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# What SEC Bonus Clawback Rule Means For Public Cos.

By **Meredith O'Leary, Elizabeth Morgan and Jake Downing**
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On Oct. 26, the U.S. Securities and Exchange Commission adopted a final rule regarding the recovery of erroneously awarded incentive-based compensation received by current or former executive officers of public companies.

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As mandated under Section 10D of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the final rule requires national securities exchanges to adopt listing standards that will require most issuers to update their clawback policies.

Under the rule, the new clawback policies — once adopted by the national securities exchanges — will require issuers to recover any incentive-based compensation erroneously paid to current and former executive officers as a result of material noncompliance with accounting rules that results in an accounting restatement.

Elizabeth Morgan

Additionally, such entities will need to file the policy as an exhibit to their annual reports and include disclosures related to recovery when recovery is triggered under the policy.

The rule will apply to a wide number of public company executives and will cover no-fault scenarios. Accordingly, and as discussed in this article, we expect the rule to be burdensome to administer and lead to substantially more compensation being subject to clawback on a relatively frequent basis.

Jake Downing

**Overview of Final Rule**

The rule directs national securities exchanges to establish listing standards requiring listed companies, or issuers, to adopt and comply with a written clawback policy. Such policies must provide for the mandatory recovery of any incentive-based compensation awarded to current and former executive officers as a result of erroneously reported financial information that is received by such individuals during the three-year period preceding the date the issuer is required to prepare the accounting restatement.

The amount of such incentive-based compensation subject to recovery under the policy is that by which any incentive-based compensation awarded exceeds the amount that would have been awarded under the restated financial statements correcting such materially misreported financial information, on a pretax basis.

The rule also requires that:

- The mandated clawback policy be filed as an exhibit to an issuer's annual report;

- Issuers include checkboxes on their annual report indicating if the included financial statements 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 under the mandated clawback policy; and

- Issuers disclose any actions they have taken pursuant to such recovery policies.

Further, issuers are prohibited from insuring or indemnifying current or former executive officers against any potential or actual clawback of erroneously awarded compensation covered by the rule. Issuers who fail to comply with the rule are subject to delisting.

**Exceptions to Mandatory Recovery Requirement**

Issuers must recover erroneously awarded compensation in compliance with the mandated clawback policy unless the pursuit of such recovery would be impracticable. The rule includes three impracticability exceptions. Situations where:

- The direct cost of recovery would exceed the amount of recovery;

- Recovery under the policy would violate foreign law that was adopted prior to when the rule was finalized; and

- Recovery might jeopardize the tax qualification of a tax-qualified retirement plan.

The commission acknowledged that several commenters recommended a de minimus threshold. However, the commission specifically rejected such a threshold, determining that "absent satisfaction of the conditions to demonstrate that recovery is impracticable due to costs, we believe a de minimis exception may risk being both over and under-inclusive, given the variation in issuer sizes and executive compensation structures."[1]

**Expansive Definition of "Incentive Compensation"**

Under the rule, incentive-based compensation subject to clawback is broadly defined to include "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure."[2]

This could include: (1) annual bonus compensation; (2) equity and equity-based compensation; (3) nonqualified deferred compensation; and (4) long-term incentive compensation, including in each case where a financial reporting measure is one of multiple (or many) factors.

"Financial reporting measure" is also broadly defined, and will capture almost any financial metric

issuers use, including stock price and total shareholder return.[3] Accordingly, most elements of compensation that are not entirely time-based and/or not entirely discretionary will be subject to the rule.

**Expansive Definition of "Executive Officer"**

Under the rule, the term "executive officer" includes an issuer's president, principal financial officer or principal accounting officer — or if there is no such accounting officer, the controller. It also includes:

- Any vice president of the company in charge of a principal business unit, division or function;
- Any other officer who performs a policymaking function; or
- Any other person who performs similar policymaking functions for the issuer.

Executive officers of an issuer's parents or subsidiaries are deemed executive officers covered by the rule if they perform such policymaking functions for the issuer.

While consistent with the definition of "officer" set forth in Rule 16a-1(f) of the Securities Exchange Act, as amended, the expansive definition of "executive officer" under the rule notably includes individuals who may have had no ability to control, supervise or otherwise impact the issuer's compliance (or noncompliance) with accounting rules.

It also does not limit the scope of recovery to individuals who were "at fault" for the errors that resulted in an accounting restatement. Relatedly, it includes not only current executive officers, but former executive officers who may not have been present at the company during restated periods.

Finally, while the SEC notes that issuers should have "strong arguments" that the rule preempts conflicting state laws that prohibit clawback with respect to U.S. executive officers, the rule provide limited exceptions for non-U.S. individuals, setting up a potential conflict between U.S. and foreign employment laws, which may prohibit the recovery of such amounts and will require significant attention before pursuing any clawback outside of the U.S.

**Expansive Definition of "Restatement"**

The clawback policy required under the rule, and a recovery analysis under such policy, is triggered when an issuer prepares an accounting restatement resulting from material noncompliance with accounting rules. The commission views material noncompliance as encompassing both accounting restatements made to correct a material error in previously issued financial statements (Big R) and those made to prevent a material misstatement if the error was corrected in the current period or left uncorrected in the current period (little r).

As a result, the rule provides for mandatory recovery under the clawback policy based on a no-fault standard: a recovery analysis is required under the rule regardless of whether the error was made without misconduct, fraud, intent or fault on the part of the issuer or any individual, or as a result of factors outside the issuer's control. Moreover, the rule adopts a broader construction of material error than the proposed rule.

**Implementation**

Currently, many issuers have a clawback policy aligned with Section 304 of the Sarbanes-Oxley Act,

addressing recovery of incentive-based compensation following an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws.

Additionally, some issuers have implemented clawback policies for certain types of workforce issues — e.g., sexual harassment or whistleblower claims. Issuers will need to determine whether to amend existing policies, or to adopt new policies to implement the rule.

**Potential Impact**

It is anticipated that the rule will have a significant impact on issuers, including, as described above, in potentially unanticipated situations such as foreign executive officers of issuers — including where laws prohibiting recovery are passed after the adoption of the rule — and in the case of voluntary filers.

The rule may affect compensation plan design as well. Some companies may look to structure compensation programs — or a greater percentage of existing compensation — where financial reporting measures are not a factor in the earning or vesting of such compensation to avoid potential clawback risk and the complexities associated with clawback calculations, as well as the required disclosures and attendant litigation risks.

For example, discretionary bonuses and equity awards with solely time-based or service-based vesting are outside the scope of the rule.

**Timing**

The rule will become effective 60 days following publication in the Federal Register. National securities exchanges will be required to file proposed listing standards with the commission no later than 90 days after publication of the rule in the Federal Register, and such listing standards must be effective within one year of such publication.

Within 60 days of the applicable listing standards becoming effective, impacted issuers will be required to adopt a clawback policy mandated by the rule, and they will be required to comply with the related disclosure requirements in proxy statements, information statements and annual reports filed on or after the date such policies are adopted.

At this point, it is difficult to predict what national securities exchanges will do with the new rule; it's possible that the exchanges could include concepts that are incremental to the rule. Once implemented by national securities exchanges, addressing these new requirements will be a time-consuming process requiring significant coordination between internal stakeholders and outside advisers.

Additionally, issuers will want to consider how to explain the implications of the rule to their executive officers because the rule:

- Applies to all executive officers on a no-fault basis;
- Covers many elements of these officers' compensation;
- Covers "Big R" and "little r" accounting restatements; and

- Could require current and former executive officers to repay substantial sums of money that they may not have available at the time of clawback.

The clawback policy itself may be relatively simple, but explaining its application to executives will likely require many examples and a commitment to transparency. Put differently, and given the expansive requirements under the rule, issuers may need to anticipate having to claw back compensation on a more routine basis.

Clawback will no longer just be required for material and potentially egregious actions but will instead apply to simple mistakes — for which many executive officers will not have had any direct or even indirect involvement.

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[1] Final Rules, page 88: https://www.sec.gov/rules/final/2022/33-11126.pdf.

[2] Final Rules, page 57: https://www.sec.gov/rules/final/2022/33-11126.pdf

[3] Final Rules, page 58: https://www.sec.gov/rules/final/2022/33-11126.pdf