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A Practical Guide to the SEC's New Clawback Rules

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Agenda

- Overview of the Final Rule
 - Timeline to the Final Rule
 - Overview of Key Provisions
 - Timing and Transition
- Details of the Final Rule
 - Key Definitions
 - Disclosure Requirements
- Practical Implications

The Long Road to Final Rule 10D-1

- **July 21, 2010** – the Dodd-Frank Wall Street Reform and Consumer Protection Act became effective, and included Section 954, which added Section 10D of the Securities Exchange Act and required the SEC to implement rules to direct exchanges to require listed companies to:
 - (i) disclose the policy of the issuers for incentive-based compensation and
 - (ii) implement a clawback policy to provide for recoupment of such compensation in the event of certain accounting restatements based on erroneous data
- **July 1, 2015** – the SEC issued a proposed rule under Section 954 of the Dodd-Frank Act
- **October 14, 2021** – the SEC announced the reopening of the comment period for the proposed rule
- **June 8, 2022** – the SEC again reopened the comment period with additional information on increased use of clawback policies without a final rule in place and a discussion of costs and benefits of the proposed rule
- **October 26, 2022** – the SEC issued the final Rule 10D-1
- **November 28, 2022** – Final Rule was published in the Federal Register

Overview of Final Rule 10D-1

Final Rule 10D-1 directs the national securities exchanges to establish listing standards that require **each issuer** to develop and implement a **required policy** providing for the recovery, in the event of a **required accounting restatement**, of **incentive-based compensation** received by **current or former executive officers** during **the coverage period** where that compensation is based on the erroneously reported **financial information**.

- **Covered Issuers:** broadly applicable to any company listed on a national exchange, including smaller reporting companies (SRCs), emerging growth companies (EGCs), and foreign private issuers (FPIs)
- **Required Clawback Policy:** a written policy to recoup incentive-based compensation in the event of an accounting restatement
- **“Big R” Restatement:** a restatement that corrects errors that are *material* to previously issued financial statements
- **“Little r” Restatement:** a restatement that corrects errors that are not material to previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period

Overview of Final Rule 10D-1 (cont.)

- **Incentive-based Compensation:** broadly defined as any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any “financial reporting measure”
- **Financial Reporting Measure:** a measure determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements, any measure derived wholly or in part from such measure, and stock price and total shareholder return. A financial reporting measure need not be presented within the financial statements or included in a filing with the SEC.
- **Excess Compensation:** the excess over what would have been paid giving effect to the accounting restatement
- **Covered Executive:** any *current or former* executive officer who received erroneously awarded incentive-based compensation (including stock-based compensation)
- **Covered Period:** the three completed fiscal years, during which any performance measure was attained, immediately preceding the date on which the company *determined or should have determined* that a restatement would be required (actual payment date is irrelevant)

Overview of Final Rule 10D-1 (cont.)

Additional Key Notes:

- Final Rule requires that the rules implemented by exchanges apply to covered executives, without regard to whether the covered executive is “at fault”
- Final Rule requires the listing standards apply to performance metrics such as TSR and share price, which present challenges as to how to calculate what constitutes excess compensation
- The listing standards must mandate recovery (not discretionary)
 - Listed companies that do not adopt, disclose, and comply with an applicable exchange’s listing standards and the related recovery policies will be subject to delisting from that exchange
- Final Rule includes additional disclosure requirements and form changes discussed later in presentation

Timing and Transition

Action	Timing
Exchanges file proposed listing rules	prior to February 27, 2023 (i.e., within 90 days after publication of the Final Rule)
Exchanges' rules must be effective	prior to November 28, 2023 (i.e., within 1 year after publication of the Final Rule)
Companies must adopt a recovery policy	within 60 days after the effective date of the applicable exchange's rules
Companies must comply with the required clawback policy and recover all excess incentive-based compensation resulting from an accounting restatement	for any compensation received after the effective date of the applicable listing standard
Companies must comply with the new disclosures in proxy or information statements and Exchange Act annual reports	for all filings on or after the effective date of the applicable exchange's rules



Key Aspects of The Final Rule

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What Is the Required Compensation Recovery Policy?

- A **compensation recovery policy** will be required by the listing standards adopted pursuant to Exchange Act Rule 10D-1
- Commonly called a “clawback policy”
- Many listed companies have implemented clawback policies even absent a final rule, often in response to shareholder feedback
- Even listed companies that have voluntarily implemented clawback policies should revisit those policies, as the requirements of the Final Rule may be more onerous than current policy

Which Companies Are Covered by the Final Rule?

The Final Rule broadly applies to most listed companies, including:

- ✓ Emerging growth companies
- ✓ Smaller reporting companies
- ✓ Foreign private issuers
- ✓ Controlled companies
- ✓ Companies listing only debt and other non-equity securities

The Final Rule does not apply to:

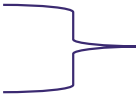
- ❑ Listed registered investment companies that have not awarded incentive-based compensation to any executive officers within the last three fiscal years
- ❑ Unit investment trusts
- ❑ Companies listing securities futures products and standardized options cleared by a clearing agency

Covered Companies (cont.)

- The SEC declined to grant exchanges discretion to exempt certain categories of securities from the rules
- However, the rules exempt the listing of certain security futures products, standardized options, securities issued by unit investment trusts, and securities issued by certain registered investment companies
- Also, the rules will not apply to exchanges that only trade securities pursuant to unlisted trading privileges but do not list securities

Which Executives Are Covered by the Final Rule?

- Rule 10D-1 applies to any current or former **executive officer** of a covered company
 - Relies on the same definition as for Section 16 officers
 - Does not apply only to named executive officers that are the subject of compensation disclosure in the Company's annual proxy statement
- Any person who was an executive officer during the "performance period" is subject to clawback
- It applies to any compensation received after becoming an executive officer



Includes the current and former:

- president;
- principal financial officer;
- principal accounting officer or controller;
- any vice-president in charge of a principal business unit, division, or function; and
- any other officer who performs a significant policymaking function for the company, whether such person is or was employed by the company, the issuer's parent, or the issuer's subsidiary(ies)

What Types of Compensation Are Covered By the Final Rule?

Incentive-based
Compensation

Any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure

Financial Reporting
Measure

A measure determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measure derived wholly or in part from such a measure, and stock price and total shareholder return (TSR)

A financial reporting measure need not be presented within the financial statements or included in a filing with the SEC

Excess
compensation

The amount of erroneously awarded incentive-based compensation subject to recovery

Equals the amount received by an executive officer that exceeds the amount that otherwise would have been received had the incentive-based compensation been determined based on the accounting restatement

"Received"
Compensation

Compensation is deemed "received" in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period

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What Is Included in Incentive-Based Compensation?

- The issuing release makes clear that the definition is intended to be principles-based and broadly applicable
- The SEC provided the following non-exhaustive list of incentive-based compensation elements:
 - Non-equity **incentive plan awards** that are earned based wholly or in part on satisfying a financial reporting measure performance goal
 - **Equity awards** (including restricted stock, restricted stock units (RSUs), performance share units, stock options, and stock appreciation rights) that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal
 - Bonuses paid from a **bonus pool** based wholly or in part on satisfying a financial reporting measure performance goal
 - Other **cash bonuses** and other cash-based awards with payment or vesting based on satisfaction of a financial reporting measure performance goal
 - **Proceeds** received from the sale of shares acquired through an incentive plan granted or vested based wholly or in part on satisfying a financial reporting measure performance goal

What Is Included in Incentive-Based Compensation? (cont.)

- **Financial reporting measures** are “[1] measures that are determined and presented in accordance with accounting principles used in preparing the issuer’s financial statements, [2] any measures that are derived wholly or in part from such measures [e.g., non-GAAP], and [3] stock price and [4] total shareholder return” (TSR).
- Need not be presented in financial statements or included in SEC filing
- Includes non-GAAP financial measures

SEC examples of **financial reporting measures**

- Revenues
- Net income
- Operating income
- EBITDA
- Earnings measures, such as earnings per share
- Profitability of one or more segments (as disclosed in a financial statement footnote)
- Financial ratios
- Net assets/net asset value per share (for BDCs and the small number of RICs subject to the rule)
- Liquidity measures, such as working capital or operating cash flow
- Sales per square foot or same store sales where sales is subject to a restatement

What Is Included in Incentive-Based Compensation? (cont.)

- The inclusion of **stock price and TSR** within the definition of “financial reporting measures” raises significant challenges (administrative and financial) in determining what constitutes recoverable incentive-based compensation
 - Issuers would be permitted to use estimates to determine excess compensation in connection with incentive-based compensation tied to stock price or TSR in order to address the “confounding factors” that make it “difficult to establish the relationship between an accounting error and the stock price”
 - Estimates must be reasonable and the company must maintain documentation of the determination of the estimate and provide it to its exchange

What Is **Not** Included in Incentive-Based Compensation?

- Incentive-based compensation **does not include**:
 - Awards that vest *solely* on the basis of completion of a specified employment period, such as service-vesting stock options, restricted stock, or RSUs
 - Awards that are granted, earned, or become vested based solely upon the occurrence of certain non-financial events, for example:
 - Opening a specified number of stores
 - Obtaining regulatory approval for a product
 - Awards earned *solely* upon satisfaction of strategic measures, such as completing a merger, divestiture, or similar transaction
 - Salaries
 - Discretionary bonuses
 - Bonuses paid based on subjective standards, such as leadership

When Is Incentive-Based Compensation Subject to Recovery?

- Incentive-based compensation is deemed to be **received**, and therefore recoverable, in the fiscal period when the financial reporting measure specified in the incentive-based compensation award is attained
- The actual payment date does not matter

Type of Award	When Received
Equity award that vests upon satisfaction of a financial reporting measure and subsequent service	Deemed received in the fiscal period when the financial reporting measure is satisfied
Cash award earned upon satisfaction of a financial reporting measure	Deemed received in the fiscal period when the financial reporting measure is satisfied

- Because incentive-based compensation awards may have both service and performance conditions, an incentive award may be deemed to be “received” before payment is made

When Is the Final Rule Triggered?

- The Final Rule requires that the clawback policy adopted be triggered by both “Big R” and “little r” restatements.
 - The **three-year look-back period** starts on the earlier of (i) the date the company’s board of directors, committee and/or management concludes (or reasonably should have concluded) that a restatement is required or (ii) the date a regulator, court or other legally authorized entity directs the company to restate previously issued financial statements.
- Application of the clawback policy will be triggered **before** the accounting restatement is actually filed.

What Is a Restatement?

- Under the Final Rule, clawback policies must mandate compensation recovery in the event a company is required to prepare an accounting **restatement** due to its material noncompliance with any financial reporting requirement under the securities laws
- The Final Rule applies to both “big R” and “little r” restatements.
- “**Big R**” restatements correct **material** errors to previously issued financial statements and require companies to file an Item 4.02 Form 8-K and amend their filings promptly to restate the previously issued financial statements
- “**Little r**” restatements correct errors that are not material to previously issued financial statements, but would result in a material misstatement if (1) the errors were left uncorrected in the current filing or (2) the error correction was recognized in the current period. As such, this includes any corrections made when filing the prior year’s financial statements and generally does not require an Item 4.02 Form 8-K

The inclusion of “little r” restatements is a stark departure from the original 2015 rule proposal

The SEC notes in the adopting release that “both types of restatements address material noncompliance . . . with the financial reporting requirements”

The SEC also conveyed that this expanded approach addresses concerns that companies “could manipulate materiality and restatement determinations to avoid application of the recovery policy”

What Types of Financial Statement Changes Do Not Constitute a Restatement?

- Consistent with the proposed rule, the Final Rule issuing release provides that the following types of changes to an issuer's financial statements **do not represent error corrections** and, therefore, would not trigger application of a clawback policy:
 - Application of a change in accounting principle
 - Revision to reportable segment information due to a change in the structure of an issuer's internal organization
 - Reclassification due to a discontinued operation
 - Application of a change in reporting entity, such as from a reorganization of entities under common control
 - Adjustment to provisional amounts in connection with a prior business combination
 - Revision for stock splits

When Is a Restatement Required?

- The clawback policy must apply whenever a restatement is **required**
- An accounting restatement is deemed **required** as of the earlier of
 1. the date the company concludes, or reasonably should have concluded, that its previously issued financial statements may contain an error; or
 2. the date a court, regulator, or other legally authorized body directs the company to prepare a restatement to correct a material error
- The SEC declined to define the terms “accounting restatement” and “material noncompliance,” noting that both are covered by existing accounting standards and guidance

What Amount of Incentive-Based Compensation Is Recoverable?

- Recoverable compensation = **excess compensation** = amount the executive received less the amount the executive would have received had the incentive-based compensation been based on the accounting restatement
- Recoverable compensation is calculated on a **pre-tax basis**
- Under the Internal Revenue Code, it is generally possible for an executive to recoup the taxes previously paid on recovered/clawed-back compensation, but only through somewhat complicated tax provisions

Are There Any Exceptions to the Final Rule?

- There are three incredibly narrow exceptions to the requirements of the Final Rule:
 1. recovery is **impracticable** due to costs, determined following an initial attempt to collect,
 2. recovery would **violate a home-country law** adopted before the publication of Final Rule 10D-1 (provided such conclusion is based on an opinion of home-country counsel), and
 3. recovery need not extend to any compensation contributed to **tax-qualified plans**
- Any determination must be made by an independent compensation committee
- Note that there is **no de minimis exception**, which the SEC said in its issuing release as carrying the risk that such exemption would be being over- and under-inclusive.

Impracticability exception is very limited

The direct expense paid to a third party to assist in enforcing recovery would need to exceed the amount to be recovered

Before reaching the conclusion that recovery is “impracticable,” a company must first “make a reasonable attempt to recover” the compensation, document its attempts, and provide the documentation to its exchange

May a Company Provide Indemnification to Executive Officers?

- The Final Rule **prohibits** a listed company from indemnifying or purchasing insurance for any executive officer or former executive officer against the loss of any erroneously awarded compensation
 - The SEC believes that such indemnification arrangements “fundamentally undermine the purpose of Section 10D”
- Executive officers could personally purchase **third-party insurance** (to the extent that such insurance is available) to fund potential recovery obligations
 - Listed companies are not permitted to pay, or reimburse the executive officer for, premiums



Reporting and Disclosure Obligations

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Reporting and Disclosure Obligations

- **New Annual Report Cover Page** must also disclose by check boxes on the cover page whether the financial statements included in the filings reflected correction of an error and whether such error corrections are restatements that require a recovery analysis
- **New Disclosure Rules** (under Regulation S-K Item 402(w) or applicable forms for issuers who don't rely on Regulation S-K) will require companies to disclose "recovery" policies and actions taken to recover erroneously awarded executive compensation during or following the end of the most recently completed fiscal year, including a requirement to provide:
 - The date on which the listed 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 incentive-based 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;

Reporting and Disclosure Obligations (cont.)

- Any outstanding amounts due from any current or former executive officer for 180 days or more, separately identified for each named executive officer (or, if the amount of such erroneously awarded incentive compensation has not yet been determined as of the time of the report, disclosure of this fact and an explanation of the reasons why); and
- If recovery would be impracticable, for each current and former named executive officer and for all other current and former executive officers as a group, the amount of recovery forgone and a brief description of the reason the listed registrant decided in each case not to pursue recovery.
 - Note that, if an amount is properly determined to be non-recoverable due to impracticality, such amount will not be considered to be outstanding at the last fiscal year for purposes of the disclosure requirements described above

Reporting and Disclosure Obligations (cont.)

- **New Exhibit Filing:** the new rules will require the clawback policy to be filed as an exhibit to the annual report on Form 10-K, 20-F or 40-F
- **XBRL:** the new disclosure on the cover page of the Form 10-K, 20-F or 40-F, as applicable, and Item 402(w) with respect to domestic companies must be tagged in interactive block text tag format using eXtensible Business Reporting Language

Consequences of Non-Compliance

- An issuer will be subject to **delisting** if the issuer does not adopt and comply with its compensation recovery policy
- SEC enforcement interest



Practical Implications

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What Should Companies Do Now?

- Companies are not required to adopt clawback policies until the exchanges amend their listing standards to require adoption of clawback policies
 - Plan for 2023 implementation
- Ensure that employment agreements, equity plans, deferred compensation plans, and bonus/incentive arrangements contain appropriate provisions to enable implementation of the Dodd-Frank recovery policies.
 - Create a contractual link between the incentive compensation and the recovery policy

What Should Companies Do Now? (cont.)

- Companies should review their existing clawback policies to determine what modifications will be needed to comply with the new rules. Potential revisions include:
 - Which officers are covered (including former officers)
 - The types of compensation covered
 - The kinds of restatements that trigger compensation recovery
 - The lookback period
 - The mandatory nature of clawbacks under the new rules (no discretion; no-fault)
 - The limited exceptions to compensation recovery
- Consider whether to limit the company's policy to the Dodd Frank policy or to add other discretionary clawbacks such as:
 - Misconduct/breach of restrictive covenants
 - Clawback for broader group of responsible employees if the Dodd Frank clawback is triggered for executive officers

What Should Companies Do Now? (cont.)

- Identify financial measures that may cause incentive compensation to become subject to recovery and consider how the recovery process would work
 - This is especially important for stock price and TSR measures
- Consider a shift toward types of compensation that would not be covered by the clawback rules, such as:
 - Equity compensation that vests based on service
 - Incentive compensation using non-financial/non-stock price measures
 - Discretionary awards
- Consider imposing mandatory deferrals or holding requirements on earned incentive awards to facilitate implementation of the recovery policy

What Should Companies Do Now? (cont.)

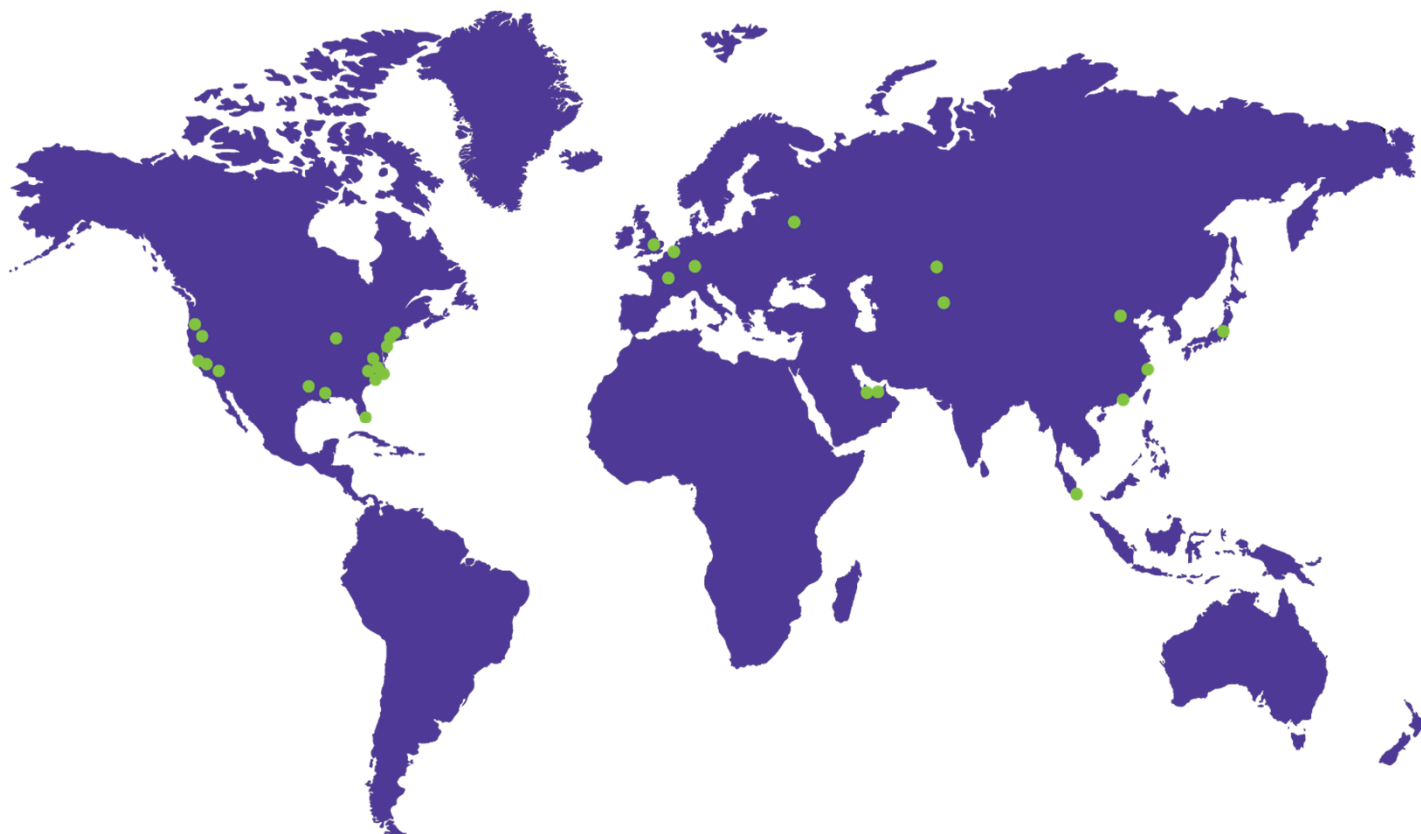
- Review committee charters and other relevant board documents to ensure that the responsibility for determining the Dodd-Frank recovery process is appropriately addressed
- Prepare to devote sufficient time and resources to develop a policy that is both compliant with the final rules and appropriate for the company's compensation policies and governance programs

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