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SEC ADOPTS DODD-FRANK "CLAWBACK" RULES

On October 26, 2022, the Securities and Exchange Commission (the "SEC") adopted rules and rule amendments to implement the compensation recovery (or "clawback") requirements of Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"). The SEC's clawback rules direct the national securities exchanges to establish listing standards to require virtually all listed companies to adopt and enforce clawback policies providing for "no-fault" recovery of erroneously awarded incentive-based compensation received by current or former executive officers as a result of material noncompliance with financial reporting requirements. The SEC's rules also impose related disclosure requirements on listed companies.

A brief summary of the SEC's Dodd-Frank clawback rules is provided below. It is possible (even if unlikely) that a securities exchange could choose to impose more extensive clawback requirements than the standards required by the SEC, and any company could choose to adopt a more extensive clawback policy than is ultimately required by the applicable exchange. In any event, a company that fails to adopt, disclose or enforce a clawback policy meeting the requirements of the final rules of the SEC and the applicable securities exchange will be subject to delisting.

As described in more detail below, companies will not be required to comply with the Dodd-Frank clawback requirements until the listing standards of the applicable securities exchange have been revised, and it is expected that it will be approximately one year before the Dodd-Frank clawback requirements are fully effective. In the meantime, we expect that companies will begin preparing for the new clawback rules.

Dodd-Frank Clawback Policies

The SEC's rules will require most listed companies to adopt (or amend) clawback policies, as described below.

- **Which companies are subject to the Dodd-Frank clawback rules?** With very limited exceptions, the SEC's rules apply to any issuer with securities listed on a national securities exchange. For example, the rules will apply to smaller reporting companies, emerging growth companies, foreign private issuers, controlled companies and companies with only listed debt securities. The rules will not apply to unit investment trusts, certain registered management investment companies that do not award incentive-based compensation to executive officers, or to issuers of certain registered securities futures products and standardized options.

- **Who are executive officers?** The SEC's rules will require clawback policies to cover current and former "executive officers," using a definition of "executive officer" modeled on the definition under Section 16 of the Securities Exchange Act and Rule 16a-1(f) under the Securities Exchange Act of 1934, which generally includes the issuer's president; principal financial officer; principal accounting officer (or controller); any vice president in charge of a principal business unit, division or function; or any other officer or other person (including an officer of a parent or subsidiary) who performs a policy making function for the issuer. For foreign private issuers, this is likely to be a new category of executives. An individual would be covered by the clawback policy if he or she served as an executive officer at any time during the applicable performance period for incentive-based compensation received after beginning service as an executive officer.

- **Which restatements can trigger a clawback?** The SEC's rules provide that a clawback is triggered if the issuer is required to prepare an accounting restatement due to its material noncompliance with any financial reporting requirement under the securities laws. Significantly, the SEC's rules define covered restatements broadly to cover not just so-called "Big R" restatements that are required to be reported on Form 8-K (a restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements), but also so-called "little r" restatements (a restatement to correct an error that is *not* material to previously issued financial statements but would result in a material misstatement if the error is corrected in the current period or left uncorrected).

- **What is the clawback period?** Clawbacks will be required for erroneously awarded incentive-based compensation received by current and former executive officers during the three completed fiscal years immediately preceding the date the company is required to prepare an accounting restatement (special rules also apply to any transition period resulting from a change in the company's fiscal year). The SEC's rules provide that the date a company is required to prepare an accounting restatement is the *earlier* of (i) the date the company's board of directors or committee (or an authorized officer or group of officers if board action is not required) concludes, *or reasonably should have concluded*, that the company is required to prepare an accounting restatement described above; or (ii) the date a court, regulator or other legally authorized body directs the company to prepare such an accounting restatement.

- **What is incentive-based compensation?** The SEC's rules define "incentive-based compensation" as any compensation that is granted, earned or vested based wholly or in part on the attainment of a financial reporting measure. "Financial reporting measures" are defined as measures determined and presented in accordance with the accounting principles used in the company's financial statements, any measures derived wholly or partly from those measures, as well as stock price and total shareholder return. Compensation based *solely* on continued service (generally including time-based stock options, stock appreciation rights, restricted stock and restricted stock units), purely discretionary bonuses and incentives based solely on criteria other than financial reporting measures (e.g., consummation of a merger or divestiture or obtaining regulatory approval of a product) generally would not be required to be subject to a Dodd-Frank clawback policy.

- **When is incentive-based compensation deemed received by an executive?** Incentive-based compensation is treated as received in the company's fiscal period during which the applicable financial reporting measure specified in the award is attained, even if the award is not granted or paid until a later date.

- **How much incentive-based compensation is subject to clawback?** Under the SEC's rules, companies must recover the amount of incentive-based compensation that exceeds the amount that would have been received if the incentive-based compensation had been determined based on the accounting restatement, determined without regard to taxes paid. For incentive-based compensation based on stock price or total shareholder return, companies must make a reasonable estimate of the effect of the accounting restatement on the company's stock price or total shareholder return (and maintain documentation of that reasonable estimate to be provided to the applicable securities exchange).

- **Does the company have discretion not to clawback?** Generally, no. With *very* limited exceptions, clawbacks of erroneously awarded incentive-based compensation will be required on a "no-fault" basis, meaning that the company may not consider the extent to which a current or former executive officer was responsible for the material error in determining whether to apply the clawback policy, and the company may not retain discretion regarding whether to recover applicable erroneously awarded incentive-based compensation. Under the SEC's rules, an issuer may decide not to recover erroneously awarded incentive-based compensation under its clawback policy only if the issuer's compensation committee (or in the absence of such a committee, a majority of the independent directors serving on the issuer's board) determines that:

    - The direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered, provided that the issuer must first make a reasonable attempt to recover the erroneously awarded incentive-based compensation and provide documentation of that attempt to the applicable securities exchange;

    - For a foreign issuer, recovery would violate the law of the issuer's home country as in effect prior to the date of publication of the SEC's rules in the Federal Register, and the issuer obtains an opinion of home country counsel to that effect that is acceptable to the applicable securities exchange; or

    - 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 Section 401(a)(13) or Section 411(a) of the Internal Revenue Code. Any determination not to recover the compensation generally must be made by the issuer's compensation committee.

- **How may erroneously awarded incentive-based compensation be recovered?** While issuers generally do not have discretion about whether to recover erroneously awarded incentive-based compensation, the SEC's rules do provide issuers with discretion to choose the *means* of recovery of erroneously awarded incentive-based compensation, as long as the excess compensation is recovered reasonably promptly.

- **Can companies indemnify executives from clawbacks?** No. The SEC's rules prohibit the indemnification of any current or former officer against the loss of erroneously awarded incentive-based compensation under a Dodd-Frank clawback policy. The issuer's payment or reimbursement of premiums under an insurance policy obtained by an executive to cover such loss would also be prohibited.

New Disclosure Requirements

The SEC's rules impose new disclosure requirements related to Dodd-Frank clawback policies, as described below.

- **Will companies need to file clawback policies?** Each covered issuer will be required to file its clawback policy as an exhibit to its annual report on Form 10-K (or the corresponding filing for covered issuers that do not file Form 10-K).

- **Will annual disclosures be required regarding restatements?** The SEC's rules amend Form 10-K (and Forms 20-F and 40-F for foreign issuers) to add two new check boxes to the cover page of the form. As a result of these changes, issuers will be required to indicate annually (i) whether the financial statements included in the filing reflect the correction of an error to previously issued financial statements, and (ii) if so, 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 clawback period.

- **What additional disclosures are required with respect to clawbacks?** A company that is required to prepare an accounting restatement that triggers a recovery under its clawback policy generally must disclose the following information in its proxy statement covering the fiscal year in which the restatement was required: (i) the date the company was required to prepare the restatement; (ii) the aggregate dollar amount of erroneously awarded incentive-based compensation attributable to the restatement, including an analysis of how the recoverable amount was calculated; (iii) any estimates used, if the applicable incentive-based compensation was based on a stock price or total shareholder return metric; (iv) the aggregate dollar amount of erroneously awarded incentive-based compensation that remains outstanding at the end of the last completed fiscal year; (v) the name of each current or former named executive officer with a balance of erroneously awarded incentive-based compensation outstanding more than 180 days and the amount of each such outstanding balance; and (vi) if the company decided not to pursue a clawback from any individual on grounds of impracticability, the company must describe the reason it did not pursue recovery and disclose the amount of recovery foregone separately for each current or former named executive officer, and as a group for all other current and former executive officers. Further, if a company is required to prepare an accounting restatement and concludes that recovery of erroneously awarded compensation was not required pursuant to its clawback policy, the company would be required to briefly explain why the application of its clawback policy resulted in this conclusion. These additional disclosures would be required to be tagged electronically in eXtensible Business Reporting Language (XBRL) format.

- **What changes are there to the Summary Compensation Table?** The SEC's rules provide that any incentive-based compensation recovered by the issuer would reduce the amount reported in the Summary Compensation Table for the fiscal year in which it was initially reported, and the reduction must be identified by footnote. While the SEC's rules do not specifically mention the new Pay Versus Performance Table, it appears that any clawback adjustments to amounts previously reported in the Summary Compensation Table would also be reflected in the Pay Versus Performance Table.

Effective Date

The SEC's rules require that the national securities exchanges file proposed listing rules within 90 days following the publication of the SEC's rules. The exchanges' listing standards will need to become effective within one year following the publication of the SEC's rules. Each company will then be required to adopt a clawback policy within 60 days following the date the listing rules of the applicable securities exchange become effective. Under those clawback policies, issuers would be required to recover excess incentive-based compensation received on or after the effective date of the applicable listing standard and provide the additional disclosures described above in any SEC filings required on or after the effective date of the applicable listing standard.

Next Steps

Given the effective date provisions described above, companies should have time in 2023 to prepare for the changes that will be required after the securities exchange listing requirements have been finalized. For example, while awaiting the final listing standards on clawback policies, companies should consider the following steps:

- Review any existing clawback policies and consider changes that will be required to comply with the Dodd-Frank clawback rules, as well as any other voluntary updates that the company may want to consider (e.g., discretionary clawbacks for "harmful activity" outside the scope of the Dodd-Frank clawback rules).

- Update the compensation committee and board of directors on the status of the Dodd-Frank clawback rules, including the updated listing requirements of the applicable securities exchange, when available.

- Review the company's compensation plans and agreements to ensure that incentive award agreements and other relevant plan documents contemplate forfeiture or recovery under the company's clawback policy as in effect from time to time.

- Keep in mind other clawback rules, such as clawbacks from CEOs and CFOs under Section 304 of the Sarbanes-Oxley Act of 2002, and other situations in which clawback policies may be significant. (For example, the use of compensation clawbacks as part of a corporate compliance program was mentioned in a September 15, 2022 memorandum from Deputy Attorney General Lisa Monaco regarding the Justice Department's corporate criminal enforcement policies).

- Consider potential adjustments to executive incentive plan design or the mix of compensation elements, in light of the Dodd-Frank clawback rules. Given the importance to companies, compensation committees and shareholders of using incentive compensation based on financial performance metrics to drive key business objectives, we generally do not expect to see major shifts away from performance-based compensation to fixed or purely discretionary compensation arrangements, but some adjustments in the types, mix and design of incentive awards (including deferral features) might be considered.

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