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SEC Adopts Final Rules for Recovery of Erroneously Awarded Compensation

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After years of deliberations and delays, the U.S. Securities and Exchange Commission (SEC) adopted final rules on clawbacks in October 2022. The new rules (known as Rule 10D-1) require U.S. national securities exchanges and securities associations to establish standards requiring listed issuers to adopt, implement and disclose policies mandating the recovery of erroneously awarded incentive-based executive compensation from executive officers if the issuer is required to prepare an accounting restatement. The new rules also apply to foreign private issuers listed on U.S. stock exchanges, including Canadian multijurisdictional disclosure system (MJDS) issuers that file their annual reports on Form 40-F.¹ Issuers that fail to comply with the new rules would be subject to delisting.

Stock exchanges are required to propose listing standards implementing the new rules within 90 days of publication of the final rules in the *Federal Register*. The listing standards must become effective within one year of such publication. Issuers will be required to adopt a compliant recovery policy within 60 days of the date on which the listing standards become effective. This means that the new rules will not take effect until mid-2023 at the earliest.

Written Recovery Policy

The new rules require listed issuers to adopt, implement and disclose a written recovery policy. The policy must provide that an issuer that is required to prepare an accounting restatement must recover from any current or former executive officer incentive-based compensation that was based on erroneous data during the three-year period preceding the date the issuer is required to prepare the accounting restatement and that exceeds what would have been paid to the executive officer under the restatement. The date an issuer is required to prepare an accounting restatement is the earlier of (i) the date the issuer's board of directors (or a board committee or authorized officers) concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement and (ii) the date a court, regulator or other authorized body directs the issuer to prepare an accounting restatement.

The term "accounting restatement" includes both an accounting restatement that corrects an error that is material to previously issued financial statements (known as a "Big R" restatement) and an accounting restatement that is not material to previously issued financial statements, but that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (known as a "little r" restatement).

The recovery policy would not be triggered if the correction of an error is recorded in the current period financial statements (referred to as an "out-of-period adjustment"), the error is immaterial to the previously issued financial statements and its correction is also immaterial to the current period. In addition, the recovery policy would not be triggered by changes to an issuer's financial statements that do not represent error corrections, such as a retrospective revision to

- reflect a change in accounting principle;
- reportable segment information due to a change in the structure of the issuer's internal organization;
- reflect a reclassification due to a discontinued operation;
- apply a change in reporting entity, such as a reorganization of entities under common control;

- adjust provisional amounts regarding a prior business combination (only for filers reporting under International Financial Reporting Standards as issued by the International Accounting Standards Board); or
- reflect a stock split, reverse stock split, stock dividend or other change in the issuer’s capital structure.

Executive Officers Subject to Recovery Policy

The term “executive officer” is broadly defined to include the issuer’s president, principal financial officer, principal accounting officer, any vice-president of the issuer in charge of a principal business unit, division, or function, 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 parent or subsidiaries will be deemed executive officers of the issuer if they perform such policy-making functions for the issuer. In addition, when the issuer is a limited partnership, officers or employees of the general partner who perform policy-making functions for the limited partnership will be deemed officers of the limited partnership. If the issuer is a trust, the trustee’s officers or employees who perform policy-making functions for the trust are deemed officers of the trust.²

Incentive-Based Compensation Subject to Recovery Policy

The term “incentive-based compensation” is defined to include any compensation that is granted, earned or vested wholly or in part based upon the attainment of any “financial reporting measure.” Financial reporting measure is defined as a measure that is determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements and any measures derived wholly or in part from such measure. This includes non-GAAP financial measures, stock price and total shareholder return (TSR), as well as other measures, metrics and ratios that are not non-GAAP measures. Financial reporting measures may or may not be included in a filing with the SEC and may be presented outside the financial statements, such as in the issuer’s management’s discussion and analysis.

Recovery Process

The erroneously awarded compensation is the amount of incentive-based compensation received by the current or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been based on the accounting restatement. The excess amount must be computed without respect to tax liabilities that may have been incurred or paid by the executive officer to ensure that the issuer recovers the full amount of incentive-based compensation that was erroneously awarded. In its adopting release, the SEC explains that recovery on a pre-tax basis permits the issuer to avoid the burden and administrative costs associated with calculating erroneously awarded compensation on the basis of the particular tax circumstances of individual executive officers, which may vary significantly according to factors independent of the incentive-based compensation and outside the issuer’s control.

For incentive-based compensation based on stock price or TSR, if the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from information in an accounting restatement, the amount must be based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. The issuer also must maintain documentation of the determination of that reasonable estimate and provide it to the exchange.

In its adopting release, the SEC provided the following additional guidance for calculating erroneously awarded compensation:

- For cash awards, the erroneously awarded compensation is the difference between the amount of the cash award (whether payable as a lump sum or over time) that was received and the amount that should have been received according to the restated financial reporting measure.
- For cash awards paid from bonus pools, the erroneously awarded compensation is the pro rata portion of any deficiency that results from the aggregate bonus pool that is reduced when the restated financial reporting measure is applied.
- For equity awards, if the shares, options or stock appreciation rights are still held at the time of recovery, the erroneously awarded compensation is the number of such securities received in excess of the number that should have been received according to the

restated financial reporting measure (or the value of that excess number). If the options or SARs have been exercised, but the underlying shares have not been sold, the erroneously awarded compensation is the number of shares underlying the excess options or SARs (or the value thereof).

Board Discretion in Seeking Recovery

A listed issuer must recover erroneously awarded compensation in compliance with its recovery policy, except where pursuit of recovery would be impracticable due to one of the following circumstances:

- The direct cost of recovery would exceed the amount of recovery; in the determination of whether recovery would be impracticable due to costs, only direct costs paid to third parties, such as reasonable legal expenses and consulting fees, may be taken into account.³
- The recovery would violate the issuer's home country law according to a home country counsel's opinion that is acceptable to the applicable exchange.
- The recovery would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees of the issuer, to fail to meet the requirements of the Internal Revenue Code.

A determination that recovery would be impracticable in any of those three circumstances must be made by the issuer's committee of independent directors that is responsible for executive compensation decisions. In the absence of a compensation committee, the determination must be made by a majority of the independent directors serving on the board.

While the rules permit issuers to exercise discretion in how to accomplish recovery, they must recover erroneously awarded compensation reasonably promptly as delays in recovering excess payments would allow executive officers to capture the time value of the funds they did not earn, which should instead belong to shareholders. The term "reasonably promptly" is not defined, and the SEC explains in its adopting release that what is reasonable may depend on the additional cost incident to recovery efforts. The SEC states that it expects that issuers and their directors and officers, in exercising their fiduciary duty to safeguard the assets of the issuer (including the time value of any potentially recoverable compensation), will pursue the most appropriate balance of cost and speed in determining the appropriate means to seek recovery. Listed issuers are prohibited from indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation.

Required Disclosure in Annual Reports

Listed issuers are required to attach their recovery policy as an exhibit to their annual reports on Form 10-K (for domestic issuers), Form 20-F (for most foreign private issuers) or Form 40-F (for Canadian MJDS issuers), and to indicate by check boxes on their annual reports whether their financial statements in the filing reflect a correction of an error to previously issued financial statements and whether any such corrections are restatements that required a recovery analysis.

In addition, Regulation S-K is amended to require issuers to disclose in their annual reports any actions that they have taken under their recovery policy, including the date and amount of any erroneously awarded compensation attributable to an accounting restatement; any estimates that were used in determining the amount; the amount that remains to be collected; and the names of, and amounts owed by, executive officers where amounts due are owed or forgone. The disclosure must be tagged using Inline eXtensible Business Reporting Language (XBRL).

¹ The rules exempt only listings of security futures products cleared by certain clearing agencies, standardized options issued by registered clearing agencies, securities issued by unit investment trusts and securities issued by certain registered investment companies. In its adopting release, the SEC expresses its view that those issuers are fundamentally different from other listed issuers.

² This definition is consistent with the definition of "officer" in Rule 16a-1(f) under the *Securities Exchange Act of 1934*.

³ Rule 10D-1 also requires the issuer to make a reasonable attempt to recover incentive-based compensation before concluding that it would be impracticable to do so. The issuer must document its attempts to recover and provide that documentation to the exchange.

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