

To the Point

SEC – final rule

SEC adopts rules to require 'clawback' policies and disclosures

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[T]hese rules will strengthen the transparency and quality of corporate financial statements ... and the accountability of corporate executives to investors.

— SEC Chair Gary Gensler

What you need to know

- ▶ The SEC adopted final rules to direct national securities exchanges and associations to establish listing standards requiring listed companies to claw back incentive-based compensation received by current and former executive officers during the three years preceding an accounting restatement.
- ▶ The rules require companies to disclose their clawback policies and any compensation subject to clawback in annual reports and in proxy and information statements.
- ▶ Exchanges and associations will have up to a year after the rules are published in the Federal Register to put their new listing standards into effect. Companies will have an additional 60 days to adopt a compliant clawback policy and to provide the required disclosures, meaning compliance will likely be required in 2024.

Overview

The Securities and Exchange Commission (SEC or Commission) adopted **final rules** to direct national securities exchanges and associations to establish listing standards requiring companies to have policies for recovering incentive-based compensation from current and former executives if the company is required to prepare an accounting restatement.

The so-called clawback rule was mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and originally proposed in 2015.

The SEC rules apply regardless of whether an executive was at fault and define executive officer broadly. A company that doesn't implement a policy that complies with the rules, disclose it or comply with its provisions could be subject to delisting. The Commission also adopted amendments to Regulation S-K to implement the new rule's disclosure requirements.

The rules apply to most listed companies, including smaller reporting companies, emerging growth companies and foreign private issuers. They don't apply to certain registered investment companies and unit investment trusts.

Key considerations

Incentive-based compensation

The rules define incentive-based compensation as any compensation that is "granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure," including stock options and other equity awards. Financial reporting measures include accounting-related measures reported in the financial statements (e.g., revenue, net income) and any measures derived wholly or in part from the financial statements, including non-GAAP financial measures (e.g., earnings before interest, taxes, depreciation and amortization), regardless of whether the measures are included in an SEC filing. Financial reporting measures can also include total shareholder return (TSR) or be based on a company's stock price.

The Commission acknowledged that it may be difficult for a company to determine how much compensation to claw back when the measure used to calculate compensation is the company's stock price or TSR. That's because it is not possible to precisely measure how the misstated financial statements affected a company's stock price or TSR. For these reasons, the Commission is allowing companies to use reasonable estimates to make that determination. In the event of a clawback, companies have to maintain documentation of how they arrived at their estimates and provide it to the listing exchange.

How we see it

While many companies voluntarily adopted clawback policies since the proposal was issued in 2015, they will likely need to revise them in light of the new rules. Many voluntary policies only apply to cases of fraud or misconduct, and some apply to a narrower group of executives or have a shorter lookback period than required by the SEC rules.

Accounting restatements

The rules require clawbacks of incentive-based compensation in the event of both "Big R" restatements and "little r" restatements.

"Big R" restatements correct errors that are material to previously issued financial statements. They generally require companies to state in Item 4.02 of Form 8-K that their previously issued financial statements can no longer be relied on and amend the periodic reports that include those financial statements.

"Little r" restatements correct errors that were not material to previously issued financial statements but would result in a material misstatement if left uncorrected in the current report or recognized in the current period. These errors are not required to be reported or corrected until the financial statements for the impacted periods are reissued in a subsequent filing.

Companies do not need to determine that executive officers were at fault or directly contributed to the factors leading to a restatement.

Definition of executive officer

The rules define executive officer broadly, and the definition also applies to former executives. The definition extends beyond the named executive officers and includes a company's president, principal financial officer, principal accounting officer (or controller) and executive officers with policymaking functions, including those who perform the function at the parent and/or subsidiary level.

Recovery period

Clawback policies are required to apply to excess incentive-based compensation received for up to three fiscal years before the date the company is required to prepare a restatement. The lookback period begins on the earlier of (1) the date a company concludes, or reasonably should have concluded, that it is required to prepare a restatement or (2) the date a court, regulator or other legally authorized body directs the company to prepare a restatement. For example, if the board of directors of a calendar-year company determines in November 2024 that a restatement is required, the lookback period would apply to compensation received during 2021, 2022 and 2023, even if the restated financial statements are not issued until 2025.

How we see it

For "Big R" restatements, we would expect the date a company concludes a restatement is required to align with the date triggering reporting on Form 8-K. For "little r" restatements, the beginning of the lookback period may be less clear and may require some judgment.

Incentive-based compensation would be deemed received for purposes of triggering the recovery policy in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is achieved, even if its payment or grant occurs after the end of that period. An award subject to multiple conditions may still be deemed received for purposes of triggering the recovery policy even if an executive officer has not satisfied all conditions.

Other provisions

Companies do not need to determine that executive officers were at fault or directly contributed to the factors leading to a restatement. Boards are not allowed to reimburse or indemnify executives for clawbacks. Companies may forego recovery only in the following situations where recovery would be impracticable:

- ▶ Direct expenses to third parties to assist in the recovery (e.g., legal expenses, consulting fees) would exceed the amount to be recovered, and the company has made a reasonable attempt to recover.
- ▶ Recovery would violate the home country laws of a foreign private issuer, and the company obtained a legal opinion to that effect and has provided it to the exchange.
- ▶ Recovery would cause a tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.

The SEC said boards should not use discretion (other than reasonable estimates related to compensation based on share price or TSR) when determining the amounts to be recovered from each executive officer because that could undermine the "no-fault" concept. However, boards have discretion to determine how executives reimburse the company.

Clawing back compensation does not preclude recovery under Section 304 of the Sarbanes-Oxley Act of 2002, which addresses the recovery of compensation from a company's chief executive officer and chief financial officer.

Disclosure requirements

A company is required to describe its clawback policy in an exhibit to its annual report on Form 10-K (or Forms 20-F or 40-F, as applicable) and, if the company is a domestic registrant, in disclosures in proxy and information statements that call for Regulation S-K's Item 402 disclosure. The following disclosures are required if, during the last completed fiscal year, a company was required to recover excess compensation or had an outstanding balance of excess compensation related to a prior restatement:

- ▶ For each restatement, the date the company was required to prepare a restatement, the total amount of excess compensation attributable to the restatement (including an analysis of how it was calculated) or an explanation of the reasons why the amount has not yet been determined (and disclosure of the amount and related disclosures in the next filing that is subject to Item 402 of Regulation S-K)
- ▶ The total amount of excess compensation that remains outstanding at the end of its last completed fiscal year
- ▶ The estimates used to determine excess compensation based on a stock price or TSR
- ▶ The name of, and amount due from, each current and former named executive officer (NEO) from whom excess compensation has been outstanding for 180 days or longer
- ▶ The names of current and former NEOs and the amount of any foregone recovery related to each of them, the total amount of any foregone recovery for all other current and former executive officers as a group, and a description of why recovery was not pursued
- ▶ An explanation of why the company concluded recovery was not required, if applicable

A company may choose to include the disclosures in either its Compensation Discussion and Analysis, if it is required to provide one, or as a separate item. The disclosures have to be tagged using Inline XBRL. Companies are also required to check boxes on the cover page of their annual reports to indicate whether (1) the financial statements contain a restatement to correct prior financial statements and (2) any of those restatements required a recovery analysis of incentive-based compensation.

Transition period

Listing standards have to be effective no later than one year after publication of the rules in the Federal Register. Companies are required to adopt clawback policies within 60 days of the effective date of the listing standards and include the required disclosures in their filings on or after that date. Companies are required to comply with the recovery policy on or after the effective date of the applicable listing standard.

Next steps

Companies that have clawback policies should review the terms and consider what changes are necessary to comply with the rules. They may also want to consider the population of executive officers that could be subject to clawbacks and review the terms of their compensation agreements with these executives.

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