Cooley

October 28, 2022

On October 26, 2022, the Securities and Exchange Commission (SEC) adopted **a new rule** governing the recovery (i.e., clawback) of erroneously awarded incentive compensation. The new rule implements Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and is codified in Rule 10D-1 under the Securities Exchange Act of 1934, as amended. The new rule also amends, or impacts, certain other schedules, forms and rules, most notably Items 402 and 601 of Regulation S-K.

The long-awaited new rule has been in motion for more than a decade. In 2010, the Dodd-Frank Act added Section 10D to the Exchange Act, requiring the SEC to direct the national securities exchanges to establish listing standards that require issuers to develop and implement a clawback policy. In July 2015, the SEC proposed rules to implement Section 10D and, following numerous comment periods – most recently in October 2021 and June 2022 – the new rule has been adopted substantially as proposed, with a few deviations as discussed below.

Overview and new clawback requirements

Under the new rule, national (US) securities exchanges and associations that list securities are required to establish listing standards mandating that each issuer adopt a clawback policy, comply with the policy and provide the required disclosures about the policy. Issuers that do not adopt and comply with clawback policies that meet the requirements of the new listing standards will be subject to delisting.

The policy must provide that, in the event an issuer is required to prepare an accounting restatement – including to correct an error that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period – the issuer will be required to recover from any current or former executive officers incentive-based compensation that was erroneously awarded during the three years preceding the date the restatement was required.

Key points to note

Issuers will have up to one year plus 60 days following publication of the new rule in the Federal Register to adopt compliant policies, depending on when exchange listing standards go into effect. The new rule becomes effective 60 days after publication in the Federal Register. Covered exchanges are required to file proposed listing standards no later than 90 days following publication of the new rule in the Federal Register, and the listing standards must be effective no later than one year after publication. Issuers will be required to adopt policies no later than 60 days after the effective date of the applicable listing standards, and they will be required to comply with the disclosure requirements in proxy and information statements and annual reports filed on or after the date such policies are adopted.

Smaller reporting companies, emerging growth companies and foreign private issuers are NOT exempt. The new rule generally applies to all listed issuers, including smaller reporting companies, emerging growth companies and foreign private issuers. Although the SEC acknowledged concerns expressed by commenters, it noted that unlike certain other provisions of the Dodd-Frank Act, Congress did not direct the SEC to treat these types of issuers differently. The SEC declined to exercise its discretion to exempt such issuers and noted its view that recovery of unearned incentive-based compensation, which encourages careful preparation and review of financial information, is equally appropriate for smaller and larger issuers.

"Little r" restatements will trigger recovery. The most glaring difference from the SEC's initial rule proposal in 2015 is the new rule will require companies to conduct a clawback analysis for "little r" accounting restatements. The new rule requires listed issuers to adopt and comply with a compensation recovery policy that will be triggered in the event of both:

- "Big R" restatements, which correct errors that are material to previously issued financial statements.
- "Little r" restatements, which correct errors that are not material to previously issued financial statements, but that would result in a material misstatement if the error were recognized or left uncorrected in the current period.

This is one of the most controversial aspects of the new rule, as expressed in **SEC Commissioner Hester Peirce's dissent** that including "little r" restatements "unnecessarily complicates the rule and may require clawback analysis when the error did not lead to erroneous compensation during the three-year period, or require a clawback of de minimis amounts" while Commissioner Jaime Lizárraga's statement noted that the rule will prevent the abuse of the potential "little r" loophole by folding both "Big R" and "little r" restatements into the rule. **Lizárraga went on to say** that "[e]mpirical evidence suggests that managers may try to use the discretion built into accounting standards to re-classify 'Big R' restatements to 'little r' restatements. These types of restatements have made up an increasingly high share of all financial restatements in recent years."

Current and former executive officers are covered, with no misconduct requirement. The new rule requires recovery from any current or former executive officer who received incentive-based compensation during the three-year look-back period preceding the date the restatement was required. "Executive officer" includes all officers who play an important role in financial reporting and is defined consistent with the definition of "officer" set forth in Exchange Act Rule 16a-1(f), including the president, principal financial officer, principal accounting officer (or controller if no principal accounting officer), any vice president in charge of a principal business unit, and any other person performing a similar policymaking function for the issuer (including officers of a parent or subsidiary of the issuer). Importantly, the new rule does not limit the scope of recovery to individuals directly responsible for preparing the financial statements or who were "at fault" for the accounting errors that resulted in a restatement. In other words, negligence or misconduct is not required.

"Incentive-based compensation" is a principles-based concept. The new rule defines 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." The SEC opted to use a "principles-based" definition in order to capture newly developed forms of compensation and measures of performance. In general, both equity and non-equity incentive plan awards are included, to the extent the grant or vesting thereof is based on financial reporting measures.

"Financial reporting measures" are defined broadly. Pursuant to the new rule, financial reporting measures are those "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," including non-generally accepted accounting principles (GAAP) financial measures, and other measures, metrics and ratios that are not non-GAAP measures, regardless of whether such measures are included in an SEC filing. In addition, financial reporting measures also include stock price and total stockholder return (TSR), and therefore, the final rule encompasses incentive-based compensation tied to such measures.

Purely time-vesting equity awards are outside the scope of the new rule. Equity awards, including stock options, for which vesting is contingent solely upon the completion of a specified employment period and/or attaining one or more nonfinancial reporting measures (and that were not granted contingent upon achieving any financial reporting measure performance goal) are not deemed to be based on the attainment of a financial reporting measure – and therefore are not within the definition of "incentive-based compensation" required to be covered by a clawback policy.

What amount of incentive-based compensation must be subject to recovery? Erroneously awarded compensation subject to recovery is defined as the amount of incentive-based compensation received by the current or former executive officer that exceeds the amount of incentive-based compensation that would have been received had such amount been determined based on

the accounting restatement, without regard to taxes paid. Reasonable estimates may be used to determine the effect of the accounting restatement for incentive-based compensation based on TSR or stock price, but issuers are required to maintain documentation of this reasonable estimate and deliver it to the exchange.

An issuer must recover erroneously awarded compensation in accordance with its clawback policy, unless such recovery would be "impracticable." The new rule allows an issuer's board of directors very limited discretion in applying the policy, noting narrow exceptions to recovery where (1) the direct cost of recovery would exceed the recovered amount **or** (2) the recovery would violate home country law and additional conditions are met. Issuers must make a reasonable attempt at recovery before determining that it is impracticable, must document their attempts at recovery and must deliver the documentation to the exchange. In addition, the new rule allows an issuer to decline to recover compensation when recovery would likely cause a tax-qualified retirement plan to fail to meet qualification requirements.

Boards retain discretion, subject to reasonable restrictions, to determine the means of recovery. The SEC recognized that the appropriate means of recovery may differ depending on the specific circumstances, noting that issuers are expected to recover erroneously awarded compensation "reasonably promptly." The amount of compensation required to be recovered is not limited under the new rule, but the rule requires boards to recover the full amount unless recovery is determined to be "impracticable" (as described above).

Indemnification is prohibited. The new rule does not allow issuers to insure or indemnify any current or former executive officer against the loss of erroneously awarded compensation. Executive officers may be able to purchase an insurance policy from a third party to fund required recovery, but the issuer may not pay or reimburse the executive officer for the policy.

No exception to recovery due to potential state law conflicts. In the new rule, the SEC declined to provide an exception to, or allow boards the discretion not to seek, recovery of covered compensation due to state law conflicts. The SEC noted that even though executive officers who are seeking to defend themselves against recovery may raise objections grounded in state law, it believes that state law will not pose a "significant obstacle" to recovery, because issuers should have "strong arguments" that state laws in conflict with the new rule are preempted.

Each issuer must file its clawback policy as an exhibit to its annual report and disclose actions taken pursuant to the policy. Each issuer must check boxes on its annual report to indicate whether the financial statements included in the filing reflect a correction of an error to previously issued financial statements and whether such corrections were restatements requiring recovery. In addition, disclosure regarding how issuers have applied their clawback policies will be required pursuant to new Item 402(w) of Regulation S-K.

Next steps

Issuers should begin to familiarize themselves with the new rule and consider the impact on their executive compensation programs, compensation arrangements and any previously adopted clawback policies. Importantly, since previously adopted clawback policies and arrangements may not be consistent with the new rule, issuers will need to determine whether (and how) to amend existing policies or adopt separate Rule 10D-1 policies. Issuers also will want to review noncompensation items affected by the new rule, such as their directors and officers insurance policies and indemnification agreements and their internal controls for evaluating restatements.

Please refer to this **PubCo blog post** for more information on the new rule, including a summary of the various statements made by the SEC chair and the other SEC commissioners at the meeting supporting and opposing the new rule.

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