

# SEC Adopts Final Clawback Rules

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## Summary

On October 26, the Securities and Exchange Commission (SEC) adopted [final rules](#) to implement Section 10D of the Securities Exchange Act of 1934, as added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Section 10D). The final rules direct the securities exchanges to adopt listing standards requiring a listed issuer to develop and implement a policy providing for the recovery of erroneously awarded incentive-based compensation received by its current or former executive officers (commonly referred to as a “clawback policy”). The final rules also require a listed issuer to file the policy as an exhibit to its annual report and to include disclosures related to the policy generally and, if a recovery is triggered, other disclosures related to the issuer’s recovery analysis.

## Transition and Timing

Each securities exchange is required to file its proposed listing rules no later than 90 days after publication of the final rules in the *Federal Register*, and the listing standards must be effective no later than one year after publication. Each listed issuer must then adopt the required clawback policy within 60 days, at the latest, following the date on which the applicable listing standards become effective. In other words, listed issuers will need to have compliant clawback policies in place by early 2024, at the latest, although the deadline may be earlier if the securities exchanges adopt final listing standards sooner than required.

Issuers should not feel compelled to take action on their clawback policies immediately. In fact, we do not recommend that policies be formally adopted or amended before the exchanges publish listing standards implementing the final rules. Now is the time for issuers to begin discussions with internal stakeholders and outside advisors regarding the new rules. We expect many issuers to focus on adopting compliant clawback policies after the spring 2023 annual shareholder meeting season, during the summer of 2023.

The additional disclosures required by the final rules are not required in applicable SEC filings until the securities exchanges' listing standards become effective.

## **Included Issuers**

The final rules require securities exchanges to apply the clawback policy and related disclosure requirements to all listed issuers, including emerging growth companies, smaller reporting companies, foreign private issuers, controlled companies, and private companies with publicly listed debt. The SEC believes that exemptions for smaller reporting companies, for example, are not warranted because its objective of recovering excess incentive-based compensation is equally relevant for all categories of listed issuers. The final rules contain only limited exceptions to covered issuers, including the listing of certain security futures products, the listing of standardized options by clearing agencies, securities issued by unit investment trusts, and securities issued by certain registered investment companies (in the case of listed funds, only to the extent that the funds have not awarded incentive-based compensation to any current or former executive officer in any of the last three fiscal years).

## **What Is a Clawback Policy?**

In general, a clawback policy documents the circumstances in which a company may seek to recover previously earned compensation from an executive as a result of a triggering event. The triggering event may include a financial restatement or an executive's engagement in certain detrimental conduct. Clawback policies also usually permit the forfeiture of unvested or unpaid incentive compensation in addition to recovery of previously paid amounts.

A clawback policy can serve one or more purposes, including to discourage manipulation of financial results, to prohibit windfalls to executives when compensation was paid based on erroneous data, and to discourage misconduct. The Section 10D clawback rules are intended specifically to encourage accurate financial reporting and to prohibit windfalls to executives as a result of misstated financials (whether or not such misstatements result from misconduct). As discussed below, factors separate and apart from the Section 10D clawback rules may motivate issuers to design their clawback policies more expansively than the parameters provided under the new rules.

## **Current Landscape for Clawback Policies**

Many public companies have voluntarily adopted clawback policies to satisfy institutional shareholders and proxy advisory firms like Institutional Shareholder Services and Glass Lewis. These policies vary in scope, purpose and breadth, and across industries. For example, financial services companies may have expansive clawback policies (with triggering events that include serious misconduct) to address concerns regarding risk management practices following the 2008-2009 financial crisis. From a documentary perspective, a company may not have all of its clawback provisions located in one place; for instance, a company may maintain a stand-alone clawback policy, but also embed an additional (and different) clawback right in its equity plan or equity award agreements.

Independent from the Section 10D clawback rules, Section 304 of the Sarbanes-Oxley Act of 2002 (Section 304) has its own clawback provision. In the event that an issuer is required to prepare an accounting restatement due to misconduct, Section 304 provides that the issuer's CEO and CFO shall reimburse the issuer for (1) incentive or

equity-based compensation and (2) profits on sales of company stock, in each case received within the prior 12 months. No written clawback policy is required to implement Section 304, and the SEC may initiate actions directly to enforce the provision. In fact, there has been a recent uptick on Section 304 enforcement activity by the SEC. The Section 10D clawback rules do not impact Section 304, which continues to provide a stand-alone clawback right. As a practical matter, however, clawback policies typically clarify that an issuer cannot “double dip” by recouping amounts from an executive under its clawback policy that have already been recouped under a Section 304 clawback.

Another timely development affecting the clawback landscape is a [September 15 memorandum](#) released by the Department of Justice (DOJ) related to corporate criminal enforcement policies and practices. In the memo, the DOJ states that the features of an issuer’s compliance program, including its compensation structure, can impact the terms of the issuer’s potential resolution with the DOJ in the context of a criminal enforcement action. Specifically, prosecutors should consider (1) whether an issuer’s compensation arrangements incorporate elements, such as clawback provisions, which enable the issuer to penalize current or former employees, executives, or directors whose direct or supervisory acts or omissions contributed to criminal conduct, and (2) whether the issuer has indeed recovered under these provisions upon its discovery of misconduct. While more guidance is expected from the DOJ by the end of the year, it is likely that the DOJ is looking for clawback policies to apply to a much larger swath of the employee population than the Section 10D clawback rules (which cover only executive officers), to include triggering events focused on misconduct (even outside of the context of a financial restatement) and perhaps to contain a longer look-back period than the Section 10D clawback rules (which are limited to the three fiscal years preceding the triggering event).

Because of various nuances in the Section 10D clawback rules, we expect that virtually all issuers will need to revise their pre-existing policies to reflect the requirements of the final rules. However, as noted above, issuers may have conduct-related triggers in their clawback policies that are not required by the final rules or cover employees beyond executive officers in their clawback policies. These features that go beyond the requirements of the final rules may serve important purposes for issuers, and we do not expect issuers to eliminate them simply because they are not required under the final rules. While we anticipate that the Section 10D clawback rules will be the primary factor motivating issuers to reconsider their current clawback policies, other external factors will continue to impact discussions on this topic.

### **Clawback Policy Requirements Under the Final Rules**

The final rules direct the exchanges to establish listing standards that require a listed issuer to develop and implement a written policy for recovery of incentive-based compensation. The clawback policy must apply to the issuer’s executive officers and provide for recovery in the event the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities law. The policy must provide for the recovery of incentive-based compensation received in the three years immediately preceding the restatement that is in excess of the amount that would have been received based on the restated financials, subject to limited exceptions. Under the final rules, a clawback policy should have the following features:

<b>Feature</b>	<b>Description</b>
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Covered Compensation	<p>Section 16 “officers”), including the issuer’s principal accounting officer.</p> <p>Does not include compensation of an officer if the officer has any compensation granted, earned, or vested based wholly or in part on attainment of a financial reporting measure, including non-GAAP measures and stock price or total shareholder return.</p>
Triggers	<p>Does not include compensation awarded on a purely discretionary basis or time-based equity awards (if not granted based wholly or in part on attainment of a financial reporting measure).</p> <p>A financial restatement, including both (1) when an accounting restatement is required to correct an error in previously issued financial statements that is material to the previously issued financial statements (a so-called “Big R” restatement) and (2) when an accounting restatement is required that is not material to previously issued financial statements, but would result in a material misstatement if the error was corrected or left uncorrected in the current period (a so-called “little r” restatement).</p> <p>Recovery is based on material noncompliance with financial reporting requirements and is on a “no fault” basis. Executive misconduct or responsibility for the error is not required.</p> <p>The triggering event occurs when the board determines (or reasonably should have determined) that a restatement is required or when a legally authorized body directs the issuer to prepare a restatement, whichever is earlier.</p>

End of Bank Period	<p>officer.</p> <p>The issuer must require that the amount of any incentive-based or bonus compensation received during the fiscal year is not to be taken into account in determining the compensation received by the executive officer for the fiscal year in which the payment was received, unless the issuer has a policy that provides for the forfeiture of such compensation if the executive officer is not employed by the issuer at the end of the fiscal year.</p> <p>Indemnification of recovered amounts is prohibited.</p>
Discretion	<p>Does not apply to incentive-based compensation received before the individual was an executive officer where direct costs of enforcement would clearly exceed the amount to be recovered, where enforcement would be prohibited by law of another jurisdiction, or where enforcement would alter the tax-qualified status of a retirement plan. An issuer's reliance on any exceptions must be publicly disclosed.</p>
Form of Policy	<p>The policy must be documented in a stand-alone policy that is publicly filed.</p>

Certain disclosures are also required in annual reports/proxy statements.

**Covered Individuals**

The final rules apply to a listed issuer's current and former "executive officers." Similar to the definition for "Section 16 officers," "executive officer" is defined as the "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." Executive officers of the issuer's parents or subsidiaries would also be considered executive officers of the issuer if the officer performs policy-making functions for the issuer. The definition is intended to expressly capture officers with an important role in financial reporting, which in turn, should further incentivize high-quality financial reporting. Both current and former executives will be subject to the recovery rules; however, recovery of incentive-based compensation received will only be required by a person "(i) after beginning service as an executive officer and (ii) if that person served as an executive officer at any time during the recovery period."

**Covered Compensation**

The final rules apply to "incentive-based compensation," which is broadly defined as "any compensation that is granted, earned or vested based wholly on or in part upon the attainment of any financial reporting measure," with "financial reporting measure," including any measure that is determined and presented in accordance with the

accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return. The SEC elected to adopt a principles-based definition to capture new forms of compensation that are developed and new measures of performance upon which compensation may be based. However, the final rules provide the following examples of financial reporting measures:

*Revenues, net income, operating income, profitability of one or more reportable segments, financial ratios, net assets or net asset value per share, EBITDA, funds from operations and adjusted funds from operations, liquidity measures, return measures, earnings measures, sales per square foot or same store sales, revenue per user or average revenue per user, cost per employee, and tax basis income.*

The SEC also provided examples of types of compensation that are and are not "incentive-based compensation" for purposes of the final rules:

**"Incentive-Based Compensation"**

Nonequity incentive plan awards that are earned based wholly or in part on satisfying a financial reporting measure performance goal.

Bonuses paid from a "bonus pool," the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal.

Other cash awards based on satisfaction of a financial reporting measure performance goal.

Restricted stock, restricted stock units, performance share units, stock options, and stock appreciation rights (SARs) that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal.

Proceeds received upon the sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying a financial reporting measure performance goal.

**NOT "Incentive-Based Compensation"**

Salaries.

Bonuses paid solely at the discretion of the compensation committee or board that are not paid from a "bonus pool" that is determined by satisfying a financial reporting measure performance goal.

Bonuses paid solely upon satisfying one or more subjective standards (e.g., demonstrated leadership) and/or completion of a specified employment period.

Nonequity incentive plan awards earned solely upon satisfying one or more strategic measures (e.g., consummating a merger or divestiture) or operational measures (e.g., opening a specified number of stores, completion of a project, increase in market share).

Equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal, and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more nonfinancial reporting measures.

**Triggers**

Under the final rules, listed issuers must adopt and comply with a written clawback policy that will be triggered if "the issuer is required to prepare an accounting restatement that corrects an error in previously issued financial statements that is material to the previously issued financial statements (commonly referred to as "Big R" restatements), or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (commonly referred to as "little r" restatements)." The SEC refrained from defining any type or characteristic of an error that would qualify as "material" under this definition, reasoning that

materiality is a determination that must be analyzed in the context of particular facts and circumstances. The final rules broadened the scope of covered restatements compared to the rules initially proposed in 2015, which only contemplated “Big R” restatements as triggers for recovery.

The primary difference between a “Big R” restatement and a “little r” restatement is the reason for the error correction, the form and timing of reporting, and the disclosure required. To illustrate the difference, the SEC provided the following comparison: An issuer must file an Item 4.02 Form 8-K and amend its filings to restate the previously issued financial statements to comply with the requirements of a “Big R” restatement. A “little r” restatement, on the other hand, normally does not trigger an Item 4.02 Form 8-K, and corrections can be made “the next time the registrant files the prior year financial statements.” While many issuers’ existing clawback policies contain a “Big R” restatement trigger, it is not typical to see a “little r” restatement trigger in existing clawback policies. The date on which an issuer is required to prepare an accounting restatement, which would trigger recovery under the listing standards, is the earlier of (1) “[t]he date the issuer’s board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take action if board action is not required, concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting statement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws as described in Rule 10D-1(b)(1); or (2) [t]he date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.” In other words, an issuer is required to prepare an accounting statement when certain issuer or third-party determinations are made that a restatement is needed.

The SEC had requested comments about triggering the clawback off of the date when the issuer “reasonably should have concluded” that a restatement was required as opposed to the actual date that the issuer concluded it was required. The SEC was worried that issuers could be incentivized to delay the date they determine that a restatement is required to avoid application of the clawback policy to certain prior incentive compensation awards. The SEC adopted the “reasonably should have concluded” standard to prevent this kind of potential manipulation of the rules.

### ***Look-Back Period***

The final rules require a clawback policy with a three-year look-back period, which covers compensation received during the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement.

Incentive-based compensation is considered “received” for purposes of triggering the clawback policy “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 occurs after the end of that period.” The date of receipt will therefore depend on the terms of the award. For example, if a restricted stock unit becomes earned based on achieving a specified net income goal for year one and then is subject to continued service vesting over years two and three, the award will be considered “received” at the end of year one (even though the company cannot determine the performance results until early in year two).

As another example, if a nonexecutive officer is granted a performance-based restricted stock unit award with a three-year performance period in year one, is promoted to an executive officer position in year two, and the

applicable financial performance metrics are achieved in year three, the full grant will be considered “received” in year three while the individual was serving as an executive officer (even though it was granted before the individual became an executive officer).

### **Enforcement**

The amount to be recovered under the clawback policy is intended to be recovered for the benefit of the issuer’s shareholders. The recoverable amount is “the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement,” which is calculated as follows: After an accounting restatement, the issuer recalculates the applicable financial reporting measure and the amount of incentive-based compensation that is based on such financial reporting measure. Then, the issuer would determine whether the executive officer received a greater amount of incentive-based compensation than the individual would have received had the recalculated financial reporting measure been used.

*For example, if an annual bonus was formulaically earned based on a level of earnings for a year and if a restatement results in the earnings for the period being less, then the bonus would be recalculated using the lower, restated earnings. The amount by which the bonus is reduced must be repaid.*

If the incentive-based compensation at issue is based only in part on the achievement of a financial reporting measure performance goal, the calculation would only apply to the portion based on or derived from the financial reporting measure that was restated. If the incentive-based compensation at issue is based on stock price or total shareholder return, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from information in an accounting restatement, a reasonable estimate of the effect of the accounting restatement on the applicable measure should apply. The SEC believes there are various approaches issuers may be able to use for this purpose but does not mandate any specific approach. A listed issuer must preserve its records as to the reasonable method used and provide documentation about the reasonable method used to the applicable securities exchange. A listed issuer must also disclose in its proxy statement the reasonable estimates used in determining any erroneously awarded compensation related to those awards.

Lastly, the final rules require that the recoverable amount be calculated on a pre-tax basis to ensure that the issuer recovers the full amount of incentive-based compensation incorrectly awarded. Although the executive officer may not be able to recover previously paid taxes on recouped amounts under applicable tax law, the SEC argues that any tax burden should be borne by the executive officer rather than the issuer.

Under the new rules, issuers are prohibited from insuring or indemnifying any executive officer or former executive officer against loss of erroneously awarded compensation. An executive officer may, however, purchase a third-party insurance policy to fund any potential recovery obligations, provided that the issuer does not pay or reimburse the executive for premiums.

### **Discretion**

The final rules establish very limited circumstances under which executive officers would be permitted to retain incentive-based compensation erroneously awarded. Under the final rules, an issuer must recover such compensation in compliance with its clawback policy except to the extent that pursuit of recovery would be

impracticable and regardless of fault or responsibility for the error or resulting restatement. Any exceptions must be disclosed in future filings pursuant to Item 402(w) (discussed below), which requires disclosure of the amount of recovery forgone and a brief description of the reason the listed issuer decided not to pursue recovery.

Boards of directors may allow executive officers to retain incentive-based compensation where recovery would be “impracticable,” if “(1) the direct cost of recovery would exceed the amount of recovery, and (2) the recovery would violate home country law and additional conditions are met.” Additionally, where recovering amounts from tax-qualified retirement plans would violate anti-alienation rules, issuers may forgo recovery.

In determining whether direct costs would render recovery impracticable, the SEC explains that the only permissible criteria under the final rules are whether the direct costs paid to a third party to assist in enforcing recovery would exceed the amount of erroneously received compensation. For instance, reasonable legal expenses and consulting fees may be considered. In addition, before an issuer’s board of directors concludes that recovery would be impracticable, it must make a reasonable attempt to recover the incentive-based compensation. In the event an issuer decides to forgo recovery, it must document its attempts to recover and provide that document to the exchange. This requirement is intended to ensure that an issuer actually does the work necessary to establish that the costs exceed the recovery amounts before asserting impracticability.

Although an issuer has very limited discretion under the rules as to *whether* it may forego recovery, an issuer has broad discretion as to *how* it may pursue recovery. In other words, if a clawback is triggered under the policy, that does not necessarily mean that the executive officer has to turn around and write a check to the issuer. The SEC states “that many different means of recovery may be appropriate in different circumstances.” In our view, these means may include, for example, an offset against other amounts owed to the executive, the forfeiture of unvested awards, the cancellation of outstanding vested awards, the reduction of future compensation, or a payment plan. However, regardless of the means selected by an issuer’s board of directors, the expectation under the final rules is that recovery will be effectuated reasonably promptly. Disclosure requirements apply in certain cases to erroneously awarded compensation that has not been repaid within 180 days.

## **Disclosure Requirements**

Under the final rules, to provide consistent disclosure across exchanges, a listed issuer must file its clawback policy as an exhibit to its annual report on Form 10-K, a new requirement provided by amended Item 601(b) of Regulation S-K. In addition, amended Item 402(w) of Regulation S-K, Form 40-F (Item 6.F), and Form 20-F (Instruction 19) further require listed issuers to disclose how they have applied their clawback policy, and a new instruction to the Summary Compensation Table requires that any amounts recovered pursuant to a listed issuer’s clawback policy reduce the amount reported in the applicable column, including the “total” column for the fiscal year in which the amount recovered initially was reported. If at any time during its last completed fiscal year an issuer prepared an accounting statement and determined that recovery of wrongly awarded compensation was not required, the issuer must briefly explain why the application of its clawback policy led it to reach such a conclusion.

In connection with the final rules, the cover pages of Form 10-K, Form 20-F, and Form 40-F are also being amended to require additional check box disclosure indicating “(a) whether the financial statements of the registrant included in the filing reflect correction of an error to previously issued financial statements, and (b) whether any of those error corrections are restatements that required a recovery analysis of incentive-based

compensation received by any of the registrant's executive officers during the relevant recovery period pursuant to Section 240.10-D-1(b).”

Finally, the final rules require issuers to tag any specific data points included within the compensation recovery disclosure, as well as the block text of these disclosures in Inline XBRL.

## **Next Steps**

Listed issuers should begin to consider what actions they may need to take, assuming the listing standards mirror the SEC's final rules. As noted, many companies already have clawback policies in effect. Those companies will need to compare their existing policies to the final rules and consider potential changes. For example, we suspect most companies will need to revise their policies to apply to “little r” restatements in addition to “Big R” restatements. They will likely need to narrow board discretion permitted under existing policies. In addition, if an issuer's current clawback policy is triggered by a financial restatement only if there is some executive misconduct or fault (similar to Section 304), the issuer will need to remove that misconduct or fault requirement. Given the number of detailed requirements under the new rules, issuers may need to adopt entirely new policies. Issuers should review existing clawback provisions across their documents holistically and consider how best to incorporate the new rules from a documentary perspective (*i.e.*, one comprehensive policy or separate policies for the Section 10D clawback rules and other purposes).

Issuers should also consider how to best posture their various compensation plans and agreements for enforcement of any clawbacks required under the final rules. An issuer may need to amend its executive agreements or annual incentive and equity award documents to specifically condition compensation on compliance with the issuer's clawback policy.

Finally, given the additional disclosure requirements imposed by the final rules, listed issuers should also evaluate their disclosure controls in light of the new rules and adjust them appropriately to be in a position to accurately prepare the required disclosures.

## **Other Consequences**

As the SEC acknowledged, the final rules may have unintended consequences regarding executive compensation design. While we expect pay-for-performance to continue to be important in the foreseeable future, given say-on-pay voting requirements, pay-for-performance disclosures, and institutional shareholder policies, some companies may de-emphasize plans that count as “incentive-based compensation” as defined under the final rules and shift pay opportunities toward more discretionary or time-based vesting programs not subject to clawback under the final rules. Performance awards tied to nonfinancial metrics, such as operational or strategic measures (*i.e.*, completing an M&A transaction or opening a specific number of stores), may become more common, given that the new rules would not mandate clawback of these types of awards. Since total shareholder return-based awards remain subject to potential adjustment and clawback, the complexities around those potential adjustments may cause some companies to move away from that design. The increased risk of clawback may induce the market to increase total executive pay packages provided by listed issuers. Finally, executive compensation litigation may thrive. Plaintiffs' firms that file shareholder derivative claims may challenge decisions by issuers as to how they implement their clawback policies, arguing for larger clawback recoveries, while executives whose compensation

is subject to clawback may litigate to limit any such recoveries.

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To discuss your company's clawback policies, please reach out to any of the authors listed above or your regular Troutman Pepper contacts.

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