

The SEC's New Clawback Rules for Erroneously Awarded Compensation

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The Securities and Exchange Commission (SEC) recently adopted [final rules](#) to recover, or “clawback,” executive compensation determined to be erroneously awarded on the basis of materially misrepresented financial information requiring an accounting restatement without regard to fault or responsibility. Section 10D of the Securities and Exchange Act of 1934—as added by Congress in Section 954 of the Dodd-Frank Wall Street Reform Act of 2010—directed the SEC to promulgate new Exchange Act Rule 10D-1. Rule 10D-1 directs national securities exchanges to establish listing standards which will require issuers to adopt policies enabling them to “clawback” erroneously awarded executive compensation.

The rationale underlying this policy, as stated by the Senate Committee on Banking, Housing, and Urban Affairs, is that it is “unfair to shareholders for corporations to allow executive officers to retain compensation that they were awarded erroneously.”

I. Requirements for Listing Standards and Policies

While each national securities exchange has the autonomy to create its own listing standards, several requirements must be met. Listing standards must require all issuers (including emerging growth companies and smaller reporting companies)—except issuers of certain security futures products, standardized options, securities issued by unit investment trusts, and securities issued by registered investment companies—to both develop and implement a clawback policy.

Listing standards must require issuers to recover incentive-based compensation from any current or former executive officers for purposes of Form 10-K, including Section 16 officers, that was received during the three-year period preceding the date an issuer is required to prepare an accounting restatement. The final rules do not limit the scope of recovery to named executive officers or executives who are “at fault” for the accounting errors leading to a restatement. However, incentive-based compensation received prior to becoming an executive officer, even if received within the three-year lookback period, will not be subject to this requirement.

Moreover, listing standards must require issuers to disclose information relating to their clawback policy in their annual reports. First, issuers must provide the clawback policy itself as an exhibit to their annual reports. Additionally, issuers must indicate by checkboxes (i) whether the included financial statements in the filing corrected an error to previously issued financial statements, and (ii) whether such corrections are restatements requiring a recovery analysis. Issuers must also disclose actions—if any—taken by the issuer pursuant to the clawback policy. When prior year compensation disclosed in a Summary Compensation Table has been recovered, the amount shown in the applicable column and the total column must be reduced to include only the amount retained by the executive officer, with a footnote explaining the recovery.

a. Accounting Restatements

Pursuant to the final rules, listing standards will require issuers to recover compensation under the clawback policy when it is required to prepare accounting restatements. This includes both “Big R” and “little r” restatements. A “Big R” restatement occurs when an issuer must correct an error in a previously issued financial statement that is material to the previously issued financial statement. This type of restatement requires an issuer to file an Item 4.02 Form 8-K and amend to promptly restate its financial statements to correct the error. On the other hand, a “little r” restatement is when an error in a previously issued financial statement would result in a material misstatement if left uncorrected or if the correction was recognized in the current period. Issuers generally need not file an Item 4.02 Form 8-K for a “little r” restatement and can make corrections the next time it files financial statements from the prior year. The inclusion in the new clawback rules of “little r” restatements means that clawback recoveries will be required more often and may result in smaller recoveries in cases in which fraud is not involved.

b. Incentive Compensation Covered

Incentive-based compensation includes “any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure.” Such compensation must be “received” after the effective date of the applicable stock exchange listing standards. Financial reporting measures include non-GAAP financial reporting measures as well as stock price and total shareholder return. Compensation subject to clawback policies is compensation that an executive officer would not have been entitled to receive had the financial statements been accurately presented. The SEC indicated that allowing executive officers to retain such pay when it was erroneously awarded based on material accounting errors would undermine the statutory purpose of Section 10D to recover these amounts for the benefit of issuers and their shareholders. The calculation of the recoverable amount does not take into account any taxes paid by the executive. The new rules also prohibit companies from insuring or indemnifying covered executives against the loss of erroneously awarded compensation.

c. Limited Exceptions

The final rules provide for three limited exceptions for issuers complying with listing standards:

1. where the direct cost of recovery would exceed the amount of recovery,
2. the recovery would violate home country laws, and
3. when recovering compensation from tax-qualified retirement plans.

To determine whether the direct cost of recovery exceeds the amount of recovery, the criteria is whether the direct costs paid to a third-party to assist in enforcing recovery would exceed the compensation to be clawed back. A condition precedent to qualifying for this rule is that the issuer must make a reasonable attempt to recover the compensation before determining it would be impracticable.

The second exception is when recovery is impracticable because it would violate the home country law of the issuer. Notably, such law must exist prior to publication of the final rules in the Federal Register. Moreover, the issuer must obtain an opinion of home country counsel asserting that clawback recovery would violate the law prior to benefiting from the exception.

Finally, the final rules provide for a narrow exception for tax-qualified retirement plans. 26 U.S.C. 40(a)(13) states that a plan will not be tax-qualified unless it provides that the plan’s benefits may not be assigned or alienated. As a result, the SEC opted to allow issuers to forgo recovery of tax-qualified retirement plans in order to avoid potentially adverse tax consequences for plan participants.

II. Timeline

National securities exchanges have 90 days following the publication of the final rules in the Federal Register to file its proposed listing standards. Listing standards must be effective within one year following the publication of the final rules in the Federal Register. Thereafter, issuers have 60 days to adopt a policy after the listing standards are effective. With this timeline in mind, issuers likely will not have to adopt a policy until late 2023 or even 2024. Issuers who do not comply with listing standards will be subject to delisting.

III. What Should Companies Be Doing Now (subject to listing standards to be adopted)?

- Consider adding provisions to future awards of incentive compensation to make it clear that executives consent to the application of any clawback policy adopted under Rule 10D-1 to all incentive compensation awards held by such executive as an express condition for receiving such an award. Note that the adopting release makes it clear that state law issues are not valid reasons for a company to not be able to clawback incentive compensation subject to Rule 10D-1.
- Review existing governance and executive compensation policies and agreements to determine if any provisions would violate the new clawback rules, including provisions that prohibit clawbacks, provide indemnification or company-paid insurance for recovered compensation, require fault on the part of the executive in order to be subject to recovery or provide too much discretion to a committee or the board to decide whether to pursue recoveries.
- Consider developing a policy applicable only to executives subject to Rule 10D-1 that either replaces or supplements their existing clawback policy.
- Reconsider which officers are deemed to be executive officers.
- Consider adding provisions to their agreements and policies that provide to help in the event that recovery is required under the new clawback rules, such as policies prohibiting the disposal of equity awards for a period of time after vesting, the forfeiture of currently outstanding awards or the application of clawbacks to non-incentive compensation, such as bonuses or time-based awards.
- Begin to educate executives about the new clawback rules and the effects on their compensatory arrangements.
- Consider whether to disclose in CD&A in their proxy statements how recoveries under the new clawback rules were applied pursuant to Item 4.02(w) of Regulation S-K, which would make it part of their compensation report.

For questions regarding the SEC's new clawback rules, please contact your GableGotwals attorney or a member of our [Corporate & Securities Group](#).



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