

FAQ Re: Incentive Based Compensation – Understanding the New Clawback Rules

February 08, 2023

Update as of June 14, 2023:

On June 9, 2023, the U.S. Securities and Exchange Commission (SEC) gave its approval to the amendments submitted by the New York Stock Exchange (NYSE) and The Nasdaq Stock Exchange (Nasdaq) earlier that week. These amendments included several provisions, one of which stated that the proposed executive compensation recovery, also known as clawback, requirement listing standards filed by NYSE and Nasdaq in February 2023 would take effect on October 2, 2023. Listed companies are required to adopt a clawback policy that aligns with the relevant stock exchange listing standards or face the risk of being delisted. The original compliance date of August 8, 2023 has now been replaced with a new compliance date of **December 1, 2023**.

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In October 2022, the U.S. Securities and Exchange Commission (the "SEC") adopted rules implementing "clawback" provisions pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The rules directed national securities exchanges to establish listing standards that will require issuers to implement written clawback policies that satisfy related disclosure obligations.

In January 2023, the SEC staff issued new Compliance and Disclosure Interpretations providing further guidance about the rules.

This memo answers many clawback related questions that public companies, including foreign private issuers ("FPIs"), are facing.

What is a clawback?

A clawback is the recovery of erroneously awarded incentive-based compensation received by current or former executive officers of an issuer.

What is "incentive-based compensation"?

The clawback rules define "incentive-based compensation" as "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure... any incentive-based compensation recovered under the final rules is compensation that an executive officer would not have been entitled to receive had the financial statements been accurately presented."

Incentive-based compensation includes compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements and any measures derived wholly or in part from such measures, as well as non-GAAP measures, stock price and total shareholder return.

Incentive-based compensation does *not* include: base salary; bonuses paid solely at a board or board committee's discretion that are not paid from a "bonus pool" determined by the satisfaction of a financial reporting measure performance goal; bonuses paid upon achievement of subjective standards and/or completion of a specified employment period; non-equity incentive plan awards earned solely upon achievement of strategic or operational measures; and equity awards that are subject only to time-based vesting conditions and/or satisfying one or more subjective, strategic or operational measures that are not financial reporting measures.

Do FPIs have to comply with the new rules?

Yes. Issuers (including smaller reporting companies, emerging growth companies, FPIs, controlled companies, and issuers of debt and non-equity securities) whose securities are listed on a national securities exchange other than issuers of security futures products, standardized options, unit investment trust securities and certain registered investment company securities are subject to the new rules.

What should a clawback policy include?

Issuers are required to adopt a clawback policy providing for recovery of incentive-based compensation erroneously received by current or former executive officers during the three completed fiscal years immediately preceding the year in which the issuer is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements.

Incentive-based compensation is considered to be received in the period during which the applicable reporting measure is attained, even if the payment or grant occurs after the end of that period. If an award is subject to both time-based and performance-based vesting conditions, it is considered received upon satisfaction of the performance-based conditions, even if the award continues to be subject to time-based vesting conditions.

Erroneous payments must be recovered even if there was no misconduct or failure of oversight on the part of an individual executive officer.

The rules apply to both "Big R" and "little r" restatement filings:

- A "Big R" restatement is when an issuer is required to prepare an accounting restatement that corrects an error in previously issued financial statements which is material to the previously issued financial statements.
- A "little r" restatement corrects an error that would result in a material misstatement if the error was not corrected in the current period or was corrected in the current period and generally does not require a special disclosure filing.

What are the new disclosure requirements?

An issuer is required to file its clawback policy as an exhibit to its annual report on Form 10-K, Form 20-F or Form 40-F.

An issuer is required to disclose in its annual report or proxy statement how it has applied its clawback policy including:

- the date on which the issuer was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded incentive-based compensation attributable to such accounting restatement;
- the aggregate amount of the compensation that was erroneously awarded to all current and former named executive officers that remains outstanding at the end of the last completed fiscal year;

- any outstanding amounts due from any current or former executive officer for 180 days or more, separately identified for each named executive officer; and
- if recovery would be impracticable, the amount of recovery forgone and a brief description of the reason the issuer decided in each case not to pursue recovery.

Amounts recovered pursuant to an issuer's clawback policy must reduce the amount reported in the applicable compensation table column and the "total" column for the fiscal year in which the amount recovered initially was reported and must be identified by footnote.

New checkboxes on the cover pages of Form 10-K, Form 20-F and Form 40-F require issuers to indicate separately (a) whether the financial statements included in the filing reflect correction of errors to previously issued financial statements, and (b) whether any of those error corrections are restatements that required a recovery analysis of incentive-based compensation received by any of the issuer's executive officers during the relevant recovery period. As indicated further below, issuers are not required to mark the check boxes in 2023 before the deadline requiring the adoption of a clawback policy and compliance with the applicable listing standards.

Which officers are covered under the new rules?

The rules apply to all current or former "executive officers." The clawback recovery is not limited to the issuer's top five "named executive officers." "Executive officers" includes the issuer's president, principal financial officer, principal accounting officer ("PAO") or controller if there is no PAO, any VP of the issuer in charge of a principal business unit, division or function (*e.g.*, 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.

The rules do *not* require recovery of incentive-based compensation in circumstances where (i) the compensation was received by a person before beginning service as an executive officer or (ii) if that person did not serve as an executive officer at any time during the three-year lookback period to which the clawback rules apply.

Disclosure on Form 20-F

Form 20-F will now include a new item, 6.F. "Disclosure of a registrant's action to recover erroneously awarded compensation." The new Item 6.F provides for individualized disclosure for an issuer's named executive officers. FPIs that file on domestic forms and provide executive compensation disclosure under Item 402 of Regulation S-K should provide individualized disclosure for their named executive officers to the extent required by Form 20-F. For FPIs that use Form 20-F, individualized disclosure is required about members of their administrative, supervisory, or management bodies for whom the issuer otherwise provides individualized compensation disclosure in the filing.

What happens if an issuer fails to adopt a compliant policy?

An issuer could be subject to delisting if it does not adopt a clawback policy that complies with the applicable listing standard, disclose the clawback policy and any application of the policy in accordance with SEC rules, or enforce the clawback policy's recovery provisions. The new rules may also lead to increased shareholder derivative lawsuits seeking to force issuers to pursue clawback.

When will the clawback rules become effective?

Although the Form 10-K/20-F/40-F checkbox requirement became effective January 27, 2023, the listing standards are not required to be effective until November 28, 2023 and issuers will not be required to adopt a clawback policy for 60 days following the effective date of the applicable standards. In the adopting release, the SEC made clear that issuers will not be required to comply with the disclosure requirements before they have adopted clawback policies under the applicable exchange listing standard. Accordingly, while the rules and forms will include

the checkboxes and other disclosure requirements in 2023, the SEC staff does “not expect issuers to provide such disclosure until they are required to have a recovery policy under the applicable listing standard.”

When does the 3-year look-back period begins?

The three-year look-back period starts on the earlier of (i) the date the issuer’s board of directors, committee and/or management determines that a restatement is required or (ii) the date a regulator, court or other legally authorized entity directs the issuer to restate previously issued financial statements.

Are there any exceptions to recovery?

The rules provide for limited exceptions to the issuer’s requirement to enforce the application of the clawback policy.

The limited exceptions apply when:

(i) pursuing such recovery would be impracticable because the direct expense paid to a third party to assist in enforcing the policy would exceed the recoverable amounts and the issuer has (A) made a reasonable attempt to recover such amounts and (B) provided documentation of such attempts to recover to the applicable national securities exchange;

(ii) pursuing such recovery would violate the issuer’s home country laws and the issuer provides an opinion of counsel to that effect to the applicable national securities exchange ; or

(iii) recovery would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees of the issuer, to fail to meet the requirements of the Internal Revenue Code.

Are benefits to executive officer retirement plans excluded?

No. Incentive compensation contributed to plans limited only to executive officers, supplemental executive retirement plan (“SERP”) or other nonqualified plans and related benefits would still be subject to recovery.

Would the rules affect compensation that is in a plan, other than tax-qualified retirement plans, including long term disability, life insurance, SERPs, or any other compensation that is based on the incentive-based compensation?

SEC Staff confirmed that the rules are intended to apply broadly. For plans that take into account incentive-based compensation, an issuer would be expected to claw back the amount contributed to the notional account based on erroneously awarded incentive-based compensation and any earnings accrued to date on that notional amount.

What is the effect on indemnification and insurance?

The rules prohibit an issuer from providing insurance or indemnification to any executive officer or former executive officer for the loss of erroneously awarded compensation. An executive officer may be able to purchase a third-party insurance policy to fund potential recovery obligations. However, the indemnification provisions prohibit an issuer from paying or reimbursing the executive officer for premiums for these policies.

How do you calculate recovery amounts?

The SEC adopted a principles-based definition of “erroneously awarded compensation”. Issuers are generally required to recover the amount, calculated on a pre-tax basis, of any incentive-based compensation received that exceeds the amount that otherwise would have been received

had the compensation been calculated based on the restated amounts. In instances where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the amount must be based on a reasonable estimate of the effect of the accounting restatement on the applicable measure, and the issuer must maintain documentation of the determination of that reasonable estimate and provide it to the applicable exchange.

Generally, for equity awards, the erroneously awarded compensation is the number of shares received in excess of the number that should have been received applying the restated financial reporting measure. If the underlying shares have not been sold, the erroneously awarded compensation is the number of shares underlying the excess options.

Could CEO or CFO's be subject to duplicative reimbursement?

Chief executive officers (CEOs) and chief financial officers (CFOs) remain subject to the clawback provisions of the Sarbanes-Oxley Act of 2002 ("SOX"), which provide that if an issuer is required to prepare an accounting restatement because of "misconduct," the CEO and CFO are required to reimburse the issuer. Under the new rules, the CEO or CFO would not be subject to duplicative reimbursement. Recovery under the new rules will not preclude recovery under SOX to the extent any applicable amounts have not been reimbursed to the issuers.

Could issuers seek recovery in different ways?

The rules allow boards to seek recovery through means that are appropriate or specific to the circumstances, including, for example, establishing a deferred payment plan that allows executive officers to repay the amounts owed without unreasonable economic hardship.

What steps should be taken now?

Issuers must start discussions within their boards and audit and compensation committees to plan for new clawback policies, evaluate existing agreements and plans, and review their internal controls. By the time the national securities exchanges adopt the listing standards, it is important to already have working drafts and an understanding of the issues. By February 24, 2023, the national securities exchange must file proposed listing standards that comply with the rules. November 28, 2023, is the latest date for NYSE and Nasdaq's listing standards to become effective and therefore January 27, 2024 (60 days after listing standards become effective) is the latest potential date for issuers to adopt a compliant clawback policy. The timetable could be accelerated depending on the date when the applicable national securities exchange take action. Accordingly, issuers should continue to monitor developments.

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