WINSTON & STRAWN LLP

BLOG

Key Implementation Steps for Listed Companies as Deadline for Adopting Clawback Policies Rapidly Approaches

AUGUST 16, 2023

Introduction

On June 9, 2023, the Securities and Exchange Commission (the SEC) approved the New York Stock Exchange (NYSE) and Nasdaq Stock Market (Nasdaq) listing standards related to recovery of erroneously awarded compensation, referred to as "clawbacks," as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). New Section 303A.14 of the NYSE Listed Company Manual and Nasdaq Rule 5608 implement the requirements of Rule 10D-1 adopted by the SEC in November 2022 pursuant to Section 10D of the Securities Exchange Act of 1934, as amended (the Exchange Act), added by the Dodd-Frank Act in 2010.

Rule 10D-1 directs the national securities exchanges, such as the NYSE and Nasdaq, to adopt listing standards that require listed companies to:

- Adopt and comply with a clawback policy providing for the recovery, following an accounting restatement, of erroneously awarded incentive-based compensation received by current ***and former*** executive officers;
- File the listed company's clawback policy as an exhibit to its annual report filed with the SEC; and
- Annually disclose any activity to recover erroneously awarded compensation during its last completed fiscal year.

What do the clawback listing standards require of listed companies?

As required by Rule 10D-1, the NYSE and Nasdaq listing standards require listed companies to have a written clawback policy that requires the company to recover erroneously awarded incentive-based compensation if a company needs to prepare an accounting restatement due to the company's noncompliance with any financial reporting requirement. Each listed company must file its clawback policy as an exhibit to its annual report on Form 10-K, 20-F, 40-F, or N-CSR, as applicable.

The NYSE and Nasdaq clawback listing standards mirror the text of Rule 10D-1 and specifically require each listed company to (i) adopt a policy governing the recovery of erroneously awarded compensation (a "clawback policy"), (ii) comply with its clawback policy for all incentive-based compensation received by executive officers on or after the effective date of the listing standards, and (iii) provide certain disclosures required by the clawback listing standards in the applicable SEC filings, as discussed further below. In addition, as required by Rule 10D-1, the clawback listing

standards prohibit the initial or continued listing of any security of any company that is not in compliance with the requirements of the clawback listing standards.

What is the compliance date?

The clawback listing standards of both the NYSE and Nasdaq will become effective on October 2, 2023, which means that listed companies must begin recovery of erroneously received incentive-based compensation received by executive officers on or after that date (see below for a further discussion of when compensation is "received"). In addition, listed companies will have to adopt compliant compensation clawback policies within 60 days after the listing standards' effective date (i.e., by December 1, 2023).

What compensation payments are subject to the clawback policy?

Under the clawback listing standards for both the NYSE and Nasdaq, listed companies must recover incentive-based compensation erroneously received by current and former "executive officers" (as discussed below). The required clawback policies apply to all executive officers regardless of fault.

Incentive-based compensation is any compensation (such as equity and equity-based awards, bonus payments, non-equity incentive plan awards, or cash awards) granted, earned, or vested based wholly or in part upon the attainment of any "financial reporting measure," which generally refers to any measure determined and presented in accordance with accounting principles used to prepare the company's financial statements, including any measures derived in whole or in part from such measures. Financial reporting measures may include both GAAP and non-GAAP measures (such as revenues, operating income, net assets, EBITDA, and financial ratios), as well as stock price and total shareholder return (TSR), regardless of whether the measure appears in the company's financial statements or SEC filings. For a non-exhaustive list of examples of clawback-eligible incentive-based compensation, see our previous client alert on the adoption of Rule 10D-1, available here.

The clawback policies must cover incentive-based compensation received by a person:

- after beginning service as an executive officer;
- who served as an executive officer at any time during the performance period for that incentive-based compensation;
- who served as an executive officer while the company had a class of securities listed on a national securities exchange, such as the NYSE or Nasdaq; and
- who served as an executive officer during the three fiscal years preceding the date on which the company is required to prepare an accounting restatement to correct a material error (i.e., the date the Board, a Board committee, or management (if no Board action is required) concludes, or reasonably should have concluded, that the company is required to prepare an accounting restatement, or the date a court, regulator, or other legal authorized body directs the company to prepare an accounting restatement).

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 payment or grant of the incentive-based compensation occurs after the end of the period. The amount of the erroneously awarded incentive-based compensation subject to recovery is the amount by which the executive officer's incentive-based compensation exceeds the amount the executive officer otherwise would have received had such amount been determined based on the restated financial reporting measures. Where the incentive-based compensation is based on stock price or TSR, companies are permitted to use reasonable estimates to assess the effect of an accounting restatement on their stock price or TSR in determining the amount recoverable.

Who is considered an executive officer?

Rule 10D-1 and the NYSE and Nasdaq clawback listing standards define "executive officer" to be the listed company's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice president 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 company. Executive officers of a parent or subsidiary are deemed executive officers of the listed company if they perform such policy-making functions for the listed company. Policy-making function is not intended to include policy-making functions that are not significant. Executive officers would include, at a minimum, the executive officers identified under Regulation S-K Rule 401(b) in the company's SEC annual reports and proxy statements.

This definition of "executive officer" mirrors the definition of "officer" under Rule 16a-1(f), which identifies the persons subject to the reporting and short-swing liability provisions of Section 16 under the Exchange Act. As a result, for domestic filers subject to Section 16, the determination of executive officers subject to the clawback policy would be a relatively simple task that would follow the company's existing process for determining its Section 16 officers. Existing practice and guidelines for Section 16 officer determinations should provide useful guidance. However, for foreign private issuers (FPIs) that are exempt from Section 16, the executive officer determination will likely be a new exercise, and FPIs will need to familiarize themselves with that analysis.

What disclosures are required by the clawback rules?

Under the NYSE and Nasdaq clawback listing standards, listed companies must file all disclosures with regard to their clawback policies in accordance with the requirements of the U.S. federal securities laws, including the disclosures required by applicable SEC rules and filings. Under the SEC rules, each listed company is required to file its compensation clawback policy as an exhibit to its Exchange Act annual report (i.e., Form 10-K, 20-F, 40-F, or N-CSR).

The SEC rules require disclosure of the following items if, during, or after the last completed fiscal year, a clawback-triggering restatement occurred or if, as of the end of the last completed fiscal year, a balance of excess incentive-based compensation subject to recovery from a prior restatement was outstanding:

- The date the company was required to prepare an accounting restatement and the aggregate amount of erroneously awarded compensation attributable to such accounting restatement (including an analysis of the calculation) or, if the amount has not been determined, an explanation of the reasons, provided that disclosure of the amount is made in the next SEC filing that requires executive compensation disclosure;
- The aggregate amount of erroneously awarded compensation that remains outstanding at the end of the company's last completed fiscal year;
- If the financial reporting measure related to a stock price or TSR metric, the estimates used to determine the amount of erroneously awarded compensation and an explanation of the methodology used for such estimates;
- If recovery would be impracticable, for each current or former named executive officer (NEO) and for all current and former executive officers as a group, disclosure of the amount of recovery forgone with an explanation of the reason not to pursue recovery; and
- For each current or former NEO, disclosure of the amount of erroneously awarded compensation still owed that had been outstanding for 180 days or longer since the company determined the amount owed.

For FPIs that do not file on domestic SEC forms, to which the concept of NEOs generally does not apply under SEC rules, the SEC issued guidance indicating that for purposes of the current and former NEO disclosure requirements under Item 6.F of Form 20-F, FPIs should provide clawback disclosures with respect to the members of their administrative, supervisory, or management bodies for whom they otherwise provide individual compensation disclosure under Item 6.B of Form 20-F. For those FPIs that only disclose aggregate compensation, as permitted by Item 6.B of Form 20-F because individual disclosure is not required in their home country and is not otherwise publicly disclosed by the company, individualized clawback disclosures would not be required. However, those FPIs will be required to disclose clawback recovery amounts on an aggregate basis, in the same manner as aggregate compensation is provided in Form 20-F.

Listed companies must make the required compensation clawback disclosures in annual reports and proxy and information statements filed on or after October 2, 2023.

Which issuers must comply with the clawback listing standards?

The Nasdaq and NYSE clawback listing standards apply to all listed companies, including FPIs, emerging growth companies, controlled companies, smaller reporting companies, closed-end and open-end funds, passive business organizations, listed derivative or special purpose securities issuers, and issuers of listed debt whose stock is not also listed, subject to very limited exceptions. Under Rule 10D-1 and the NYSE listing standards, the clawback listing standards do not apply to listings of: (1) securities futures products cleared by a registered or exempt clearing agency; (2) a standardized option issued by a registered clearing agency; (3) any security issued by a unit investment trust; and (4) any security issued by a management company registered under the Investment Company Act of 1940, if such management company has not awarded incentive-based compensation in the past three fiscal years. The requirements under the Nasdaq clawback listing standards do not apply to listings of securities described in clauses (3) and (4).

Are there any exceptions to the requirements to recover erroneously awarded compensation?

The Nasdaq and NYSE clawback listing standards provide exceptions from the requirement for a company to recover erroneously awarded incentive-based compensation "reasonably promptly" in compliance with its clawback policy where it would be "impracticable" to do so, due to one or more of the following circumstances:

- If the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered; provided, however, that the company must first make a reasonable attempt at recovery and must document such attempt and provide such documents to the relevant stock exchange;
- For FPIs, if recovery would violate any home country law that was adopted prior to November 28, 2022 (the effective date of Rule 10D-1), provided that the company provides to the relevant stock exchange an opinion of home country counsel that the recovery would result in such a violation; or
- If recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the U.S. Internal Revenue Code.

In each case, the company's committee of independent directors responsible for executive compensation decisions (or in the absence of such a committee, a majority of the independent directors serving on the board) would have to make the determination that recovery would be impracticable.

Both the NYSE and Nasdaq declined to provide more specific guidance on what the exchange would consider in evaluating whether a company is pursuing recovery "reasonably promptly" under its clawback policy or to provide a nonexclusive list of factors. However, both exchanges indicated that a listed company's obligation to recover erroneously awarded incentive-based compensation reasonably promptly would be "assessed on a holistic basis with respect to each such accounting restatement" and that they would consider whether the company is "pursuing an appropriate balance of cost and speed in determining the appropriate means to seek recovery … and securing recovery through means that are appropriate based on the particular facts and circumstances of each executive officer that owes a recoverable amount."

Can the listed company indemnify the executive officers with respect to clawback amounts?

Under both the NYSE and the Nasdaq clawback listing standards, listed companies are prohibited from indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation, including by paying or reimbursing for insurance policy premiums covering potential losses.

What are the consequences of noncompliance?

Nasdaq decided to apply its existing delisting procedures applicable to companies with similar corporate governance deficiencies to noncompliance with the clawback listing standards, except that it does not permit the use of a public reprimand letter for violations of the clawback listing standards. Under the Nasdaq clawback listing standards, a company will be subject to delisting if it does not adopt and comply with its clawback policy or if it does not disclose the policy in accordance with SEC rules. A noncompliant company will have 45 days to submit to Nasdaq a plan to regain compliance. Nasdaq may grant a cure period of up to 180 days and could extend the cure period for up to another 180 days. If after any applicable cure period, the company has not cured the

noncompliance, the Nasdaq Staff will issue a delisting letter, which the company could appeal to the Nasdaq Hearing Panel.

The NYSE's delisting procedures for noncompliance with any part of the clawback listing standards are closely modeled on its current procedures applicable to companies that are delinquent with their SEC filings. The NYSE clawback listing standards require the company to issue a press release disclosing its noncompliance and contact the NYSE to discuss curing the noncompliance within five days of receiving notice of noncompliance from the NYSE. The NYSE may grant a cure period of up to six months and could extend the cure period for up to another six months. Notwithstanding the foregoing, the NYSE may decide not to allow any cure period or extension at all and may at any time (including during the initial or extended cure period) truncate the cure period and immediately begin suspension and delisting procedures.

Are there special rules for foreign private issuers?

In general, there are no special rules applicable to FPIs, except for the very limited exception permitting an FPI to forgo recovery of incentive-based compensation under its clawback policy if the recovery would violate home country law that was in effect prior to November 28, 2022. To the extent such recovery would violate home country laws in effect on or after November 28, 2022, FPIs may face the uncomfortable position of potentially violating home country laws or facing a potential delisting in the United States, unless the company is able to determine the cost of recovery would exceed the recovered amounts, after making documented efforts to seek recovery. FPIs should review home country laws to determine if there would be any applicable laws implicated by seeking compensation recovery under a clawback policy.

The application of the same clawback listing standards to FPIs as U.S. domestic issuers with very little, if any, accommodation for the different circumstances of FPIs is part of an increasing trend by the SEC to impose on FPIs many of the same disclosure and compliance requirements that apply to domestic issuers, including the recently adopted share repurchase disclosure requirements and the proposed climate change and cybersecurity risk disclosure requirements. The SEC's view appears to be that FPIs voluntarily choose to access the U.S. capital markets and can elect not to use the U.S. capital markets if they do not want to comply with U.S. rules.

* * *

Implications

Listed companies should begin the process of adopting their clawback policies, determining the executive officers to be subject to those clawback policies, reviewing their existing and proposed incentive-based compensation awards to determine the awards that will be subject to recovery under the clawback policy, and implementing compliance procedures to be in compliance by the effective date of October 2, 2023. FPIs will have the additional challenges of applying an unfamiliar executive officer analysis, determining which executive officers will require individual disclosure of erroneously paid incentive-based compensation, and determining if there would be home country laws implicated by seeking compensation recovery under the clawback policy.

10+ Min Read

Authors

Sey-Hyo Lee

Precious Nwankwo

Related Locations

New York

Related Topics

Benefits Bulletin

Related Capabilities

Labor & Employment

Related Regions

North America

Related Professionals

Sey-Hyo Lee

Precious Nwankwo

This entry has been created for information and planning purposes. It is not intended to be, nor should it be substituted for, legal advice, which turns on specific facts.