

# THE JOURNAL OF FEDERAL AGENCY ACTION

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# Securities and Exchange Commission's New Expansive Rule for Clawback of Incentive-Based Compensation Is Now in Effect

Jake Downing and Jessica M. Stricklin\*

*In this article, the authors review the Securities and Exchange Commission's final "clawback" rule concerning the recovery of incentive-based compensation. They note that the application of this final rule is particularly expansive, with the potential impact reaching far beyond the United States.*

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Several recent developments with the U.S. Securities and Exchange Commission (SEC) come into effect this year, including the new pay-versus-performance proxy disclosure as well as new Rule 10b5-1 rules and related disclosure requirements intended to enhance protections against insider trading.

There is also a key third development—the final “clawback” rule concerning the recovery of incentive-based compensation, the application of which is particularly expansive, with the potential impact reaching far beyond the United States.

## The New Rule

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Encouraging executive officers to reduce errors requiring restatements, the new rule targets compensation awarded to executive officers as a result of erroneously reported financial information that is received in the three-year period preceding the date when an issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under securities laws. The main points of the new rule are discussed below.

*Who does it apply to?* All issuers listed on any national securities exchange, including foreign private issuers.<sup>1</sup>



*What is required?* Issuers must implement a written clawback policy that provides for the recovery of incentive-based compensation erroneously awarded to current and former executive officers.

*Who is affected?* Current and former executive officers,<sup>2</sup> including non-U.S. executives of foreign private issuers.

The final rule establishes new reporting and disclosure requirements. Listed companies must file their written clawback policy as an exhibit to their annual report and disclose any actions taken pursuant to the policy.

They must also indicate—via checkboxes—if financial statements disclosed in their filing reflect the correction of an error in previously issued financial statements and whether analysis under the company’s clawback policy was required.

## Expansive Scope

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The scope of the new rule is notably expansive in respect of a few areas, discussed below.

*Payment timing.* Recovery of compensation is allowed regardless of when payments are made, as compensation is deemed “received” in the fiscal period during which the financial reporting measure is attained.

*Relevant years.* The policy applies to both material accounting errors that require a restatement of prior years’ financial results and errors corrected in current year results.

*Board discretion.* The clawback policy removes the board’s discretion to pursue recovery and applies a “no fault” standard requiring clawback without regard to the individual executive officer’s knowledge or engagement in the errors resulting in the accounting restatement.

*Indemnification.* Companies are prohibited from insuring or indemnifying any current or former executive officer against the loss of erroneously awarded compensation.

## Limited Exceptions

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There are a few, limited exceptions to the application of the new rules:

- The policy will not apply to tax-qualified retirement plans, nor options or restricted stock with time-based vesting,

incentive-based compensation tied to operational metrics, or discretionary bonuses not linked to financial measures; as a result, these options may be considered more heavily when determining executive compensation;

- Recovery is impracticable, that is, the cost would exceed the amount of recovery; and/or
- Recovery would violate preexisting national laws of the issuer's home country, that is, laws dating before the adoption of the rules on October 26, 2022. While new laws passed in response to the final rules will not affect their application to foreign issuers, countries may still attempt to limit the application of the new rules by increasing the costs of recovery from executive officers in their jurisdiction.

## Important Dates

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The final rule became effective on January 27, 2023, 60 days following its publication in the Federal Register. The New York Stock Exchange and Nasdaq Stock Market filed rule proposals on February 22, 2023, which will become effective once approved by the SEC. The absolute deadline for issuers to comply with the final listing rules is January 27, 2024, or 60 days following the latest date on which final listing rules may become effective. This deadline will be earlier if the SEC approves the rule proposals within 45 days of publication in the Federal Register.

The SEC released Compliance and Disclosure Interpretations (C&DIs) in January 2023, which note that even though the rule and disclosure requirements are effective in 2023, issuers need not comply with related disclosure requirements (e.g., the new checkboxes on Form 10-K) until a clawback policy is required under applicable exchange listing standards.

## What Now?

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The C&DIs make clear that the clawback rule is intended to apply broadly to incentive-based compensation arrangements, including those awarded to former officers and by foreign companies. While the final rule acknowledged the possibility that it could disincentivize foreign firms from listing in the United States, it also noted that with the new rule foreign issuers that choose to list on U.S. exchanges could signal the accuracy of their financial

reporting, which may work to incentivize listing by foreign firms. As the final rule awaits SEC approval, companies should do the following:

- Review existing policies and plan for any required changes to policies and procedures, while keeping in mind that existing policies may be broader than required (e.g., #MeToo and policies targeting other detrimental activity);
- Review existing incentive compensation plans and agreements and covered executive officers;
- Foreign private issuers and multinational companies in particular should consider covered executive officers as well as any possible intersection between clawback policies and existing local law; and
- Plan for the adoption and implementation of a new clawback policy in compliance with the final rule.

## Notes

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1. The rule also applies to emerging growth companies, smaller reporting companies, and controlled companies as well as issuers listing only debt or preferred securities that do not have listed equity.

2. “Executive officers” under the final rule is generally consistent with the definition of officer under Rule 16a-1(f) of the Securities Exchange Act, as amended. See <https://www.govinfo.gov/content/pkg/COMPS-1885/pdf/COMPS-1885.pdf>. The new rule requires recovery from any individual meeting this definition at any time during the recovery period, including non-U.S. executives of foreign private issuers.