes mandatory under the listing standards.

2. Does adopting the policy trigger a Form 8-K?

No. Adopting the policy does not trigger a Form 8-K, nor are companies required to post their policy on their website.

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3. What happens if a company fails to adopt a compliant policy by the deadline?

While unlikely, companies may be subject to potential delisting if they do not adopt a policy by the deadline.

If Nasdaq determines that a compliance failure has occurred (including a failure to adopt a policy by the deadline), it will immediately notify the company. Within four business days of receipt of the notification, the company must issue a press release disclosing the failure. The company must also submit to Nasdaq a plan for regaining compliance within 45 days. Nasdaq can then provide the company an extension of up to 180 days to cure the deficiency. If the company does not cure the failure within the cure period provided by Nasdaq (including any extension), Nasdaq will issue a delisting letter.

NYSE-listed companies are obligated to notify the NYSE within five days of any failure to comply with the SEC Clawback Rules (including a failure to adopt a policy by the deadline). If the NYSE determines that a failure has occurred, it will promptly notify the company. Within five days of receipt of the notification, the company must contact the NYSE to discuss the status of the delinquency and issue a press release disclosing the delinquency. The NYSE may provide the company with an initial six-month cure period. If the company does not cure the failure during the initial cure period, the NYSE may grant up to an additional six-month cure period before commencing delisting procedures. Notwithstanding the foregoing, the NYSE may commence suspension and delisting procedures without affording any cure period at all based on an analysis of all relevant factors.

No later than December 31, 2023, NYSE-listed companies are also required to confirm via Listing Manager their compliance with the SEC Clawback Rules.

4. If a company adopts its policy after the deadline but before its Form 10-K filing (or Form 20-F or Form 40-F, in the case of FPIs and MJDS filers), will the NYSE and Nasdaq really begin delisting procedures, given that the compliance failure will have been cured?

Both the NYSE and Nasdaq have traditionally been receptive to companies' response letters in delisting situations, so we expect that companies will be given the opportunity to explain the delay. But even if companies are permitted to cure the adoption failure (or granted quick relief for having cured it by the time the failure is public), the failure will be public because the company will be required to file a Form 8-K if it becomes aware of any material noncompliance with a listing standard or is notified by the applicable exchange. This public disclosure could cause negative pressure on the company's stock as a result.

Neither the NYSE nor Nasdaq has expressly stated that the noncompliance discussed above would trigger the filing of a Form 6-K, but FPIs will still need to issue a press release in accordance with the NYSE and Nasdaq listing rules.

5. Why are some companies choosing to maintain their existing clawback policies while also adopting a new separate policy in response to the SEC Clawback Rules? In that case, does the company need to file only the new policy that addresses the SEC Clawback Rules?

Many companies have existing compensation recovery policies that are broader in scope than the SEC Clawback Rules. For example, an existing policy may (i) apply to a larger group of employees beyond current and former executive officers; (ii) allow for the clawback of compensation beyond the portion of incentive-based compensation that was erroneously received; and/or (iii) include

recoupment triggers that go beyond an accounting restatement, such as misconduct causing reputational harm or breach of restrictive covenants. Compensation committees will need to decide whether to retain the broader aspects of their existing policies — a decision that will be informed by the reasons and facts surrounding the adoption of the original policies and whether those continue to be applicable.

From a governance perspective and in order to be responsive to institutional investors and advisory firms, many companies are choosing to retain the broader aspects of their existing clawback policies, either by retaining their existing policies as a separate policy or by integrating these broader aspects and the SEC Clawback Rules into one policy. With either approach, companies should retain any discretion afforded to the board of directors and administrators in respect of any retained aspect of an existing policy that goes beyond the SEC Clawback Rules.

Companies that retain their existing policies as a separate policy will only need to file the policy that is compliant with the SEC Clawback Rules.

6. Are there changes that can be made to existing compensation programs or other actions that can be taken to improve the enforceability of clawback policies? Should companies amend officer employment contracts to require compliance with new clawback policies, including for officers who later leave the company?

In response to a recent federal court case challenging the enforceability of clawback policies (in this case, prior to the stock exchange rules mandating clawbacks), some companies are requiring that executive officers sign acknowledgments agreeing to comply with the terms of those policies and to the recovery of compensation in accordance with the terms of the policies, notwithstanding any other contractual obligation to the contrary. The acknowledgments provide the company with a contractual basis to enforce the policy. Similar language can also be included in go-forward compensation arrangements, including employment agreements, cash incentive plans, equity incentive plans, and award agreements, as well as in severance agreements for departing executives.

However, acknowledgments from covered officers are not required by the SEC Clawback Rules. Companies should consult outside counsel in making this decision, as boards exercising their business judgment can make reasonable determinations for or against requiring such acknowledgments.

7. Which governance body of the company should administer the policy?

The SEC Clawback Rules require that a committee composed of independent directors charged with oversight of executive compensation, or the independent members of the board of directors, must make any determination that the recovery of erroneously awarded compensation would be impracticable. Otherwise, the SEC Clawback Rules do not explicitly prescribe which governing body of the company must administer other aspects of the clawback policy. In practice, we expect that most companies will administer their clawback policies through the compensation committees of their boards. We recommend that issuers add to their compensation committee charters (if not already included) the responsibility for overseeing and administering the clawback policy.

Enforcing a Clawback Policy

8. What types of restatements trigger a recovery under the rules? What is a “little r” restatement? What is an out-of-period adjustment?

Rule 10D-1 requires the clawback of erroneously awarded incentive-based compensation received by executive officers after an accounting restatement.

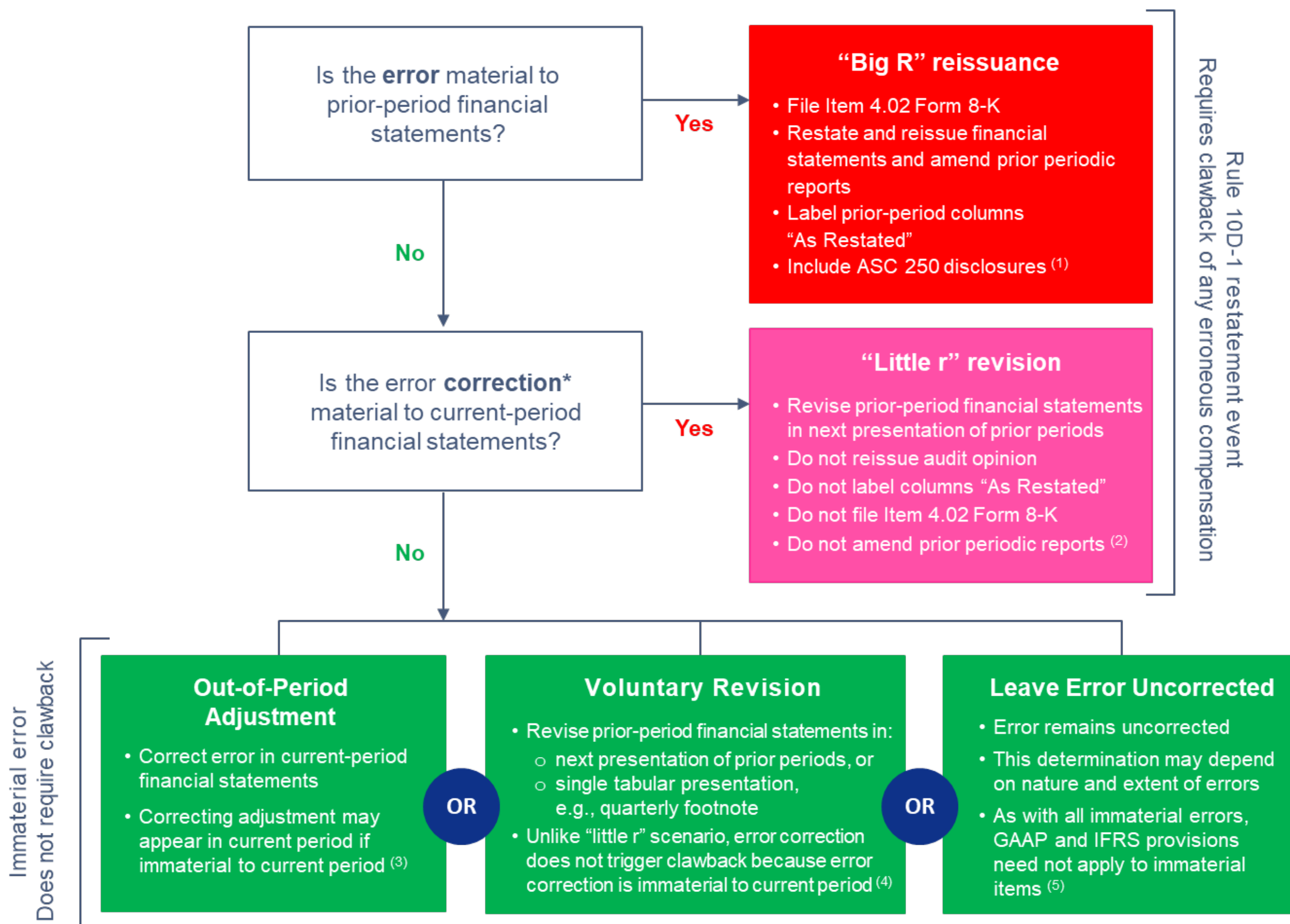
The rule includes a novel definition of an accounting restatement. The new definition’s unprecedented breadth captures not only the traditional understanding of an ASC 250 restatement “to correct an error in previously issued financial statements that is material to the previously issued financial statements” (i.e., a “Big R” restatement), but also a type of immaterial error correction process for an *unreported* error “that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period” (i.e., a “little r” restatement).

The distinction between the “Big R” and “little r” scenarios hinges on whether an error identified in prior-period financial statements is material. If so, the company must correct the prior-period material error via “Big R” restatement and then determine whether executive officers received erroneously awarded compensation requiring clawback.

If the error identified in prior-period financial statements is not material, the company must evaluate whether the error correction is material to the current period. That question focuses on whether correcting the prior-period error in the current period (or leaving the error uncorrected) would materially misstate the current-period financial statements:

- If so, the company must revise the prior-period financial statements to correct the immaterial error via a “little r” restatement and then, as with a “Big R” restatement, determine whether executive officers received erroneously awarded compensation requiring clawback.
- If not, the company may correct the error in the current period through an immaterial error correction process. An out-of-period adjustment is the preferred method of correcting an immaterial error. In some cases, depending on the circumstances, the company may instead use a voluntary revision or even leave the immaterial error uncorrected. In each of these three scenarios, the company need not undertake a clawback analysis.

The flowchart on the following page summarizes each of these steps.



* Under Rule 10D-1(b)(1), the question is whether correcting the prior-period error in the current period (or leaving the error uncorrected) would materially misstate the current-period financial statements.

(1) ASC 250-10-50-7 requires, for the correction of a material error in previously issued financial statements: "When financial statements are restated to correct an error, the entity shall disclose that its previously issued financial statements have been restated, along with a description of the nature of the error. . . . The effect of the correction on each financial statement line item and any per-share amounts affected for each prior period presented. . . . The cumulative effect of the change on retained earnings or other appropriate components of equity or net assets in the statement of financial position, as of the beginning of the earliest period presented." Reissued financial statements in a "Big R" restatement must be labeled "Restated" — hence the "Big R" — whereas revised financial statements in a "little r" restatement should not bear the "Big R" label.

(2) Revised financial statements are not labeled "Restated." Optional narrative disclosure may accompany the error corrections. The financial statement audit opinion is not reissued, although the identification of a material weakness in internal control over financial reporting (ICFR) could require reissuance of the ICFR audit opinion. Form 10-K now includes two Rule 10D-1 checkboxes, an error-correction checkbox, and a clawback-analysis checkbox: (i) a company must check the first, error-correction checkbox if the financial statements in the filing include any error correction, irrespective of materiality, relating to previously issued financial statements; and (ii) a company must check the second, clawback-analysis checkbox only if the filing includes an error correction resulting from a restatement as specifically defined in Rule 10D-1 (i.e., a "Big R" restatement or a "little r" restatement) because, absent the checkbox, a reader would have no way to distinguish a "little r" restatement from a voluntary revision.

(3) The out-of-period adjustment is the most common approach for immaterial error corrections. The correcting adjustment may appear in the current period only if the adjustment is deemed immaterial to the current period financial statements.

(4) Voluntary revisions are most commonly used to correct balance sheet or cash flow errors but otherwise are often avoided to minimize potential confusion with "little r" restatements.

(5) *See* ASC 105-10-05-6 ("The provisions of the [Accounting Standards] Codification need not be applied to immaterial items."); *see also* IAS 8, ¶ 8 (noting that IFRS policies "need not be applied when the effect of applying them is immaterial"). These principles supply the basis for leaving immaterial errors uncorrected and also apply to each of the other types of error correction approaches. However, companies can reduce the risk of both "Big R" and "little r" restatements by correcting all known errors, including immaterial errors, during the period in which the error is first identified.

9. Who determines whether an accounting error requires a restatement?

The identification and evaluation of financial statement errors requires careful analysis by management and outside auditors, and the oversight of the audit committee of the board of directors. Whether a restatement will be required depends on an evaluation of the materiality of errors in prior periods and the materiality of the possible correction of those errors in the current period. As described above, where prior-period errors are material, that requires a "Big R" restatement. Where prior-period errors are immaterial but a correcting adjustment in the current period would result in a material misstatement of the current period, that requires a "little r" restatement, in which the immaterial errors occurring in prior periods are corrected to avoid a material misstatement in the current period. These materiality determinations are often complex and require substantial time and effort by management and outside auditors, all with the oversight and ultimate review and conclusion by the audit committee of the board of directors. This determination should be informed by relevant facts and circumstances and requires a detailed materiality analysis using applicable guidance, including Staff Accounting Bulletin No. 99 and Staff Accounting Bulletin No. 108.

10. Will procedures with respect to errors that are identified in financial statements and related materiality analysis change in the face of the new clawback rules?

The playbook for assessing and correcting accounting errors will now change. Until now, the key distinction has been between "Big R" restatements versus other types of error corrections, since "Big R" restatements trigger the filing of an Item 4.02 Form 8-K (in the case of a US domestic registrant) to disclose that previously issued financial statements should no longer be relied upon and require correction via amendment to prior periodic reports. Now, "little r" restatements can also have a significant impact on an issuer by reason of application of the SEC Clawback Rules, even if prior-period financial statements contain no material errors and therefore may continue to be relied upon.

The SEC's release provides that:

> "The involvement of an independent auditor in evaluating management's materiality analyses, with the oversight of the audit committee, protects investor interests by helping ensure that material errors do not go uncorrected by an issuer seeking to avoid the recovery of erroneously awarded compensation. Furthermore, we note the potential serious consequences, including but not limited to Commission enforcement action and private litigation, of mischaracterizing material accounting errors as immaterial."

For these reasons, the SEC did not adopt a requirement for a company to disclose the materiality analysis of an error if the company determines the error is immaterial.

The nature of a no-fault clawback policy triggered only by accounting restatements puts increased pressure on directors and employees who are responsible for reviewing financial statements and the materiality of any errors. As a result, companies are reassessing their financial reporting function to ensure that they are appropriately investing in sufficient personnel with the necessary expertise in GAAP or IFRS requirements and robust internal control over financial reporting, which is every company's first line of defense in avoiding financial statement errors.

11. What steps should a company take once it determines that a restatement is required?

Once a company has determined that a restatement is required, it should assess whether any of its current or former executive officers' compensation is subject to recovery.

A company should:

- Determine whether any incentive compensation was earned or vested based wholly or in part on a financial reporting measure that is restated as a result of the restatement or stock price or total shareholder return (TSR) metrics. Remember that the recovery analysis must also evaluate derivative forms of incentive compensation, including other payments that were calculated based on such incentive compensation.
- Determine if any current or former "executive officers" (as defined under Rule 10D-1) "received" the incentive compensation on or after October 2, 2023, and during the three completed fiscal years prior to the date the restatement determination is made. For purposes of this determination, compensation is received when the applicable financial reporting measure is attained.
- Confirm which current or former executive officers (1) received the incentive compensation after beginning service as executive officers, and (2) were executive officers during at least a portion of the applicable performance period.

  - For example, if an individual is an executive officer during the beginning of the performance period for performance stock units (PSUs) tied to a financial reporting measure, but then transitions to a non-executive officer role before the PSUs are earned, the PSUs earned by this individual could be recoverable under the clawback policy, even if the individual did not serve as an executive officer either (1) at the time the PSUs were received or (2) when the company determines that a restatement is required. On the other hand, if an individual is not an executive officer during any part of the performance period for the PSUs, but transitions to an executive officer role prior to the date the company determines a restatement is required, the individual's incentive compensation would not be subject to recovery because the individual did not serve as an executive officer during any part of the performance period.

- Determine what portion of the incentive compensation was "erroneously awarded" or, in other words, was in excess of the amount of compensation that would have been earned based on the restated financial measure. Companies may use "reasonable estimates" when determining the impact of a restatement on incentive compensation based on stock price and TSR results, as further discussed in Question 12 below.
- Assess whether the recovery of the excess compensation would be "impracticable" (e.g., the direct costs paid to third parties to enforce recovery would exceed the excess compensation after reasonable attempts, or the recovery would violate home-country law or jeopardize the qualified status of a tax-qualified retirement plan, as further discussed in Question 15 below).
- If recovery is not "impracticable," the company is required to recover, reasonably promptly, the excess compensation on a pre-tax basis, as further discussed in Questions 14, 16, 17, and 18 below.

Once a company determines that erroneously awarded compensation has been received by a covered executive officer and an impracticability exception does not apply, it should engage in discussions with the applicable governing body and counsel regarding the desired means of recovery, necessary disclosure obligations, and communications with the applicable executive officer.

12. How should companies measure an accounting restatement's impact on TSR and stock price metrics?

Generally, when a restatement is required and it impacts a financial reporting measure upon which incentive compensation was granted, earned, or paid, the amount of erroneously awarded compensation is subject to mathematical recalculation directly from the information in an accounting

restatement. However, for incentive-based compensation earned based on TSR or stock price, the SEC recognized that direct mathematical recalculation is likely not possible. The SEC further acknowledged that the calculations necessary to determine excess compensation based on stock price and TSR may require complex analyses, significant technical expertise, and specialized knowledge. The SEC, therefore, requires companies to use "reasonable estimates" when determining the impact of a restatement on incentive-based compensation based on stock price and TSR results. Companies are also required to disclose such reasonable estimates, as discussed further below, maintain documentation of the determination, and provide such documentation to the applicable stock exchange.

For example, a company may grant performance stock units that vest in tranches based on increases in the issuer's stock price (i.e., stock price milestones) over a 10-year period. If the company determines it must restate its financial statements for one of the years within the 10-year performance period, it should consider whether and how such restated financial statements may have impacted the issuer's stock price such that the officer received erroneously awarded compensation based on any earned tranches achieved during the three completed fiscal years prior to the date the restatement determination is made.

Companies are advised to work with in-house and outside counsel when evaluating whether and the extent to which a restated financial metric impacted the company's stock price or TSR performance and to take appropriate steps to document these analyses. Companies may also want to monitor peer group members' disclosures and recoveries in connection with any clawbacks based on stock price or TSR.

13. What are the required disclosure obligations when a clawback is triggered?

If a company is required to issue an accounting restatement that triggers a clawback of erroneously awarded incentive-based compensation, it must comply with two new disclosure requirements under Item 402 of Regulation S-K (and analogous disclosure provisions in the forms applicable to FPIs and MJDS in Forms 20-F and 40-F).

First, as part of the executive compensation disclosure provisions in new Item 402(w) of Regulation S-K, if at any time during or after the last completed fiscal year the company was required to prepare an accounting restatement that required recovery pursuant to the clawback policy, or there was an outstanding balance as of the end of the last completed fiscal year of erroneously awarded compensation to be recovered from the application of the policy to a prior restatement, the company must provide in its proxy statement (and Part III of its annual report on Form 10-K):

- the date on which the company was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded incentive-based compensation attributable to such accounting restatement (including an analysis of how the recoverable amount was calculated) or, if the amount has not yet been determined, an explanation of the reasons and disclosure of the amount and related disclosures in the next filing that is subject to Item 402 of Regulation S-K;
- the aggregate amount of incentive-based compensation that was erroneously awarded and that remains outstanding at the end of the last completed fiscal year;
- if the financial reporting measure related to a stock price or TSR metric, any estimates used in determining the amount and an explanation of the methodology used for such estimates;
- any outstanding amounts due from any current or former named executive officer for 180 days or more, separately identified for each named executive officer; and

- 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, the amount of recovery forgone and a brief description of the reason the listed registrant decided in each case not to pursue recovery.

In addition, companies must disclose in the Summary Compensation Table the effect of any recovered amounts, which will be deducted from the applicable column in the table for the year in which the recovered amount was originally reported and identified in a footnote to the table.

Further, a company will be required to check appropriate boxes on its Form 10-K (and analogous form appliable to FPIs and MJDS, such as Form 20-F and Form 40-F) regarding whether financial statements included in the filing reflect the correction of an error to previously issued financial statements and whether any of those error corrections are restatements that require a recovery analysis of incentive-based compensation received by its executive officers.

14. What is the timing for recovery?

Companies must pursue recovery under the clawback policy “reasonably promptly.” Although the SEC does not define the term, it expects companies and their executive officers to balance cost and speed when determining the appropriate means of recovering excess compensation to safeguard the time value of any potentially recoverable compensation.

Nasdaq and the NYSE clarified that they will use a holistic approach to assess whether an issuer’s recovery meets the “reasonably promptly” standard by considering whether the issuer’s recovery efforts strike a balance of cost versus speed and whether such efforts are appropriate in light of the facts and circumstances surrounding the recovery.

As discussed above, under the new disclosure requirement added to Item 402 of Regulation S-K, a company must disclose any erroneously awarded compensation that remains outstanding at the end of the last completed fiscal year and any amounts that are outstanding for 180 days or more. By acting efficiently to recover excess compensation, companies will minimize their ongoing disclosure obligations.

15. What level of discretion is permitted, if any?

The final rules only include limited impracticability exceptions whereby companies may forgo recovery if:

- the direct cost of recovery to third parties, including reasonable legal expenses and consulting fees, would exceed the recoverable amounts, and the company has made and documented reasonable attempts to recover the compensation and furnishes such documentation to the applicable exchange;
- the recovery would violate home-country law that was effective prior to November 28, 2022, and only if the company obtained and provided to the applicable exchange an opinion of home-country counsel, acceptable to the applicable exchange, establishing that recovery would result in such violation; or
- such recovery would jeopardize the qualified status of a tax-qualified retirement plan.

Any determination that recovery would be impracticable in any of the above three circumstances must be made by the issuer’s committee of independent directors that is responsible for executive compensation decisions, or if no such committee exists, the independent members of the board of directors.

In practice, companies have very limited discretion about whether to recover excess compensation, and there is no exception for de minimis amounts. In order to show that direct costs of recovery exceed the recoverable amounts, the company would still have to navigate the normal recovery process, run the calculations necessary to identify the recoverable amounts against which the enforcement costs would be measured, and ultimately attempt to enforce the clawback policy, all while monitoring and documenting the associated costs along the way to prove the recovery is a futile effort. To obtain an exemption for a home-country law violation — the second recovery exemption described above — the company must obtain an opinion of home-country counsel, and the exception is only applicable if the recovery would violate a home-country law that was effective prior to November 28, 2022. These requirements may result in companies having to enforce a clawback even in countries where the clawback would be prohibited, document those efforts, and then determine that recovery is impracticable due to costs under the first recovery exemption described above.

16. How does a company collect on a clawback? What if the executive officer has already been paid the compensation and paid tax on the compensation, or the excess compensation is in the form of shares that have already been sold? What if the officer does not have the liquid assets to return erroneously issued compensation?

The amount of incentive compensation that is subject to recovery is the amount the officer received in excess of the amount that would have been received based on the restated financial statements and is computed on a pre-tax basis. Recovery may include reduction or cancelation by the company of the excess incentive compensation, reimbursement or repayment by the officer and, to the extent permitted by law or the applicable incentive plan, an offset of the excess incentive compensation against other compensation payable by the company or an affiliate of the company to such person.

This recovery could result in a harsh outcome if an executive officer has already paid potentially 50% of the excess incentive compensation to tax authorities. As discussed in more detail below, elective or mandatory holdback or deferral policies that defer payment or settlement of incentive compensation that is potentially subject to clawback, until a date after the expiration of the potential recovery period, can help to mitigate these issues if structured in an appropriate manner. Where taxes have already been paid, Section 1341 of the Internal Revenue Code, which codifies the "claim of right" doctrine, may provide relief to an executive seeking to recoup taxes paid on compensation that is recovered under the SEC Clawback Rules. Section 1341 is designed to allow a taxpayer who receives income in one year and repays it in a later year to be in the same income tax position as having not received the income at all by receiving a tax deduction or credit for the year of recovery. Executives and their advisers will need to determine Section 1341's application to a recovery under the SEC Clawback Rules based on the relevant facts and circumstances in each case. Finally, to the extent all or a portion of the excess incentive compensation has already been recovered pursuant to the Sarbanes-Oxley Act Section 304 or otherwise, the amount already recovered may be credited to the amount required to be recovered pursuant to the SEC Clawback Rules.

17. Does a company also need to recover any gains on the sale of shares that are determined to be excess incentive compensation?

A company will have to consider whether to recover any gains on the sale of shares that are determined to be excess incentive compensation. For example, a company may grant to an executive officer PSUs that vest based on return on invested capital over a three-year performance period ending in 2026, and in 2027, the officer decides to sell the shares that were earned upon vesting of the PSUs to a third party. The company then determines in 2028 that a restatement of its 2025 financial statements is necessary and that the PSUs awarded resulted in the officer receiving erroneously awarded compensation. Given that the shares have already been sold, the company

can determine whether to require reimbursement from the officer, offset the recovery against other compensation payable to the officer if permitted by applicable law (such as the officer's bonus compensation), and/or cancel any unvested equity compensation still held by the officer (including non-incentive based compensation). If the officer sold the shares at a gain, the company must determine whether the recovery value should only take into account the proceeds from the sale based on the fair market value of the shares at the time of settlement or also take into account the value of the appreciation from the time of settlement to the date of sale. While the SEC's proposed clawback rules issued in 2015 provided that if the excess shares have been sold, the recoverable amount would be the sale proceeds in respect to the excess number of shares, the final SEC Clawback Rules do not specifically address this treatment and do not expressly mandate the recovery of gains on the sale of shares that are excess incentive compensation. Instead the SEC's release provides that the determination will depend on the particular facts and circumstances applicable to that company and the executive officer's particular compensation arrangement and that companies and their boards will be in the best position to make these determinations.

18. What should a company do if a former officer contests whether a restatement was necessary and refuses to return the erroneously awarded compensation paid to the officer?

In the case of a former officer, there may not be any future compensation payable to offset the recovery against and/or any unvested equity compensation to cancel. As a result, if a company cannot come to agreement with the former officer, the company may need to pursue recovery against the former officer through a negotiated resolution or pursue litigation. The company will face delisting if it is not able to seek recovery of the erroneously awarded compensation, unless it has made a determination that recovery of the erroneously awarded compensation falls within one of the limited impracticability exceptions, including if the company can show that the direct cost of recovery to third parties, including reasonable legal expenses and consulting fees, would exceed the recoverable amounts, and the company has made and documented reasonable attempts to recover the compensation and furnishes such documentation to the applicable exchange. If recovery would be impracticable, the company will need to disclose in its proxy statement (and Part III of its annual report on Form 10-K) for each current and former named executive officer and for all other current and former executive officers as a group, the amount of recovery forgone and a brief description of the reason the company decided to not pursue recovery.

19. What is the shareholder litigation risk related to a clawback policy?

A significant number of law firms specialize in representing shareholder plaintiffs in challenges to public company corporate governance matters, including executive compensation and benefits matters. These firms may identify companies that are not in compliance with the rules and pursue demands or fiduciary duty claims against boards that they believe should execute a clawback or have not implemented sufficient clawbacks. These shareholder firms may identify other ways in which the company is not compliant with the clawback policy and demand changes to bring the company into compliance, or threaten derivative claims for failure to meet the relevant standards.

The rules could also potentially increase the risk of liability arising from private shareholder litigation associated with "Big R" or "little r" restatements. This risk is particularly acute for executive compensation programs based on stock price or TSR targets. For example, the rules contemplate that companies must assess and publicly disclose the stock price inflation associated with previously misstated financial statements. Companies should therefore take particular care and include counsel when evaluating the stock price impact of a restatement, if any.

Considerations to Mitigate the Impact of a Clawback Policy

20. What types of incentive-based compensation structures are outside the scope of the new clawback rules?

Non-financial reporting measures are not subject to clawback under the SEC Clawback Rules. Companies may therefore consider implementing incentive-based compensation that is less directly or not tied to financial reporting or TSR and stock price measures. For example, a company may currently sponsor a short-term incentive program with payouts tied to EBITDA (40% weight), free cash flow (30% weight), and a strategic objective based on meeting a research milestone (30% weight). Under this approach, if a covered restatement occurs, only the portion of the payouts based on achievement of the EBITDA and free cash flow objectives could be potentially recoverable (if the other criteria under the SEC Clawback Rules are satisfied), while the portion of the payouts based on the achievement of the strategic objective would not be subject to clawback under the policy. In this example, the company could consider shifting a higher weighting under the program to the research milestone to mitigate the impact of future restatements on the payouts under that program.

Similarly, incentive program designs that focus on annual performance periods, as opposed to multiyear performance periods, can also serve to limit the impact of a restatement on incentive compensation recovery obligations. For example, if a company grants PSUs in 2024 that are earned based on cumulative earnings per share (EPS) from 2024-2026, and the company determines in 2028 that it must restate its earnings reported in its 2025 financial statements, the entire amount of earned shares from the PSU award could be subject to recovery because the 2025 financial statements impact the cumulative EPS performance achievement for the entire three-year performance period. If instead the PSUs granted were subject to annual EPS achievement in each of 2024, 2025, and 2026, in this same scenario only the PSUs earned based on 2025 performance would be subject to recovery, as the remainder of the award would not have resulted in erroneously awarded compensation.

Further, the SEC Clawback Rules do not capture incentive awards that are granted without regard to achieving financial reporting measures, or if the vesting is solely based on continued service over time, as well as awards that are completely discretionary. While shifting some compensation to solely service-vesting compensation may be possible, significant shifts away from performance-based compensation to discretionary or solely service-vesting compensation will be viewed as a poor pay practice by institutional investors and advisory firms.

21. Should companies consider permitting executive officers to defer a portion of incentive compensation?

Due to the requirement to recover compensation on a pre-tax basis, companies may choose to implement deferral arrangements that give executive officers the election to defer payment of incentive-based compensation that is potentially subject to clawback until a date after the expiration of the recovery period. If properly structured, these types of delayed payments can potentially allow for a potential future clawback to draw from deferred amounts that have not yet been paid or subject to income tax, which may facilitate recoupment efforts because recovery is required on a pre-tax basis. Any deferral arrangements will need to be carefully reviewed in light of Section 409A of the Internal Revenue Code.

22. Can companies buy insurance or otherwise indemnify officers against the impact of the SEC Clawback Rules? How do the rules interact with indemnification agreements and bylaw provisions?

Companies are not permitted to indemnify or insure any person against losses under the SEC Clawback Rules, nor are they permitted to directly or indirectly pay or reimburse any person for any premiums for third-party insurance policies that such person may elect to purchase to fund such person's potential obligations under the SEC Clawback Rules.

Companies' organizational documents and indemnification agreements may include existing indemnification provisions that may appear to conflict with the SEC Clawback Rules. As part of the acknowledgement to the clawback policies, covered officers may be asked to acknowledge that they are not entitled to indemnification to the extent required by the SEC Clawback Rules.

Notably, the SEC Clawback Rules do not prohibit the right to advancement of expenses. Thus, an executive could still receive advancement for defense costs incurred in disputing a clawback if the company's organizational documents or indemnification agreements so provide. Without such right to advancement of expenses, an executive would need to go out-of-pocket to fight a potentially improper clawback action.

Other Considerations for Foreign Private Issuers

23. How should FPIs make their officer determinations?

The SEC has modeled the definition of "executive officer" under Rule 10A-3 on the definition of "officer" under Section 16 of the Exchange Act, which is the same definition as the Exchange Act definition of executive officer but also captures the principal accounting officer (or if there is no such accounting officer, the controller). Thus, the definition 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 (such as sales, administration, or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer.

FPIs, which are not subject to Section 16 of the Exchange Act, will need to determine which of their senior management are executive officers subject to the new clawback rules. We recommend that a company make the determination at the time the policy is first adopted and when a new executive officer commences employment or is promoted so that the officer can be put on notice and acknowledge the policy. FPIs may also choose to have their board or other governing bodies annually confirm the list of executive officers.

In selecting executive officers, we recommend that FPIs not designate a list that is more expansive than required by the rules, as it will have collateral impacts, including subjecting the officers to longer cooling off periods under the Rule 10b5-1 plan rules and additional disclosures related to company repurchases. The company's annual report on Form 20-F can still have a list of senior management that is different from the executive officer list.

24. How should FPIs address potential conflicts between the SEC Clawback Rules and obligations under the laws of their country of incorporation or laws of other jurisdictions where an executive may be domiciled?

In the final rule release, the SEC stated that while it recognizes some commenters' concerns that the SEC Clawback Rules could intrude into the public policy determinations of other nations or create a disincentive for foreign firms to list in the US, issuers that choose to list on US exchanges have chosen to be subject to the rules of those exchanges and the laws of the United States.

Thus, to the extent that recovery under the SEC Clawback Rules is inconsistent with a foreign regulatory regime, the SEC Clawback Rules provide FPIs with two limited impracticability exceptions whereby they may forgo recovery if:

- the direct cost of recovery to third parties, including reasonable legal expenses and consulting fees, would exceed the recoverable amounts, and the company has made and documented reasonable attempts to recover the compensation and furnishes such documentation to the applicable exchange; or
- the recovery would violate home-country law that was effective prior to November 28, 2022, and only if the company obtained and provided to the applicable exchange an opinion of home-country counsel, acceptable to the applicable exchange, establishing that recovery would result in such violation.

The final rule release states that the home-country law exception is limited to those laws in effect as of November 28, 2022, in order to minimize any incentive countries may have to change their laws in response to the SEC Clawback Rules. With respect to laws of jurisdictions outside of the issuer's home country (such as the jurisdiction of the issuer's corporate headquarters or the executive officer's residence), the final rule release provides that to the extent the laws of these other jurisdictions would present obstacles to recovery, those obstacles need to be addressed by the discretion to not pursue recovery in situations in which the direct costs of recovering the erroneously awarded compensation would exceed the amount to be recovered.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Keith L. Halverstam
keith.halverstam@lw.com
+1.212.906.1761
New York

Jenna B. Cooper
jenna.cooper@lw.com
+1.212.906.1324
New York

Joel H. Trotter
joel.trotter@lw.com
+1.202.637.2165
Washington, D.C.

Holly M. Bauer
holly.bauer@lw.com
+1.858.523.5482
San Diego

Maj Vaseghi
maj.vaseghi@lw.com
+1.650.470.4852
Silicon Valley

Colleen C. Smith
colleen.smith@lw.com
+1.858.523.3985
San Diego

Latham & Watkins Public Company Representation Practice
Latham & Watkins National Office
Latham & Watkins Executive Compensation, Employment & Benefits Practice

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SEC RELEASES FINAL CLAWBACK RULES

To Our Clients and Friends:

On October 26, 2022, the Securities and Exchange Commission ("SEC" or "Commission"), in a 3-to-2 vote, adopted final rules that will require listed companies to implement policies for recovery (*i.e.*, "clawback") of erroneously awarded incentive compensation, implementing Section 10D of the Securities Exchange Act, which was added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The SEC originally proposed clawback rules on July 14, 2015,[2] but the proposed rules remained dormant until October 14, 2021, when the SEC reopened the comment period[3] (and which was reopened for a second time on June 8, 2022).[4] The final rules add new Exchange Act Rule 10D-1 ("Rule 10D-1"), which largely tracks the long-pending proposed rules but also incorporate terms previewed in the 2021 release reopening the comment period.

Rule 10D-1 directs the national securities exchanges to establish listing standards that require issuers to adopt and comply with written clawback policies meeting strict conditions:

- The clawback policy must provide that, in the event the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the federal securities laws, the company will recover (on a pre-tax basis) the amount of incentive-based compensation received by its current and former executive officers in excess of the amount of incentive-based compensation that would have been received had it been determined based on the restated amount, subject to limited exceptions.

- Compensation recoupment is required regardless of whether the executive officer engaged in any misconduct and regardless of fault.

- The policy must apply to compensation "received"—which is defined as occurring when the financial reporting measure was attained regardless of when payment is actually made—during the three-year "recovery period" preceding the date the company is required to prepare the accounting restatement (the three-year period was mandated by the Dodd-Frank Act).

- The clawback policy must apply both to material accounting errors that require a restatement of prior years' financial results (commonly known as "Big R" restatements), *as well as* to errors that are corrected in the current year's results (commonly known as "little r" restatements).

In addition, the final rules require companies to file a copy of their policy as an exhibit to their Form 10-K, 20-F, 40-F or N-CSR, as applicable, and to publicly disclose how they have applied the policy whenever they experience a restatement. Rule 10D-1 also requires that issuers add two checkboxes to the cover page of their 10-Ks (or 20-Fs or 40-Fs): one checkbox to indicate whether the financial

statements included in the filing 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 Rule 10D-1 clawback policy.

Almost all issuers are subject to the clawback rules, including those companies that are otherwise excluded from other SEC disclosure requirements related to executive compensation. A company would be subject to delisting if it does not adopt and comply with an exchange-compliant clawback policy.

The final rules release is available here and a Fact Sheet (*Recovery of Erroneously Awarded Compensation*) is available here. Set forth below is a summary of the final rules and considerations for companies.

When the Rules Take Effect

Each exchange will be required to propose rules or rule amendments consistent with Rule 10D-1 no later than 90 days following the date of the publication of the rules in the Federal Register. The listing standards must be effective no later than one year following the final rules publication date. Each company subject to such listing standards must adopt a compliant recovery policy no later than 60 days following the date on which the applicable listing standards become effective. The mandated clawback policies must apply to any incentive-based compensation that is received by current or former executive officers on or after the effective date of the applicable listing standard (which is a modification from the proposed rules). Compliance with the disclosure requirements is required in the first annual report or proxy or information statement required to be filed after the effective date of the new listing standards.

Summary of the Final Rules

All listed companies are covered by the rule, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and companies with only listed debt securities, but certain registered investment companies are excluded to the extent they have not provided incentive-based compensation to any current or former executive officer of the fund in the last three fiscal years.

There are five key components of the final rules:

1. *Covered individuals*. Current and former "executive officers" are subject to clawback of incentive-based compensation. "Executive officer" includes the company's president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division or function, and any other person who performs policymaking functions for the company and otherwise conforms to the full scope of the Exchange Act Section 16 definition. In a change from the proposed rules, the final rules will only require recovery of incentive-based compensation received by a person (i) after beginning service as an executive officer and (ii) if that person served as an executive officer at any time during the recovery period. Recovery of compensation received prior to becoming an executive officer will not be required, although compensation received during the recovery period by former executive officers is covered.

2. *Restatements that trigger application of clawback policy*. In a change from the proposed rules, the final rules require recoupment of erroneously awarded compensation (i) when the company is required to prepare an accounting restatement that corrects an error in previously issued financial statements that is material to the previously issued financial statements (commonly referred to as "Big R" restatement) and (ii) when the company is required to prepare an accounting restatement that corrects an error that is not material to previously issued financial statements, but that would result in a material misstatement if (A) the error was left uncorrected in the current report or (B) the error correction was recognized in the current period (commonly referred to as "little r" restatements). Application of the recovery policy would not be triggered by an "out-of-period adjustment" – a situation where the error is immaterial to the previously issued financial statements and the correction of the error is also immaterial to the current period. The recovery policy also would not be triggered by changes to prior period financial statements that do not arise due to error corrections, such as retrospective revisions to financial statements due to changes in accounting principles or segments.The Commission rejected a bright-light standard for determining when the recovery period begins, reasoning that doing so might incentivize companies to delay a restatement determination in order to manipulate the recovery date. Therefore, the final rules state that the recovery period runs from the earlier of: (i) the date the company's board of directors, committee of the board, or the officer or officers of the company authorized to take such action, concludes, or *reasonably should have concluded*, that the company is required to prepare an accounting statement due to the material noncompliance with any financial reporting requirement under the securities laws; or (ii) the date a court, regulator, or other legally authorized body directs the company to prepare an accounting restatement. The SEC stated in its October 14, 2021 Notice when it reopened the comment period: "For errors that are material to the previously issued financial statements, we generally expect the date . . . to coincide with the date disclosed in the Item 4.02(a) Form 8-K filed."

3. *Definition of incentive compensation and when it is "received."* "Incentive-based compensation" is any compensation (including cash and equity) granted, earned or vested based in whole or in part on the attainment of a "financial reporting measure." "Financial reporting measures" are measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, and any measures derived in whole or in part from such measures, as well as stock price and total shareholder return ("TSR"). A financial reporting measure is subject to the rule even if it is not actually presented in the company's financial statements or included in an SEC filing.

   Incentive-based compensation does not include compensation that is based *solely* on continued employment for a specified period of time (*e.g.*, time-vesting awards, including time-vesting stock options), unless such awards were granted or vested based in whole or in part on a financial reporting measure. Incentive-based compensation also does not include base salary (however, in the preamble to the proposed rule the SEC indicated that if the executive officer receives a salary increase earned wholly or in part based upon the attainment of a financial reporting measure, such increase would be subject to recovery), compensation awarded solely at the board's discretion, or compensation awarded upon the achievement of subjective, strategic or operational measures that are not financial reporting measures (such as the

achievement of ESG goals).The Dodd-Frank Act specified that the compensation subject to clawback is that which was received by the executive during a recovery period that is defined as "the three-year period preceding the date on which the issuer is required to prepare an accounting restatement." The final rules provide that incentive-based compensation is "received," and thus subject to clawback, in the fiscal period during which the applicable financial reporting measure is attained, even if the payment or grant occurs after the end of that period. In other words, the date of "receipt" of such compensation is tied to the satisfaction of the financial reporting measure goal, irrespective of applicable vesting, grant or payment dates. An award subject to both time- and performance-based vesting conditions is considered received upon satisfaction of the performance metric even if the award continues to be subject to time-based vesting criteria.

4. *Calculating the amount of clawback*. The amount required to be recouped is the amount of incentive-based compensation received by the executive in excess of what would have been received if the incentive-based compensation was determined based on the restated financial statements. To the extent the incentive-based compensation was based on stock price or TSR, such excess amount must be based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. The company must maintain documentation of the determination of that reasonable estimate and provide it to the relevant exchange. In all cases, the calculation of erroneously awarded compensation would be calculated on a pre-tax basis. As discussed below, companies are required to disclose in their Form 10-K, 20-F, 40-F or N-CSR, as applicable, and proxy statement information on their calculation of the amount subject to clawback.

5. *Minimal discretion regarding recovery and its enforcement*. The rules require a company to recover erroneously awarded compensation in compliance with its recovery policy subject to limited exceptions. Recovery is not required only if the company's board or compensation committee has determined that recovery is impracticable for one of three reasons: (1) because the direct expenses paid to third parties to assist in enforcing the policy would exceed the amount to be recovered and the company has made a reasonable attempt to recover; (2) in the case of a foreign private issuer, because pursuing such recovery would violate home country law in effect prior to publication of the final rules in the Federal Register and where the company provides an opinion of counsel to that effect to the exchange; or (3) because recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.[5] Clawback must be evaluated on a "no fault" basis – *e.*, without regard to whether any misconduct occurred or whether an executive bears responsibility. Executives may not be indemnified for the clawback, nor may companies pay premiums on an insurance policy that would cover an executive's potential clawback obligations. The rules require that companies pursue recovery "reasonably promptly," which suggests that boards may not allow covered executives to repay any clawed back amount in installments under a payment plan of any extended duration, barring any unreasonable economic hardship to the executive. In addition, under the new disclosure requirements (addressed further below), any amount subject to clawback from a current or former named executive officer but unpaid after 180 days must be disclosed.

New Disclosure Requirements

There are three key new disclosure requirements tied to the clawback rules:

1. *Clawback Policy Exhibit Requirement*. Each listed company must file its clawback policy as an exhibit to its annual report on Form 10-K, 20-F, 40-F or N-CSR, as applicable.

2. *New Item 402 disclosures*. Item 402 of Regulation S-K was amended to require companies to disclose how they have applied their recovery policies. If, during its last completed fiscal year, the company either completed a restatement that required recovery, or there was an outstanding balance of excess incentive-based compensation relating to a prior restatement, the company must disclose the following information for each restatement in any Form 10-K or proxy or information statements that includes executive compensation disclosure:

   (i) the date on which the company was required to prepare each accounting restatement and the aggregate dollar amount of excess incentive-based compensation attributable to the restatement, *including an analysis of how the recoverable amount was calculated* (an expansion of the proposed rules), or if the clawback amount has not been determined yet, an explanation of the reasons why it has not, and subsequent disclosure in the next filing that is subject to Item 402 of Regulation S-K;

   (ii) if the compensation is related to a stock price or TSR metric, the estimates used to determine the amount of erroneously awarded compensation attributable to such accounting restatement and an explanation of the methodology used for such estimates;

   (iii) the aggregate dollar amount of excess incentive-based compensation that remained outstanding at the end of the company's last completed fiscal year;

   (iv) where a company is invoking an impracticability exception, for each current and former named executive officer and for all other current and former executive officers as a group, the amount of recovery forgone and a brief description of the reason the listed registrant decided in each case not to pursue recovery, as well as (to the extent applicable to the invoked impracticability exception) a brief explanation of the types of direct expenses paid to a third party to assist in enforcing the recovery policy, identification of the provision of foreign law the recovery policy would violate, or how the recovery policy would cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code; and

   (iv) for each current and former named executive officer, the amounts of incentive-based compensation that are subject to a clawback but remain outstanding for more than 180 days since the date the company determined the amount owed.

The final rules also add a new instruction to the Summary Compensation Table to require that any amounts recovered pursuant to a company's compensation recovery policy 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, with the clawback identified by footnote.

The final rules require information mirroring the above Item 402 disclosures to be included in annual reports on Form N-CSR and in proxy statements and information statements relating to the election of directors; on Form 20-F or, if the foreign private issuer elects to use the registration and reporting forms that U.S. issuers use, on Form 10-K; and on Form 40-F.

3. *New check boxes on cover pages of Forms 10-K, 20-F and 40-F*. In addition, and according to the SEC, "to assure that issuers listed on different exchanges are subject to the same disclosure requirements regarding erroneously awarded compensation recovery policies," companies must indicate by check boxes on their annual reports whether the financial statements included in the filings reflect a correction of an error to previously issued financial statements and whether any such corrections are restatements that required a recovery analysis.

Observations and Considerations for Companies

Companies do not need to adopt a Rule 10D-1 clawback policy until after the stock exchanges' listing standards implementing Rule 10D-1 are proposed, adopted and become effective. Nevertheless, there are important steps that companies should be taking before that time to prepare for the new rules:

1. *Prepare for Implementation*. The new listing standards will require companies to adopt "and comply" with their Rule 10D-1 clawback policies. In addition, the clawback policy needs to apply to any incentive compensation "received" on or after the effective date of the new listing standards, even if that compensation was received pursuant to an award granted before adoption of the company's Rule 10D-1 clawback policy. Therefore, to the extent they have not done so already, companies should be adding a term to their existing incentive compensation plans or award agreements and taking any other appropriate measures to enhance the enforceability of their Rule 10D-1 clawback policy once it is adopted.

2. *Evaluate Incentive Compensation Arrangements*. Companies should evaluate their existing compensation arrangements to assess which have any element that relates to a "financial performance measure" as defined under the SEC rules. At the same time, companies may wish to evaluate whether to modify or clarify the operation of arrangements that have financial performance measure elements. For example, companies with a legacy Section 162(m) bonus pool that is based on a financial performance measure, but under which actual payments are discretionary or based on other criteria, may wish to eliminate the performance-based funding of the bonus pool component. The clawback rules may also accelerate the trend toward the use of non-financial, strategic and ESG-related performance criteria in incentive compensation arrangements.

3. *Interaction with Existing Clawback Policies*. Companies will need to determine whether to integrate the Rule 10D-1 clawback policy with their existing policies, replace their existing policies, or adopt the Rule 10D-1 policy on a stand-alone basis. Various aspects of the Rule 10D-1 clawback requirements go beyond what companies typically have adopted to date, including

the mandatory nature of the clawback, the timing and length of the recovery period and the no-fault standard. At the same time, many company policies cover triggering events beyond financial restatements, may cover a larger population, and may apply to broader categories of compensation. Given the differences, companies may find it easier to adopt a stand-alone Rule 10D-1 clawback policy, and simply modify their existing clawback policies to clarify that they apply only to the extent that the Rule 10D-1 clawback policy does not. As noted above, the new rules require attaching the clawback policy as an exhibit to the annual report, so it is advisable to review the policy in light of that anticipated public disclosure.

4. *Enhance Documentation Around Compensation Committee Determinations*. Going forward, it will be more important than ever to have clear documentation around the extent to which financial performance measures affect decisions regarding granting, vesting and settlement/payout of each element of executives' compensation. To the extent that a compensation committee is exercising discretion, particularly if awarding compensation without regard to financial results, those decisions should be documented. Finally, it will be important to enhance internal and disclosure controls so that the implications of any restatement, including a "little r" restatement, can be taken into account.

The Rule 10D-1 clawback rules are designed to enhance an environment promoting compliance with applicable accounting rules. However, their application on a no-fault basis means that executives could be subject to compensation clawbacks based on inadvertent failures to satisfy complex accounting standards. It will be important to assess whether that possibility will lead to inadvertent consequences, such as a move away from financial performance measures in compensation arrangements or the loss of talented executives who feel unfairly penalized under a clawback claim that they intend to contest.

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[1] Pub. L. No. 111-203, 124 Stat. 1900 (2010).

[2] Listing Standards for Recovery of Erroneously Awarded Compensation, Exchange Act Release No. 34-75432 (July 14, 2015), available here.

[3] Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation, Exchange Act Release No. 34-93311 (Oct. 14, 2021), available here.

[4] Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation, Exchange Act Release No. 34-95057 (June 8, 2022), available here, which sought review and comment on the memo prepared by the staff of the SEC's Division of Economic and Risk Analysis, available here.

[5] With respect to this exception, Rule 10D-1(b)(1)(iv)(C) provides: "Recovery would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees of the registrant, to fail to meet the requirements of 26 U.S.C. 401(a)(13) or 26 U.S.C. 411(a) and regulations thereunder."

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The following Gibson Dunn lawyers assisted in the preparation of this alert: Sean Feller, Krista Hanvey, Elizabeth Ising, Ronald Mueller, Michael Scanlon, Lori Zyskowski, Aaron Briggs, and Christina Andersen.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these issues. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work in the firm's Executive Compensation and Employee Benefits or Securities Regulation and Corporate Governance practice groups, or any of the following practice leaders and members:

Executive Compensation and Employee Benefits Group:
Stephen W. Fackler – Palo Alto/New York (+1 650-849-5385/+1 212-351-2392, sfackler@gibsondunn.com)
Sean C. Feller – Los Angeles (+1 310-551-8746, sfeller@gibsondunn.com)
Krista Hanvey – Dallas (+ 214-698-3425, khanvey@gibsondunn.com)
Christina Andersen – New York (+1 212-351-3857, candersen@gibsondunn.com)

Securities Regulation and Corporate Governance Group:
Elizabeth Ising – Washington, D.C. (+1 202-955-8287, eising@gibsondunn.com)
Thomas J. Kim – Washington, D.C. (+1 202-887-3550, tkim@gibsondunn.com)
Ron Mueller – Washington, D.C. (+1 202-955-8671, rmueller@gibsondunn.com)
Michael J. Scanlon – Washington, D.C. (+1 202-887-3668, mscanlon@gibsondunn.com)
Michael Titera – Orange County (+1 949-451-4365, mtitera@gibsondunn.com)
Lori Zyskowski – New York (+1 212-351-2309, lzyskowski@gibsondunn.com)
Aaron Briggs – San Francisco (+1 415-393-8297, abriggs@gibsondunn.com)
Julia Lapitskaya – New York (+1 212-351-2354, jlapitskaya@gibsondunn.com)

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