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SEC Adopts Final Compensation Clawback Rules

Last week, the SEC released final [compensation clawback rules](#) under the Dodd-Frank Act, more than thirteen years after the Act became law. Under the final rules, which closely track the 2015 proposed rules, an issuer must adopt a policy that requires it to recover from executive officers incentive compensation that would not have been earned based on specified accounting restatements.

*When do the rules become effective?* The final rules become effective 60 days following their publication in the Federal Register. Exchanges must file proposed listing standards no later than 90 days following the publication date, and the listing standards must be effective no later than one year following the publication date. Issuers have 60 days following the effective date of the applicable listing standards to adopt a compliant recovery policy. Failure to comply with these rules will result in delisting by the applicable exchange.

*Which companies are covered?* With limited exceptions, the rules apply broadly to all issuers with listed securities, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and issuers of listed debt whose stock is not also listed.

*Which individuals are covered?* The recovery policy must apply to an issuer's current and former executive officers who served in that capacity at any time during the applicable look-back period. The term "executive officer" is defined expansively to include the issuer's president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division or function and any other person (including executive officers of a parent or subsidiary) who performs similar policy-making functions for the issuer. Policy-making function is not intended to include policy-making functions that are not significant.

*What types of restatements trigger application of the recovery policy?* A restatement due to material non-compliance with any financial reporting requirement under the securities laws triggers application of the recovery policy. The determination regarding materiality is based on facts and circumstances and existing judicial and administrative interpretations.

*How is the applicable look-back period determined?* Incentive-based compensation received during the three completed fiscal years immediately preceding the date that a restatement is required is subject to the recovery policy. Incentive-based compensation is deemed *received* in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the grant or payment occurs before or after that period.

*What types of incentive-based compensation are covered?* Under the final rules, "incentive-based compensation" means any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. "Financial reporting measures" include measures that are determined and presented in accordance with the accounting principles used in an issuer's financial statements, as well as an issuer's stock price and total shareholder return. Importantly, stock options and other equity awards that vest exclusively on the basis of service, without any performance condition, and bonus awards that are discretionary or based on subjective goals or goals unrelated to financial reporting measures, do not constitute incentive-based compensation. Issuers should be mindful that board materials and proxy disclosures regarding pay programs could impact whether or not the applicable compensation is treated as "incentive-based compensation" for purposes of the final rules.

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*How is the recovery amount determined?* The recovery amount equals the amount, calculated on a pre-tax basis, of incentive-based compensation received in excess of what would have been paid to the executive officer upon a recalculation of such compensation based on the restated amounts. For incentive-based compensation that is not subject to mathematical recalculation based on the information in an accounting restatement (e.g., compensation based on stock price goals or total shareholder return), the recoverable amount must be determined based on a reasonable, documented estimate of the effect of the accounting restatement on the applicable measure.

For equity awards that are incentive-based compensation, if the shares or options are still held at the time of recovery, the recoverable amount is the number of shares or options received in excess of the number that should have been received after applying the restated financial reporting measure. If options have been exercised, but the underlying shares have not been sold, the recoverable amount is the number of shares underlying the excess options applying the restated financial measure. If shares have been sold, the recoverable amount is the sale proceeds received by the executive officer with respect to the excess number of shares.

*Does a board have discretion whether to seek recovery?* Board discretion is limited. An issuer is required to recover compensation in compliance with its recovery policy, except to the extent that pursuit of recovery would be impracticable because it would: (1) impose undue costs on the issuer, (2) violate home country law based on an opinion of counsel or (3) cause a broad-based retirement plan to fail to meet the tax-qualification requirements. Before concluding that pursuit is not feasible, the issuer must first make a reasonable attempt to recover the incentive-based compensation. Finally, a board is required to apply any recovery policy consistently to executive officers and an issuer is prohibited from indemnifying any current or former executive officer for recovered compensation.

*What additional disclosure requirements do the rules impose?* A listed U.S. issuer must file its recovery policy as an exhibit to its Form 10-K. In addition, the final rules require disclosure in an issuer's annual proxy statement of the following items, among others, if, during the prior fiscal year, either a triggering restatement occurred or any balance of excess incentive-based compensation was outstanding: (1) the name of, and the amount due from, each individual from whom excess incentive-based compensation had been outstanding for 180 days or longer, and (2) the names of individuals from whom the issuer declined to seek recovery, and the reasons for declining to do so. The additional proxy statement disclosures apply immediately following the effective date of the applicable listing standards.

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Most public companies already have in place thoughtfully crafted compensation clawback policies. These clawbacks are an important tool in the case of misconduct or unjust enrichment. It is unfortunate that the final rules deprive boards of meaningful discretion to exercise business judgment in nuanced situations. Some issuers may restructure elements of their compensation programs to fall outside the scope of the statutory clawback rules. Looking forward, now is the time for each company to prepare to adopt a policy that will meet the new requirements on the anticipated schedule.

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