# December 1 Deadline Nears for Adoption of Clawback Policies

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## Introduction

Companies that are listed on the Nasdaq Stock Market or the New York Stock Exchange are required to adopt a clawback policy that provides for the recovery from any current or former executive officers of incentive-based compensation in excess of the amount that would have been paid based on an accounting restatement. The Nasdaq[1] and NYSE[2] listing rules require listed companies to (i) adopt a compliant clawback policy by December 1, 2023, (ii) apply their clawback policies to all incentive-based compensation received on or after October 2, 2023, the listing rules' effective date (**Effective Date**), and (iii) comply with new disclosure requirements for annual reports and proxy statements beginning December 1, 2023.[3]

The listing rules were required by Rule 10D-1 under the Securities Exchange Act of 1934, as amended (**Exchange Act**). Rule 10D-1 was adopted by the Securities and Exchange Commission (**SEC**) on October 26, 2022 to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

## Key Takeaways

- The deadline is fast approaching. Listed companies must adopt a compliant clawback policy no later than December 1, 2023.
- The clawback policy must apply to all incentive-based compensation "received" on or after October 2, 2023, even if the policy is adopted on a later date.
- All issuers with securities listed on a national securities exchange (including smaller reporting companies, emerging growth companies, and foreign private issuers) are subject to the new listing rules.
- Companies will be required to file their clawback policies as an exhibit to their annual reports beginning December 1, 2023 and, if there has been an accounting restatement, check new checkboxes on the cover page of their annual reports and provide additional narrative disclosures.

## Coverage of Mandated Clawback Policies

The clawback policy required by the listing rules must provide that the company will recover reasonably promptly the amount of "erroneously awarded incentive-based compensation" if the company is required to prepare either a "Big R" or a "little r" accounting restatement.[4] The policy must apply to erroneously awarded incentive-based compensation "received" on or after the Effective Date of October 2, 2023, even if pursuant to a compensation award or arrangement in effect prior to the Effective Date.[5] Recovery under the mandated clawback policy is required without regard to any fault or misconduct on the part of the company's executive officers.

For purposes of the mandated clawback policy, "incentive-based compensation" is any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a "financial reporting measure." Financial reporting measures are measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements, and any measures that are derived wholly or in part from such measures.[6] Consistent with Rule 10D-1 under the Exchange Act, the listing rules prescribe that stock price and total shareholder return are financial reporting measures for purposes of the clawback policy.[7] Erroneously awarded incentive-based compensation is the amount of incentive-based compensation received that

exceeds the amount of incentive-based compensation that otherwise would have been received had the amount of incentive-based compensation been determined based on the restated amounts.[8] Erroneously awarded incentive-based compensation must be computed without regard to taxes paid by an executive officer.[9]

For incentive-based compensation based on stock price or total shareholder return, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement,[10] Rule 10D-1 and the listing rules provide that the amount to be recovered must be based on a reasonable estimate of the effect of the accounting restatement on the stock price or total shareholder return, and the company must maintain documentation of its determination of the reasonable estimate and provide the documentation to the applicable stock exchange.[11]

The clawback policy must provide for the recovery of any erroneously awarded incentive-based compensation received by an executive officer during the three completed fiscal years immediately preceding the date that the company is required to prepare an accounting restatement[12] where the executive officer served as an executive officer at any time during the performance period covered by such incentive-based compensation.[13] As a result, former executive officers and persons who served as executive officers for only a portion of a performance period subject to a restatement would be subject to the clawback if they served as executive officers at any time during the performance period of the incentive-based compensation and if the erroneously awarded compensation was received during the three-year lookback period. For example, if a calendar year company should reasonably conclude that a restatement is required in February 2024 for 2022 financial results and the company granted performance stock units based on relative TSR for the period January 1, 2021 through December 31, 2023, the three-year lookback period would be 2021 through 2023, and any person who served as an executive officer at any time during the three-year performance period (even if for a short period) would be subject to the clawback if such person received more shares upon vesting of the performance stock units than would have been the case if vesting had been based on the restated financials. In this example, a person appointed as an executive officer in December 2023 who previously served in a non-executive officer role and who was granted performance stock units in early 2021 would be subject to the clawback policy for any shares determined to be in excess of the number of shares that would have vested based on the restated financials. Likewise, a person who served as an executive officer for a portion of 2021 and then ceased to be an executive officer because of retirement, departure, or transitioning to a non-executive position also would be subject to potential clawback.

For purposes of determining the three-year lookback period, a company is deemed to be required to prepare an accounting restatement on the date the company's board of directors, a committee of the board, or the officer or officers of the company authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the company is required to prepare an accounting restatement.[14]

Accounting restatements that would trigger recovery may be either "Big R" or "little r" restatements.[15] A "Big R" restatement is a restatement that corrects errors that are material to previously issued financial statements. A "little r" restatement is a restatement that corrects errors that are not material to previously issued financial statements, but would result in a material misstatement if (i) the errors were left uncorrected in the current period or (ii) the error correction is recognized in the current period.[16] Out-of-period adjustments, where the correction of an error is recorded in the current period financial statements, do not trigger recovery because the error is not material to the previously issued financial statements and the correction of the error also is not material to the current period.

For purposes of determining whether incentive-based compensation is received during the three-year lookback period, incentive-based compensation is deemed received in the company's fiscal period during which the applicable financial performance measure is attained, regardless of when the award is granted or when payment of the award is made.

Executive officers subject to the clawback policy are the same executive officers who are subject to reporting under Section 16(a) of the Exchange Act.[17] Consistent with the statute, Rule 10D-1 and the listing rules require recovery from executive officers without regard to fault or misconduct. In the Adopting Release, the SEC noted that the categories of executive officers subject to clawback policies would result in recovery from officers who did not play a direct role in an accounting error consistent with the legislative intent. The SEC believes that this may provide executive officers with an increased incentive to reduce the likelihood of inadvertent misreporting and discourage intentional misreporting, and thereby improve the quality and reliability of financial reporting.[18] The SEC also noted that the statute is premised on the principle that shareholders should not bear the economic burden of erroneously awarded compensation and that executive officers should not benefit from accounting errors at the expense of shareholders.

### Enforceability of Clawbacks

The determination of how quickly companies need to recover erroneously awarded compensation will depend on the facts and circumstances. The listing rules do not prescribe how "reasonably promptly" is to be determined. In their proposed rule changes, each of Nasdaq, the NYSE, and the NYSE American stated that a company's obligation to recover erroneously awarded incentive-based compensation reasonably promptly will be assessed on a holistic basis with respect to the accounting restatement and that in evaluating whether a company is acting reasonably promptly, the exchange will "consider whether the [company] is pursuing an appropriate balance of cost and speed in determining the appropriate means to seek recovery, and whether the [company] is securing recovery through means that are appropriate based on the particular facts and circumstances of each executive officer that owes a recoverable amount." Rule 10D-1 and the listing rules also do not prescribe the means by which companies must recover erroneously awarded compensation; such means may be accomplished by offsets against future compensation, cancellation of unvested awards or other appropriate means, provided that recovery is accomplished reasonably promptly so that shareholders do not lose the time value of money (in cases of cash compensation).

Companies will need to have valid contractual bases to enforce their clawback policies against current or former executive officers who are unwilling to comply. Although the listing rules and Rule 10D-1 do not require that companies put such arrangements into effect, a company would be subject to delisting if recovery is required and the company is unable to obtain recovery (subject to the impracticability exceptions discussed below).

### Prohibition on Indemnification

Companies may not indemnify executive officers against the loss of erroneously awarded incentive-based compensation that is recovered. Companies also are prohibited from paying or reimbursing executives for insurance coverage to fund potential recovery obligations. This prohibition may not be evaded through compensation arrangements, such as by awarding a new bonus, which is then used to offset a recovery obligation.

### Impracticability Exceptions

The listing rules provide for limited impracticability exceptions to the company's requirement to recover erroneously awarded incentive-based compensation. Such exceptions are where (i) the direct costs (e.g., legal and consulting fees) of recovery would exceed the amount of recovery, (ii) recovery would violate the laws of the jurisdiction of incorporation of the company adopted prior to November 28, 2022, or (iii) recovery likely would result in disqualification of a tax-qualified retirement plan under which benefits are broadly available to employees of the Company. Any of these determinations must be made by the company's compensation committee (or, in the absence of such a committee, a majority of independent directors). Before availing itself of the exception based on the costs of enforcing the clawback, the company must make a reasonable attempt to recover the compensation, document such attempts, and provide such documentation to the exchange. Before availing itself of the exception based on violation of home country law, the company must obtain an opinion of home country counsel acceptable to the exchange and provide such opinion to the exchange.

## Disclosure Requirements

The listing rules require that listed companies provide all disclosures with respect to their clawback policies required under the federal securities laws.

The SEC adopted Item 402(w) of Regulation S-K[19] and amended Form 10-K[20] to require disclosure regarding a company's clawback policy and, if applicable, information about actions taken pursuant to the clawback policy.[21] Companies are required to file their clawback policies as an exhibit to their annual reports, to indicate by checkboxes on their annual reports whether their financial statements included in the filing reflect a correction of an error to previously issued financial statements and whether any such corrections are restatements that required a recovery analysis. Item 402(w) of Regulation S-K[22] requires disclosure, if applicable, of any actions a company has taken pursuant to its clawback policy. More specifically, in the event of a restatement that required recovery of erroneously awarded incentive-based compensation,[23] a company must disclose (i) the date the company was required to prepare the restatement, (ii) the aggregate amount of erroneously awarded incentive-based compensation, including an analysis of how the amount was calculated, (iii) if the erroneously awarded incentive-based compensation was based on stock price or total shareholder return, an explanation of the estimates used in the computation, (iv) the aggregate amount of unrecovered compensation outstanding as of the end of the fiscal year, (v) an explanation, if applicable, of the reasons why the amount of erroneously awarded compensation has not yet been determined, and (vi) an explanation, if applicable, of the company's reliance on forgoing recovery for reasons of impracticability, including the amounts forgone. The company also must disclose, for each current and former named executive officer,[24] erroneously awarded compensation as of the fiscal year end that has been outstanding for 180 days or more since the date of determination. In the case of a restatement that did not require recovery of compensation, a company must disclose the reasons why recovery was not required. The disclosures required by Item 402(w) must be provided in inline XBRL. Finally, the summary compensation table required by Items 402(c) and 402(n) of Regulation S-K should reflect and explain by footnote any reductions in past compensation as a result of clawbacks.

## References

[1] See Nasdaq Listing Rule 5608. Nasdaq Listing Rule 5608(c) provides that Rule 5608 does not apply to the listing of (i) any security issued by a unit investment trust and (ii) any security issued by a management company registered under the Investment Company Act if the management company has not awarded incentive-based compensation to any executive officer during the last three fiscal years. Nasdaq's amended proposal of its rule is available here.

[2] See Section 303A.14 of the NYSE Listed Company Manual and Section 811 of the NYSE American Company Guide. NYSE and NYSE American listed companies also are required to confirm to their exchange no later than December 31, 2023 via Listing Manager either (i) the adoption of a clawback policy by December 1, 2023 or (ii) reliance on an applicable exemption (limited to the listing of (a) a security futures product cleared by a clearing agency registered under the Exchange Act or that is exempt from registration, (b) standardized options issued by a registered clearing agency, (c) any security issued by a unit investment trust, and (d) any security issued by a management company registered under the Investment Company Act if the management company has not awarded incentive-based compensation to any executive officer during the last three fiscal years). NYSE's amended proposal of its rule is available here. NYSE American's amended proposal of its rule is available here.

[3] In Exchange Act Rules Compliance and Disclosure Interpretation 121H.01, the Staff of the Division of Corporation Finance clarified that that the SEC does not expect compliance with the disclosure requirements until companies are required to have a clawback policy under the applicable exchange listing standards.

[4] Under Section 304 of the Sarbanes-Oxley Act of 2002, in the event of an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws as a result of misconduct, the company's chief executive officer and chief financial officer must reimburse the company for any bonus or incentive-based or equity-based compensation received during the 12-month period following the first public issuance or filing of the financial statements and any profits realized from the sale of securities during such 12-month period. In cases where compensation has been recovered under Section 304, Rule 10D-1 would not provide for duplicative recovery.

[5] As an example, assuming a restatement is required in January 2025 for a calendar year company for its 2023 financial statements, compensation earned or vested under an incentive-based compensation award granted prior to the Effective Date and based on 2023 financial results would be deemed to have been received in 2023 and would be subject to potential clawback. On the other hand, assuming a restatement is required in January 2024 for a calendar year company for its 2022 financial statements, compensation earned or vested under an incentive-based compensation award based on 2022 financial results would be deemed to have been received in 2022, prior to the Effective Date, and would not be subject to clawback.

[6] Consistent with Rule 10D-1, the listing rules provide that a financial reporting measure need not be presented within a company's financial statements or included in a filing with the SEC in order to be a financial reporting measure. In the adopting release for Rule 10D-1 and related rules (Adopting Release), the SEC provides the following non-exclusive list of financial reporting measures: revenues; net income; operating income; profitability of one or more reportable segments; financial ratios (e.g., accounts receivable turnover and inventory turnover rates); net assets or net asset value per share (e.g., for registered investment companies and business development companies that are subject to the rule); EBITDA; funds from operations and adjusted funds from operations; liquidity measures (e.g., working capital, operating cash flow); return measures (e.g., return on invested capital, return on assets); earnings measures (e.g., earnings per share); sales per square foot or same store sales, where sales is subject to an accounting restatement; revenue per user, or average revenue per user, where revenue is subject to an accounting restatement; cost per employee, where cost is subject to an accounting restatement; any of such financial reporting measures relative to a peer group, where the company's financial reporting measure is subject to an accounting restatement; and tax basis income.

[7] In the Adopting Release, the SEC confirms that service-based restricted stock or restricted stock units are not incentive-based compensation. The SEC also states that proceeds from the sale of shares received based in whole or in part on satisfying a financial reporting measure are treated as incentive-based compensation.

[8] Where incentive-based compensation is based only in part on the achievement of a financial reporting measure performan be pro rata based ce goal, the company must first determine the portion of the original incentive-based compensation based on the financial reporting measure that was restated and recover the excess of such amount over the amount that would have been received based on the restatement. In the case of "pool plans," recovery should be pro rata based on the size of the original award rather than discretionary. For nonqualified deferred compensation, the executive officer's account balance or distributions would be reduced by the erroneously awarded compensation contributed to the nonqualified deferred compensation plan and the interest or other earnings accrued thereon under the nonqualified deferred compensation plan.

[9] Executive officers may be able to reduce their current period taxes to reflect tax payments made on compensation that is clawed back.

[10] The SEC notes in the Adopting Release that "little r" restatements are unlikely to result in stock price reactions that would require clawbacks.

[11] The SEC declined to provide specific guidance or a safe harbor for the method estimating the impact of an accounting restatement on stock price or TSR, and noted that there are a number of possible methods with different levels of complexity.

[12] In addition to these last three completed fiscal years, the clawback policy must apply to any transition period (that results from a change in the company's fiscal year) within or immediately following those three completed fiscal years. However, a transition period between the last day of the company's previous fiscal year end and the first day of its new fiscal year that comprises a period of nine to 12 months would be deemed a completed fiscal year. A company's obligation to recover erroneously awarded compensation is not dependent on if or when the restated financial statements are filed.

[13] In addition, the incentive-based compensation must be received while the company has a class of securities listed on a national securities exchange or a national securities association.

[14] If earlier, such date would be the date a court, regulator, or other legally authorized body directs the company to prepare an accounting restatement. In the Adopting Release, the SEC notes that, while a bright-line or single-date standard (for example, the date of the filing of the accounting restatement) would be easier to apply, such an approach would allow for the delay of a restatement in order to manipulate the recovery period. In the case of a "Big R" restatement, the date should coincide with the date of the event reported in an Item 4.02(a) Form 8-K.

[15] In the Adopting Release, the SEC observes that the following changes would not represent error corrections and therefore not trigger application of the mandated clawback policies: retrospective application of a change in accounting principle; retrospective revision to reportable segment information due to a change in the structure of a company's internal organization; retrospective reclassification due to a discontinued operation; retrospective application of a change in reporting entity, such as from a reorganization of entities under common control; retrospective adjustment to provisional amounts in connection with a prior business combination (IFRS filers only); and retrospective revision for stock splits, reverse stock splits, stock dividends, or other changes in capital structure.

[16] In the Adopting Release, the SEC states that including "little r" restatements as triggers addresses the concern that companies could manipulate materiality and restatement determinations to avoid application of the clawback policy. However, the SEC determined not to adopt a requirement for companies to disclose the materiality analysis of an error when the error is determined to be immaterial, noting that the involvement of independent auditors in

evaluating management's materiality analysis, with the oversight of audit committees, helps to ensure that material errors do not go uncorrected by companies seeking to avoid the recovery of erroneously awarded compensation. In addition, restatements will need to be disclosed by checkbox on the cover page of the annual report.

[17] The definition of "executive officer" in Rule 10D-1(d) is substantially identical to the definition of "officer" in Rule 16a-1(f) under the Exchange Act. Foreign private issuers that file annual reports on Form 20-F and 40-F are not subject to Section 16 of the Exchange Act or the rules promulgated thereunder, and therefore these companies previously have not typically needed to make a determination as to their executive officers for purposes of Section 16. Accordingly, such companies and listed companies that only have debt listed will need to make this determination.

[18] The SEC declined to exercise its discretion to exempt foreign private issuers, smaller reporting companies, and emerging growth companies from the new rules. In the Adopting Release, the SEC noted that Congress did not direct the SEC to consider differential treatment for these issuers and that the clawback requirements would, as in the case of other companies, incentivize such companies to prepare reliable financial information. In addition, the SEC stated that recovery of incentive-based compensation that was not earned is as appropriate for these companies as for other companies.

[19] Foreign private issues are required to provide the same disclosures required by Item 402(w) in their annual reports.

[20] Foreign private issuers are subject to reporting on Forms 20-F and 40-F.

[21] Item 402(b) of Regulation S-K has required, for companies subject to this disclosure requirement, disclosure in a company's "compensation discussion and analysis" of a company's clawback policy and decisions regarding the recovery of awards and payments if the performance measures upon which such compensation were based are restated or otherwise adjusted. Smaller reporting companies, emerging growth companies and foreign private issuers are not required to provide "compensation disclosure and analysis" disclosures in their annual reports or proxy statements.

[22] Forms 20-F and 40-F have been amended to require the same disclosures required by Item 402(w).

[23] Disclosure also is required if there is an outstanding unrecovered erroneously awarded compensation.

[24] Named executive officers are determined in accordance with Item 402(a)(3) of Regulation S-K and Item 402(m)(2) of Regulation S-K for smaller reporting companies and emerging growth companies. In Exchange Act Rules Compliance and Disclosure Interpretations 121H.02 and 121H.03, the Staff of the Division of Corporation Finance clarified that foreign private issuers should provide disclosure for executive officers for whom individualized compensation disclosure is included in the Form 20-F or Form 40-F (or, in the case of foreign private issuers that file reports on domestic forms, for executive officers for whom individualized disclosure would be required by Form 20-F).

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