Proskauer

Effect of the New NYSE and Nasdaq Clawback Listing Standards on Registered Funds and BDCs

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Beginning on December 1, 2023, companies listed on the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") will need to adopt and comply with policies providing for the recovery, or "clawback", of erroneously awarded incentive-based executive compensation, as required by Rule 10D-1 under the Securities Exchange Act of 1934 ("Rule 10D-1").[1] The new NYSE and Nasdaq listing standards ("Listing Standards") will apply to all exchange-listed business development companies ("listed BDCs") and to a subset of listed registered management companies ("listed registered closed-end funds," and together with listed BDCs, "listed funds").

The clawback policy requirements under the Listing Standards do not, on their face, apply to investment advisory fees paid by listed funds to external investment managers. The clawback requirements do, however, generally apply to: (i) incentive-based compensation received by executive officers of internally-managed listed funds; (ii) incentive-based compensation received by executive officers of externally-managed listed BDCs; and, (iii) in the case of externally-managed listed registered closed-end funds, incentive-based compensation awarded directly by the fund to executive officers within the last three fiscal years. The clawback requirements would also apply to compensation awarded to executives who perform certain services for a listed BDC or non-exempt registered closed-end fund, where some or all of such executives' compensation is reimbursed by the listed fund, even if not paid to them directly as employees.

Listed funds should be mindful of the scope of the clawback requirements under the new Listing Standards as they adopt and apply their mandated recovery policies under Rule 10D-1 and the amended Listing Standards and comply with applicable disclosure requirements.

I. Background

Rule 10D-1, adopted by the Securities and Exchange Commission (the "SEC") in October 2022,[2] mandates national securities exchanges to establish listing standards that require each issuer to implement and disclose a policy providing for the recovery, in the event of a required accounting restatement, of incentive-based compensation received by current or former executive officers where that compensation is based on the erroneously reported financial information (each, a "Recovery Policy"). The NYSE and Nasdaq each proposed Listing Standards in accordance with Rule 10D-1 on February 22, 2023. The clawback listing standards are set forth in Section 303A.14 of the NYSE Listed Company Manual and Rule 5608 of the Nasdaq Rulebook, respectively. In June 2023, the SEC approved the proposed Listing Standards, including amendments filed by each exchange to delay the effective date of the Listing Standards to October 2, 2023.

Issuers listed on NYSE and Nasdaq must implement compliant Recovery Policies by December 1, 2023. However, such policies must apply retroactively to any incentive compensation "received" (as defined in Rule 10D-1)[3] on or after October 2, 2023.

II. Recovery Policy and Disclosure Requirements

The Listing Standards closely conform to the text of Rule 10D-1 and introduce the following requirements, among others:

- A listed issuer's Recovery Policy must provide that the issuer will recover reasonably promptly the amount of erroneously awarded incentive-based compensation in the event that the issuer has to prepare accounting restatements due to the issuer's material noncompliance with any financial reporting requirement under the securities laws. This includes restatements that correct an error in prior period financial statements that is material to the prior period financial statements, or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.
- Recovery Policies must apply to all incentive-based compensation received by a person who served as an executive officer at any time during the performance period for that incentive-based compensation, if such payment was made in the three fiscal years immediately preceding the date that the issuer is required to prepare a qualifying accounting restatement.
- The amount of incentive-based compensation subject to the issuer's Recovery Policy is the amount of incentive-based compensation received that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts, computed pre-tax.

In addition, listed issuers subject to the requirements of Rule 10D-1 must file their Recovery Policies as an exhibit to their annual reports and make certain other disclosures related to their Recovery Policies on Form 10-K, 20-F, 40-F or N-CSR, as applicable.

III. Scope of the Application of the Listing Standards to Registered Closed-End Funds and BDCs

Under the Listing Standards, a compliant Recovery Policy must apply to current and former "executive officers" of a listed issuer, as defined in Rule 10D-1. This includes an officer who performs a policy-making function for the issuer, or any other person who performs similar policy-making functions for the issuer, including executive officers of an issuer's parent or subsidiary, officers or employees of the general partner of an issuer that is a limited partnership, and officers or employees of the trustee of an issuer that is a trust.[4]

The Listing Standards apply to all listed issuers, except for unit investment trusts and management companies registered under Section 8 of the Investment Company Act of 1940 (the "Investment Company Act") that have not directly awarded incentive-based compensation to any executive officer in the last three fiscal years (or since initial listing, if listed for less than three years). Based on a plain reading of this exception, a listed registered closed-end fund does not have to adopt a Recovery Policy so long as it has not directly awarded incentive-based compensation within the relevant period to a person providing it with executive officer services, even if it may have reimbursed such executive's compensation indirectly. Listed BDCs—which do not register under the Investment Company Act—do not qualify for the aforementioned exception and must adopt a compliant Recovery Policy even if they have never awarded any incentive-based compensation.

The clawback requirements under the Listing Standards do not, on their face, apply to investment advisory fees paid by listed funds to external investment managers. The clawback requirements do, however, apply to the following types of compensation where the other conditions necessary to trigger clawback requirements are met: (i) incentive-based compensation received by executive officers of internally-managed listed funds; (ii) incentive-based compensation received by executive officers of externally-managed listed BDCs; and, (iii) in the case of externally-managed listed registered closed-end funds, incentive-based compensation awarded directly by the fund to executive officers within the last three fiscal years. For example, externally-managed listed registered closed-end funds may be subject to the clawback requirements if they employ a chief compliance officer and include incentive-based compensation as part of their pay package. Additionally, a listed BDC and a non-exempt listed registered closed-end fund will be obligated to clawback incentive-based compensation erroneously awarded to an executive officer who performed accounting, compliance or similar administrative services and where a portion or all of their compensation is reimbursed by the issuer, even if the issuer did not employ or compensate such officer directly.

IV. Takeaways

- All listed BDCs, whether or not they pay incentive-based executive compensation, must adopt Recovery Policies that comply with the Listing Standards beginning December 1, 2023.
- Listed registered closed-end funds do not have to adopt a Recovery Policy if they have not directly awarded incentive-based compensation to any executive officer (whether employed by the listed registered closed-end fund or by another entity) in the last three fiscal years or since initial listing, whichever is shorter. Listed registered closed-end funds that intend to pay incentive-based executive compensation should adopt clawback policies prior to making such payments to avoid the consequences of non-compliance.
- The clawback policy requirements under the Listing Standards will not generally apply to externally-managed registered closed-end funds, but will apply to internally-managed registered closed-end funds that pay incentive-based executive compensation. Additionally, externally-managed registered closed-end funds may still be required to adopt Recovery Policies that contain provisions to recover compensation erroneously awarded to a person performing executive officer services for the listed registered closed-end fund, even if not awarded to them as

an employee. Listed funds should be mindful of whether their Recovery Policies capture certain incentive-based arrangements with non-employees who perform accounting, administrative or other policy-making services for such fund.

- As a practical matter, while the clawback policy requirements under the Listing Standards will apply to all listed BDCs, they will only apply to a small handful of internally-managed listed registered closed-end funds.

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[1] See SEC Release No. 34-97688 (June 9, 2023) (approving NYSE Rule 303A.14); SEC Release No. 34-97687 (June 9, 2023) (approving Nasdaq Rule 5608).

[2] See SEC Release No. 33-11126 (October 26, 2022) (Adopting Release).

[3] Incentive-based compensation is deemed received in the issuer's 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.

[4] "Executive officer" means generally a listed issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division, or function (such as sales, administration, or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer. See NYSE Listed Company Manual Section 303A.14(e) and Nasdaq Rulebook Rule 5608(d).