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Long Time Coming: SEC Adopts Final Dodd-Frank Clawback Rules

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Twelve years after the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and many years after the Securities and Exchange Commission started considering regulations implementing the clawback provisions of Dodd-Frank, the SEC published the Final "Clawback" Rules (the "Final Rules") on October 26, 2022. The Final Rules task national securities exchanges ("exchanges") with adopting formal listing standards that, in turn, require publicly listed companies to establish compensation clawback policies that meet the standards prescribed in the Final Rules.

As discussed below, the Final Rules impose (i) substantive standards for identifying and calculating "erroneously paid" incentive compensation subject to clawback and (ii) a series of procedural steps to be taken, and disclosures to be made, in implementing the new clawback regimen and protocols.

Effectiveness and Consequences of Non-Compliance. The Final Rules will not actually go into effect until after exchanges update their listing standards. The timeline is as follows:

- Exchanges must propose formal listing standards that comply with the Final Rules within 90 days after the Final Rules are published in the *Federal Register* (the "Publication Date"), which must then be approved by the SEC.
- Formal listing standards must become effective within 12 months after the Publication Date.
- Issuers will then have 60 days following SEC approval to adopt a compliant written clawback policy.

Any issuer that fails to comply with an exchange's compensation recovery policy requirements will be subject to delisting.

Content of Clawback Policy. The written policy required by the exchanges' formal listing standards must meet strict minimum requirements requiring the recovery of "erroneously awarded" incentive based compensation received by an executive officer:

- triggered by issuer being required to prepare an accounting **restatement** due to material non-compliance by the issuer with any financial reporting requirement under the federal securities laws;
- requires the issuer to recover the gross amount of **"excess" incentive-based compensation** (i.e., before reduction for withholding and other deductions);
- covers incentive-based compensation **received** by **current and former executive officers** (regardless of whether the officer engaged in any misconduct and regardless of fault), within a three-year **"recovery period**."

Restatement. The Final Rules require clawback both in the case of "Big R" Restatements and "little r" restatements. "Big R" Restatements correct errors that resulted in a material accounting misstatement in previously issued financials. On the other hand, "little r" restatements correct errors that are not material to previously issued financials but that would result in a material accounting misstatement if the error were left uncorrected in the current period or if the error correction was recognized in the current period (versus corrected for prior periods). An issuer must consider all relevant facts and circumstances (quantitative and qualitative) surrounding the error in order to assess materiality. Given the extensive reliance in the Final Rules on accounting terminology and methodology, the confirmation of a triggering restatement will require close coordination and review with the issuer's accounting team and outside accountants.

Incentive-Based Compensation. Incentive-based compensation is defined as "any compensation" that is "granted, earned or vested" based in whole or in part upon the attainment of "financial reporting measures." Measures count as "financial reporting measures" if they are determined in accordance with the accounting principles the issuer uses to prepare financial statements, including non-GAAP financial measures. Under the Final Rules, stock price and total shareholder return metrics are also deemed to be "financial reporting measures."

Received. For purposes of the Final Rules, compensation is treated as "received" when the financial reporting measure is attained (even if payment is actually made at a later date). Compensation will be subject to the new rules only if (a) it is received after the recipient becomes a "covered individual" (as described below), and (b) the recipient served as a current or former executive officer at any point during the "recovery period" (discussed below).

Covered Individuals. The Final Rules cover current and former executive officers, which includes an issuer's president, principal financial officer, principal accounting officer, vice president in charge of a principal business unit, division or function, and any other person who performs policymaking functions and otherwise is an executive officer within the meaning of the Section 16 definition of the Securities Exchange Act of 1934. Coverage (i) is tied to executive officer status at any time during the three-year "recovery period" (i.e., not based on status at the time of clawback or even at the time of the restatement) and (ii) does not require that the officer be "at fault" for accounting errors or be directly responsible for preparation of the accounting statements (i.e., it is a strict liability regime). Issuers are prohibited from indemnifying covered individuals from clawbacks, which affects issuers prospectively and retroactively to the extent existing indemnification agreements contain provisions that would be affected by this prohibition.

Recovery Period and Recovery Amount. The Final Rules define the applicable "recovery period" as the three years immediately preceding the earlier of: (i) the date that the issuer concluded or reasonably should have concluded that a restatement was required or (ii) the date that a court directs the issuer to file a restatement. The amount to be recovered is the excess of the erroneous compensation received versus that amount that would have been received had it been determined based on the restated metrics (computed on pre-tax basis); in the case of incentive-based compensation based on stock price or total shareholder return, the recovery amount must be based on a "reasonable estimate" of the effect of the accounting restatement on stock price/shareholder return, with supporting documentation provided to the applicable exchange.

Reporting and Disclosure Requirements. The Final Rules establish a new set of reporting and disclosure requirements:

- Issuers are required to file a copy of their written clawback policy as an exhibit to their Form 10-K, 20-F, 40-F or N-CSR.
- Checkboxes must be included on any 10-K, 20-F or 40-F filed to indicate whether the filed financial statements are a correction to a previous error and whether the correction required an analysis to determine whether excess incentive-based compensation was received.
- Issuers are also required to disclose when the clawback policy is applied. A specific disclosure and/or exhibit must also be made on the proxy statement, Form 10-K,

20-F or 40-F to report the information about the restatement and any potential excess incentive-based compensation payments.

- Inline XBRL tagging is required for the cover page check boxes and data points in an issuer's compensation clawback disclosure.

Very Limited Exclusions. The Final Rules have very limited safe harbors/exclusions. Notably:

- No exclusion for EGCs, SRCs, FPIs, controlled companies or companies with only listed debt securities.
- Compensation not considered "incentive-based compensation" for purposes of the Final Rules:
  - salaries;
  - purely discretionary bonuses;
  - compensation tied to subjective or strategic performance standards (i.e., event-based or operational metrics that are not financial);
  - purely time/service-based awards (e.g., purely time-based equity or equity-based awards, purely service-based retention awards).
- Clawback is not required where the independent Compensation Committee (or if none exists a majority of independent directors on the Board) has determined that recovery would be "impracticable" and any of the following conditions are met: the direct enforcement expenses paid to a third party would exceed the amount to be recovered (after the issuer has made a reasonable and documented attempt to recover such amounts); where recovery would violate a home country law in effect prior to the Publication Date; or where compliance with the clawback policy would cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code. A decision not to claw back compensation is required to be disclosed and is subject to review by the exchange.

Looking Forward. Issuers should work with counsel to determine how the Final Rules will affect their approach to incorporating clawback policies and the potential effect of clawback policies in compensation design, as well as related governance and other considerations. We will continue to publish more on this topic as exchanges propose listing standards and as there are further developments.

Proskauer's Employee Benefits and Executive Compensation team is advising issuers on implementation of new clawback policies and updating existing clawback policies to comply with the listing standards as they are finalized. Please contact a member of the team with questions.

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