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SEC Releases Final Rules Regarding Clawback Policies

By Karen Hsu Kelley, Gregory T. Grogan, Jamin Koslowe, Jeannine McSweeney, Andrew Blau and David E. Rubinsky

This article summarizes new Rule 10D-1 under the Securities Exchange Act of 1934 (the “Exchange Act”) as adopted and released by the Securities and Exchange Commission (the “SEC”) on October 26, 2022, requiring the recovery of erroneously awarded incentive-based compensation in the event that an issuer is required to prepare an accounting restatement.

Background

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) added Section 10D to the Exchange Act, requiring the SEC to direct the national securities exchanges to establish listing standards that require issuers to develop and implement a clawback policy. The clawback policy must provide that, in the event an issuer is required to prepare an accounting restatement, the issuer will recover incentive-based compensation erroneously paid to its current or former executive officers based on any misstated financial reporting measure. The policy must apply to incentive compensation received during the three-year period preceding the date the issuer is required to prepare the accounting restatement.

In July 2015, the SEC proposed rules to implement Section 10D. Following several comment periods, the SEC has now adopted the final rules, which largely track the previously proposed rules.

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Effective Date of Final Rules

The final rules will become effective 60 days following publication of the adopting release in the Federal Register. Exchanges will be required to file proposed listing standards no later than 90 days following publication of the release in the Federal Register, and the listing standards must be effective no later than one year following publication. Issuers subject to the listing standards will then be required to adopt a corresponding clawback policy no later than 60 days following the date on which the applicable listing standards become effective, and will thereafter be required to comply with related disclosure requirements.

Issuers Subject to the Final Rules

As under the proposed rules, final Rule 10D-1 generally applies to all listed issuers, including smaller reporting companies, emerging growth companies, foreign private issuers, controlled companies and issuers of debt and non-equity securities. The SEC apparently was unpersuaded by numerous commenters who questioned the utility and feasibility of applying the rules to foreign private issuers and certain other classes of issuers. The only exempted issuers under the final rules are issuers of security futures products, standardized options, unit investment trust securities and certain registered investment company securities.

Clawback Trigger and Covered Period

An issuer’s clawback policy must require recovery of incentive compensation erroneously paid during the three completed fiscal years immediately preceding the date on

which the issuer is required to prepare an accounting restatement to correct an error that is material to previously issued financial statements.

The final rules clarify that triggering restatements may include both (1) restatements that correct errors that are material to previously issued financial statements (commonly referred to as “Big R” restatements) and (2) restatements that correct errors that are not material to previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period (commonly referred to as “little r” restatements).

Although the Dodd-Frank Act did not require the SEC to mandate clawbacks in the context of “little r” restatements, the SEC previously expressed concern that excluding “little r” restatements from the scope of the rules might encourage opportunistic behavior by companies when choosing between a “Big R” and “little r” restatement. This requirement extends well beyond the reach of clawback policies currently adopted by most public companies and, when combined with other features of the rules, will likely lead to a significant increase in the number of required clawbacks.

As under the proposed rules, the final rules provide that the “date on which the issuer is required to prepare an accounting restatement” (which, in turn, triggers the three-year lookback for recoverable incentive compensation) will be deemed to be the earlier of:

- The date the issuer’s board of directors (or committee thereof) or the officer or officers of the issuer authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement due to the material non-compliance of the issuer with any financial reporting requirement under the securities laws; or

- The date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.

Covered Executive Officers

The final rules define covered “executive officers” using the same definition used to determine an issuer’s Section 16 officers. This includes an 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.

The final rules also confirm that executive officers are subject to the clawback requirements without regard to any scienter or responsibility on their part related to the restatement or the mistaken payments. Moreover, the final rules prohibit issuers from insuring or indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation.

In a change from the proposed rules, the final rules will not require recovery of incentive-based compensation in circumstances where (i) the compensation was received by a person before beginning service as a covered executive officer or (ii) if that person did not serve as an executive officer at any time during the three-year lookback period for which the clawback rules apply.

Incentive Compensation Subject to Clawback

Similar to the proposed rules, the final rules define “incentive-based compensation” subject to the clawback policy to be “any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial

reporting measure.” The final rules clarify that “financial reporting measures” may include both GAAP and non-GAAP financial measures, and also includes measures linked to stock price and total shareholder return (TSR).

Specific examples of “incentive-based compensation” include, but are not limited to:

- Non-equity 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 that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal; and
- 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.

Examples of compensation that is *not* “incentive-based compensation” for purposes of the final rules include, but are not limited to:

- 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;

- Non-equity 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); and
- 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 (*e.g.*, discretionary grants of time-vesting restricted stock, restricted stock units, stock options or stock appreciation rights).

Mandatory Recovery by Issuers and Related Disclosure Requirements

The final rules provide that a clawback policy must require the issuer to seek recovery of any incentive-based compensation paid to executive officers in excess of the amount that otherwise would have been received during the relevant three-year period had the compensation been determined based on the restated financial measure. The rules permit issuers to decline to seek such a recovery of payments only in very limited circumstances where:

- Direct expenses paid to third parties to assist in enforcing the policy would exceed the amount to be recovered and the issuer has made a reasonable attempt to recover;
- Recovery would violate home country law that existed at the time of adoption of the rule, and the issuer provides an opinion of counsel to that effect to the exchange; or
- Recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.

Moreover, the final rules require issuers to file their clawback policy as an exhibit to their annual report and disclose in their annual report and in any proxy or information statements that call for disclosure pursuant to Item 402 of Regulation S-K, how they have applied the policy, including, as relevant:

- the date the issuer was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (including the estimates used in calculating the recoverable amount in the case of awards based on stock price or TSR);
- the aggregate amount of erroneously awarded incentive compensation that remains outstanding and any outstanding amounts due from any current or former named executive officer for 180 days or more, separately identified for each individual (or, if the amount of such erroneously awarded incentive compensation has not yet been determined as of the time of the report, disclosure of this fact and an explanation of the reasons why); and
- details regarding any reliance on the impracticability of recovery exceptions.

This disclosure will be required to be tagged in Inline XBRL.

The final rules also add a new instruction to the Summary Compensation Table requiring any amounts recovered pursuant to an issuer's clawback policy to reduce the amount reported in the applicable column, as well as the "total" column" for the fiscal year in which the amount recovered initially was reported, and be identified by footnote.

In addition, the final rules require new check-the-box disclosure on the cover of Forms 10-K, 20-F, and 40-F that indicate separately (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 Rule 10D-1.

Observations and Next Steps

Monitor the Effective Date of the Final Rules. Even though the final rules will become effective 60 days after publication in the Federal Register, the listing exchanges have up to 90 days post-publication to release their implementing rules which, in turn, must become effective within one year following the Federal Register publication date. Issuers will then have 60 days following the effective date of the listing exchange rules before they are required to implement the required clawback policy and comply with related disclosure requirements in subsequent proxy statements and annual reports.

Review Clawback Policies. Issuers should review their existing policies to consider potential updates that may be required under Rule 10D-1. However, issuers may want to wait for the listing exchanges to release their implementing rules before actually adopting or amending clawback policies to comply with the new rules.

Review Existing Incentive Compensation Plans and Agreements. Issuers should review their existing plans and agreements and consider incorporating language that specifically subject incentive compensation awards to any applicable clawback policies that the issuer may adopt from time to time.

Clawback Policies May Exceed Rule 10D-1 Requirements. It is important to note that Rule 10D-1 sets a baseline floor for minimum requirements that a clawback policy must meet, but does not prevent an issuer from adopting policies that would provide for recovery of compensation from individuals and in situations not specifically required by Rule 10D-1. For example, an issuer may choose to extend its clawback policy to cover individuals who are not executive officers and may also choose to implement

clawbacks in situations not linked to financial restatements (*e.g.*, situations involving employee misconduct or breaches of restrictive covenants).

Difficulties in Calculating Excess Compensation Amounts. The final rules may require issuers to conduct difficult and costly analyses to determine the amount of performance-based compensation that would have been paid to covered executives based upon restated financial reporting measures, particularly in situations involving updated TSR calculations or multiple performance measures. As the recalculation and related conclusions are required to be disclosed, there may be heightened scrutiny from plaintiffs' lawyers challenging the methodology and/or the outcome of the issuer's clawback analysis.

Impact on Prevalence of Incentive Compensation. The final rules may result in a shift in the balance of the total compensation provided to executive officers away from the types of incentive-based compensation awards that would be subject to the rules. For example, issuers may consider shifting a greater portion of executives' total compensation into increases in discretionary bonuses or time-vesting equity awards in lieu of incentive-based compensation, in order to avoid the potential complexity of future mandated clawbacks. However, any such tendency may be mitigated by compensation committees' and shareholders' continued desire to substantially link executive pay to financial performance in the ordinary course.