ARCHER
ATTORNEYS AT LAW

November 2022 *Client Advisory*

SEC Adopts Executive Compensation Clawback Rules Mandated Under Dodd-Frank Act

On October 26, 2022, the Securities and Exchange Commission (SEC) adopted final executive compensation clawback rules (Clawback Rules) that require securities exchanges adopt listing standards requiring each listed company to:

- develop and implement a clawback policy providing for the recovery, in the event of an accounting restatement, of incentive-based compensation received by current or former executive officers where that compensation is based on the erroneously reported financial information;
- file the clawback policy as an exhibit to its annual report; and
- disclose in the company's SEC filings a recovery analysis in the event a clawback under the policy is triggered.

The controversial Clawback Rules, originally proposed in 2015, was approved by the Commission by a vote of 3-2 along party lines. The dissenting Commissioners argue that the Clawback Rules are overly broad and beyond the scope of the Dodd-Frank's clawback provision. Although it is anticipated that the Clawback Rules will be challenged in the courts, listed companies need to prepare.

Which companies must comply with the Clawback Rules?

The Clawback Rules will apply to all companies listed on a national securities exchange, like Nasdaq and NYSE. There are no exceptions for smaller reporting companies, emerging growth companies or foreign private companies.

When must companies comply with the Clawback Rules?

The Clawback Rules require exchanges adopt new rules, so deadline for companies to comply is unknown. The Clawback Rules will become effective sixty days following publication of the SEC's release in the Federal Register. The exchanges must adopt final listing standards implementing clawback requirements consistent with the Clawback Rules no later than one year after such publication date. The Clawback Rules require each listed company to adopt a compliant clawback policy no later than sixty days after the date on which the exchange's final listing standards become effective.

Who must be covered under a company's clawback policy?

The clawback policy shall apply to any current or former executive officer of the company who received incentive-based compensation during the three-year completed fiscal year lookback period preceding the restatement. Generally, the definition of "executive officer" utilizes the definition of a Section 16 officer, including the company's president, principal financial officer, principal accounting officer (or the controller if there is no such accounting officer), any vice president in charge of a principal business unit, division or function, and any other person who performs similar policy-making functions for the company. Note that misconduct of such executive officer is not a prerequisite to the clawback requirement.

What events must trigger a clawback?

A company's clawback policy must provide for recovery of incentive-based compensation erroneously received during the lookback period. The Clawback Rule mandates clawback of erroneously awarded compensation when a company 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, sometimes referred to as a "Big R" restatement, or

© Copyright 2022 by Archer. All rights reserved.

- is not material to previously issued financial statements, but that would result in a material misstatement if the error was corrected in the current period or left uncorrected in the current period, sometimes referred to as a "little r" restatement.

What type of executive compensation subject to clawback?

The goal of the Clawback Rules is to align incentive-based compensation when the incentive metrics were thought to be achieved but later discovered to not have been achieved. As a result, the Clawback Rules apply to incentive-based compensation, which includes any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measures that are determined and presented in accordance with the accounting principles used in preparing the company's financial statements and any measures derived wholly or in part from such measures, including non-GAAP measures, stock price and total shareholder return.

Incentive-based compensation does not include: base salary, discretionary bonuses, compensation based on completion of a specified employment period, non-equity incentive plan awards earned solely upon achievement of strategic or operational measures, and equity awards that are subject only to time-based vesting conditions.

What amount is recovered upon trigger of the clawback policy?

Listed companies are generally required to clawback any incentive-based compensation received that exceeds the amount that otherwise would have been received had the compensation been calculated based on the restated amounts. Recognizing the difficulty in determining such amount, the Clawback Rules grant some flexibility where the amount of erroneously awarded compensation is not subject to mathematical recalculation, the amount must be based on a reasonable estimate. Companies are not permitted to indemnify or reimburse an executive officer for such amount subject to the clawback.

What must listed companies disclose?

Each company will be required to file its clawback policy as an exhibit to its annual report on Form 10-K. In addition, in the event that the clawback policy is triggered, the company must report in its Form 10-K or proxy statement details on the triggering event causing the restatement and the incentive compensation recovery.

What should listed companies do now?

Until the relevant exchange has finalized listing standards to include the requisite clawback provisions, a company cannot finalize its clawback policy. However, there are several steps a company should do in the interim.

- Prepare Board. Boards of listed companies will need to assess and, if desired, delegate responsibility for modifying an existing clawback policy, or adoption of new clawback policy, to meet the applicable exchange's rules when adopted. Typically, but not always, the compensation committee will be delegated this responsibility.
- Educate Compensation Committee. The compensation or the relevant board committee needs to be educated on the Clawback Rules and the implications of the anticipated exchange listing rules on executive compensation.
- Review Executive Compensation Agreements. A company should review its existing executive company agreements and arrangements to provide for the forthcoming clawback policy.
- Review Internal Controls. Companies will need to reassess internal controls to determine if changes are necessary to (i) recognize not only "Big R" but also "little r" restatements, and (ii) detect incentive compensation that may be subject to clawback as a result of such restatement.

If you have any questions regarding Clawback Rules, please contact James G. Smith at 646-863-4301 or jsmith@archerlaw.com.

DISCLAIMER: This client advisory is for general information purposes only. It does not constitute legal or tax advice, and may not be used and relied upon as a substitute for legal or tax advice regarding a specific issue or problem. Advice should be obtained from a qualified attorney or tax practitioner licensed to practice in the jurisdiction where that advice is sought.

© Copyright 2022 by Archer. All rights reserved.