



SEC adopts rules

Compensation clawback rules to create transparency

November 4, 2022



Final rules require issuers to establish a ‘recovery policy’ for erroneously awarded incentive-based compensation.

Source and applicability

- SEC Release Nos. 33-11126 and 34-96159, [Listing Standards for Recovery of Erroneously Awarded Compensation](#)
- Listed issuers with limited exemptions (issuers).

Fast facts, impacts, actions

The final rules require an issuer to develop, implement and disclose a compensation recovery policy that ‘claws back’ incentive-based compensation paid to executive officers when an accounting restatement changes financial reporting measures that affect the amount of such compensation. The final rules do not directly impose these requirements on issuers; instead, they direct the national securities exchanges and associations that list securities to establish listing standards meeting these minimum requirements.

Elements of a recovery policy...

Triggered when it is determined the issuer is required to prepare an [accounting restatement](#) that corrects an error in previously issued financial statements due to material noncompliance.

Applies to [incentive-based compensation](#) paid to five categories of [executive officers](#).

Recovers erroneously awarded incentive-based compensation awarded during a [look-back period](#).

Determines the [recoverable amount](#) that the issuer is required to pursue for recovery unless certain limited impracticability exceptions are met.

Required disclosures...

Recovery policy as an exhibit to annual reports.

Specified information about a recovery event.

The final rules establish a set timeline for the exchanges and associations to develop listing standards and for issuers to adopt them. See [Effective dates and transition](#).

Background

The SEC has adopted a new rule (new Exchange Act Rule 10D-1) and amended existing rules and forms to implement the provisions required by Section 954 of the Dodd-Frank Act. The new and amended rules require issuers to:

- develop and implement a recovery policy to claw back incentive-based compensation previously paid to executive officers that is determined to be erroneous; and
- disclose the recovery policy in an exhibit to each annual report and specific information about any recovery events.



Recovery from executive officers is required regardless of fault. The intent of the rules is to recover erroneously awarded compensation resulting from errors in order to protect shareholders from bearing the burden of such erroneous compensation.

Overview

The final rules require the national exchanges (and similar associations) to develop requirements applicable to their listed entities to implement clawback policies. The final rules are prescriptive in that they dictate the minimum requirements the exchanges must adopt. However, the exchanges may adopt stricter requirements. Issuers will need to determine how to apply the final listing requirements to their specific facts and circumstances.

Executive officers covered under the recovery policy

The recovery policy will apply to a broader group of executive officers than executive officers defined in other SEC rules. The SEC expanded upon other definitions to specifically include officers with an important role in financial reporting. There are five categories of current and former executives that a recovery policy must cover if they served in that role during the recovery period.

President	Principal Financial Officer	Principal Accounting Officer (if none, Corporate Controller)	VP in Charge of Principal Business Unit, Division or Function	Other officers performing a policy-making function
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Listed issuers may have different organizational structures. The rules are meant to apply to executive officers who perform policy making functions for listed issuers. For example, consolidated issuers may have executive officers at a subsidiary or parent level and limited partnerships may have executives that are officers or employees of the general partner.

When is a recovery policy triggered

A recovery policy is triggered when an issuer is required to prepare an accounting restatement that corrects an error in previously issued financial statements and the error is one that:

- is material to the previously issued financial statements (i.e. 'Big R' restatements); or
- would result in a material misstatement if corrected in the current period or left uncorrected in the current period (i.e. 'little r' restatements).

A 'little r' restatement differs from a 'Big R' restatement primarily in that the materiality conclusion relates to the effect of the error on the current period, the form and timing of reporting are different, and the required disclosures vary.



The SEC does not provide new guidance on when an error would be considered material because materiality is analyzed in the context of an issuer's specific facts and circumstances.

Revisions to previously issued financial statements that are not error corrections do not trigger recovery. These revisions are generally required under US GAAP and include retrospective revisions.

The date that an issuer determines it is 'required to prepare' an accounting restatement is the earlier of the date:

- the issuer's board of directors, a committee of the board or the officer(s) concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement; or
- a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.

What is clawed back under the recovery policy

The final rules require an issuer to claw back excess incentive-based compensation. The claw back is required when incentive-based compensation previously awarded during the look-back period is determined to be erroneous based on an accounting restatement that corrects an error in previously issued financial statements.

Incentive-based compensation

Incentive-based compensation is defined as any compensation that is granted, earned or vested based wholly or in part on the attainment of any financial reporting measure.

Such compensation may be in the form of cash, bonuses paid from a bonus pool, equity awards and proceeds from the sale of shares. However, these items must be based on a financial reporting measure. Therefore, equity awards are included only if they are granted or vest based on satisfying a financial reporting measure performance goal. Similarly, proceeds from the sale of shares are included only if the shares are granted or vest based on satisfying a financial reporting measure performance goal.

Compensation that is not based on a financial reporting measure, such as awards tied to operational or strategic goals, are not subject to the recovery policy.

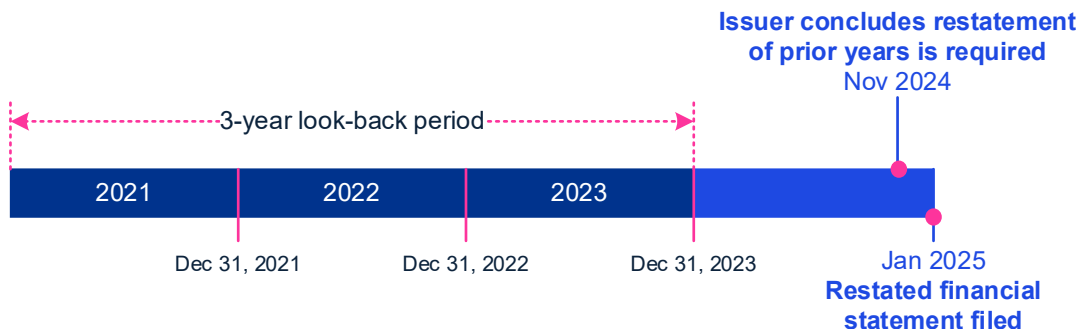
Financial reporting measures

A financial reporting measure is a measure taken directly from or derived from the financial statements or a performance measure based on stock price or total shareholder return. This includes GAAP performance measures and other financial measures, metrics and ratios, even if they are not 'non-GAAP measures' as defined in the Exchange Act. Financial measures may be measures presented outside the financial statements.

Look-back period

A recovery policy must be designed to claw back erroneously awarded compensation received during the look-back period. That period is the three completed fiscal years immediately preceding the date it is determined that the issuer is required to prepare an accounting restatement.

The fiscal year in which incentive-based compensation is deemed to have been awarded is based on when the award's financial reporting measure is attained, not when the award is actually paid or granted. Further, procedural acts necessary to effect a payment or grant are not relevant. Examples of such acts are calculation of an award or obtaining board approval for payment.



Evaluating whether incentive-based compensation is received can be complex. The SEC clarified that awards may be subject to multiple conditions and that an executive officer need not satisfy all conditions of an award for the award to be deemed received.

Recoverable amount

The amount of erroneously awarded compensation is called the recoverable amount. This amount is the incentive-based compensation received by the officers that exceeds the amount the officers would have received had the compensation been determined based on the restated financial results. While the definition is principles-based, the SEC provided specific guidance in the release for certain awards.

An issuer may not settle for an amount less than the full recovery amount, or indemnify executive officers against the loss of erroneously awarded compensation. However, it does not have to pursue recovery if it would be impracticable to do so. A determination that recovery is impracticable must be made by the committee of independent directors responsible for executive compensation after collection attempts have been made and is generally permitted when (1) third-party costs of recovery are in excess of the recovery amount, (2) recovery would violate home-country law adopted prior to the final rules being posted to the Federal Register along with a legal opinion stating such being obtained, or (3) recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet applicable requirements. These circumstances are expected to be limited.



The final rules do not allow board discretion as to *whether* to recover erroneously awarded compensation. However, they do allow discretion as to *how* recovery is achieved and whether recovery is impracticable.

Required disclosures

Listed issuers will file their written recovery policies as an exhibit to their annual reports and tag the disclosure using Inline XBRL.

If an accounting restatement triggers recovery (or recovery amounts are outstanding), the issuer will disclose various details in its annual report regarding the recovery amount, including how the amount was determined. If the issuer does not pursue recovery, it will disclose the reason. Further, it will need to make any appropriate updates to the Summary Compensation Table.

The cover page of Forms 10-K, 20-F, and 40-F will be amended to add check boxes that indicate separately (1) whether the financial statements of the registrant included in the filing reflect correction of an error to previously issued financial statements, and (2) whether any of those error corrections are restatements that required a recovery analysis of incentive-based compensation received by any of the registrant's executive officers during the relevant recovery period.

The SEC will revise Forms 20-F and 40-F for foreign issuers and Form N-CSR for investment company issuers to facilitate the new disclosures.

Effective dates and transition

The SEC has developed the following timeline for implementation of the final rules.



The SEC stated in the release that it does not expect compliance with the disclosure requirements until issuers are required to have a policy under the applicable exchange's listing standard. Under the final amendments, compliance is required whether such incentive-based compensation is received pursuant to a preexisting arrangement, or one that is entered into after the effective date of the exchange's listing standard.

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