SEC ISSUES NEW EXECUTIVE COMPENSATION CLAWBACK RULES – IMPACT ON FOREIGN PRIVATE ISSUERS

Last week, the SEC adopted a new rule (Rule 10D-1 under the Securities Exchange Act of 1934) and rule amendments to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which added Section 10D of the Securities Exchange Act of 1934.[1] Section 954 is intended to encourage reliable financial reporting by listed issuers. The rulemaking directs US stock exchanges to amend their listing standards to require listed issuers:

- to develop and implement a written policy providing for the recovery by the issuer, in the event of a required accounting restatement, of incentive-based compensation received by current or former executive officers where that compensation is based on the erroneously reported financial information during the three completed fiscal years immediately preceding the date the issuer is required to prepare the restatement (in effect, recovery of the excess over what should have been received based on the restated financial statements);
- to disclose the compensation recovery policy;
- to file the policy as an exhibit to their annual reports
- to indicate by check boxes on their annual reports whether the financial statements included in the report reflect the correction of an error to previously issued financial statements; and
- to provide other disclosures in the event a recovery analysis is triggered under the policy.

Listed issuers that fail to adopt and comply with their compensation recovery policies would be subject to delisting.

Ultimately, the provisions of Rule 10D-1 will be reflected in stock exchange listing standards. The other provisions are reflected in amendments to existing SEC rules and form requirements.

Issuers Covered

The new rules apply across the spectrum of issuers, and listed foreign private issuers ("FPIs") are not exempted.[2] The SEC specifically considered whether to exempt listed FPIs, and declined to do so. The SEC addressed the issue of extraterritorial application of US law, and concluded that its final rules do not constitute extraterritorial application as they only apply to issuers that have voluntarily chosen to list in the United States.

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1 This rulemaking has been 12 years in the making. Rulemaking was proposed in 2015. The comment period was reopened in October 2021 and again in June 2022.

2 The new rules also apply to emerging growth companies, debt-only issuers, controlled companies and smaller reporting companies. An FPI that is any of the foregoing remains subject to the new rules. Note that an FPI that registers securities on a Form F-4 in connection with an acquisition but does not list in the United States will not be subject to these new rules.

Restatements Covered

The new rules will require a listed issuer to adopt and comply with a written compensation recovery policy that will be triggered in the event the issuer is required to prepare:

- an accounting restatement that corrects an error in previously issued financial statements that is material to the previously issued financial statements (so-called "Big R" restatements), or
- an accounting restatement that corrects errors that are not material to previously issued financial statements, but would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (so-called "little r" restatements).

The SEC release makes specific reference to Staff Accounting Bulletins No. 99 and 108, setting forth staff guidance that an issuer's materiality evaluation of an identified unadjusted error should consider the effects of the identified unadjusted error on the applicable financial statements and related footnotes, and evaluate quantitative and qualitative factors. The SEC notes that requiring recovery analysis for both "Big R" and "little r" accounting restatements does not eliminate the risk that an issuer could avoid a recovery obligation by manipulating its materiality analysis of an error.

While this is an inherent risk, the involvement of an independent auditor in evaluating management's materiality analyses, with the oversight of the audit committee, should protect investors by helping ensure that material errors do not go uncorrected by an issuer seeking to avoid the recovery of erroneously awarded compensation. Furthermore, the SEC notes that there are potential serious consequences, including but not limited to SEC enforcement action and private litigation, of mischaracterizing material accounting errors as immaterial.

The SEC declined to require issuers to disclose the materiality analysis of an error when the error is determined to be immaterial. It also declined to provide separate definitions of "accounting restatement" or "material noncompliance," since existing accounting standards and guidance already set out the meaning of those terms.

The SEC notes that the following would not trigger compensation recovery policies under the listing standards, since they do not represent correction of errors:

- retrospective application of a change in accounting principle;
- retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization;
- retrospective reclassification due to a discontinued operation;
- retrospective application of a change in reporting entity, such as from a reorganization of entities under common control;
- retrospective adjustment to provisional amounts in connection with a prior business combination (IFRS filers only); and
- retrospective revision for stock splits, reverse stock splits, stock dividends or other changes in capital structure.

Trigger Date

The new rule requires recovery of erroneously awarded compensation "during the three-year period preceding the date on which an issuer is required to prepare an accounting

restatement." The date on which an issuer is required to prepare an accounting restatement is the earlier to occur of:

- the date the issuer's board of directors, a committee of the board of directors, 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 noncompliance of the issuer with any financial reporting requirement under the securities laws (the "reasonably should have concluded" concept reduces the incentive for an issuer to delay the investigation of a known error and the decision that a restatement is necessary); or
- the date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.

Officers Covered

The new rule departs from prior approaches to clawbacks in various ways. It applies to executive officers, defined as an issuer's[3]:

- 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 recovery obligation:

- is not limited to the CEO and CFO (as is the case under Section 304 of the Sarbanes-Oxley Act);
- is not limited to only those who are so-called "named executive officers";
- is not limited to executive officers who had a role in preparing the financial statements;
- is not limited to those who might be deemed at fault for the accounting error that triggered the restatement;
- is not limited to executive officers who otherwise had a role in the accounting error that triggered the restatement;

[3] Executive officers of the issuer's parent(s) or subsidiaries are deemed executive officers of the issuer if they perform such policy making functions for the issuer. If the issuer is a limited partnership, officers or employees of the general partner(s) who perform policy-making functions for the limited partnership are deemed officers of the limited partnership. If the issuer is a trust, officers, or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust. Policy-making function is not intended to include policy-making functions that are not significant.

- is more expansive than other securities law definitions of covered officers that might exclude officers with an important role in financial reporting;
- covers current and former executive officers, and as to current officers only requires recovery of compensation received by a person after beginning service as an executive officer, if that person served as an executive officer at any time during the three-year recovery period. Recovery of compensation received while an individual was serving in a non-executive capacity prior to becoming an executive officer will not be required. The SEC notes that the recovery requirement also does not apply to an individual who is an executive officer at the time recovery is required if that individual was not an executive officer at any time during the period for which the incentive-based compensation is subject to recovery. Nothing in the rule would limit an issuer's compensation recovery policy from requiring recovery more broadly.

Incentive-Based Compensation

The new rule defines "incentive-based compensation" to be "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure." The principles-based definition is intended to capture new forms of compensation that are developed and new measures of performance upon which compensation may be based.

The new rule defines "financial reporting measures" as measures that are 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 measures. This would include "non-GAAP/IFRS financial measures," as well other measures, metrics and ratios that are not non-GAAP/IFRS measures, like same store sales. Financial reporting measures may or may not be included in an SEC filing and may be presented outside the financial statements, such as in the MD&A.

As guidance, the SEC has provided a non-exhaustive list of financial reporting measures:

- revenue;
- net income;
- operating income;
- profitability of one or more reportable segments;
- financial ratios (*e.g.*, accounts receivable turnover and inventory turnover rates);
- net assets or net asset value per share (*e.g.*, for registered investment companies and business development companies that are subject to the rule);
- earnings before interest, taxes, depreciation and amortization;
- funds from operations and adjusted funds from operations;
- liquidity measures (*e.g.*, working capital, operating cash flow);
- return measures (*e.g.*, return on invested capital, return on assets);
- earnings measures (*e.g.,* earnings per share);
- sales per square foot or same store sales, where sales is subject to an accounting restatement;
- revenue per user, or average revenue per user, where revenue is subject to an accounting restatement;
- cost per employee, where cost is subject to an accounting restatement;

- any of such financial reporting measures relative to a peer group, where the issuer's financial reporting measure is subject to an accounting restatement;
- tax basis income; and
- stock price and total shareholder return (TSR), which are treated as separate measures from the foregoing list by reason of the fact that Section 954 evidences an intention to have an expansive definition as it refers to compensation "based on" financial information and recovery of compensation "based on" erroneous accounting.

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 this purpose 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

Incentive-based compensation will be deemed received for purposes of the recovery policy in the fiscal period (including any transition period for a change in fiscal year, if applicable) during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs after the end of that period. The time period covered for the recovery policy will be the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement.

Recovery

Issuers will be required to adopt and comply with recovery policies that apply to the amount of incentive-based compensation received "in excess of what would have been paid to the executive officer under the accounting restatement," computed without regard to taxes paid. For incentive-based compensation based on stock price or TSR, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the 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, and the issuer must maintain documentation of the determination of that reasonable estimate and provide it to the relevant exchange.

After an accounting restatement, the issuer must first recalculate the applicable financial reporting measure and the amount of incentive-based compensation based on that measure. The issuer must then determine whether, based on that financial reporting measure as calculated by relying on the original financial statements and taking into account any discretion that the compensation committee had applied to reduce the amount originally received, the executive officer received a greater amount of incentive-based compensation than would have been received applying the recalculated financial reporting measure.[4]

An issuer must recover erroneously awarded compensation in compliance with its recovery policy, except to the extent that pursuit of recovery "would be impracticable." As noted above, neither fault nor responsibility for an error or restatement is relevant. There are only three bases for a board to determine that recovery would be impractical, namely where:

- the direct cost of recovery (*e.g.,* costs paid to a third party such as legal or consulting fees) would exceed the amount of recovery;
- the recovery would violate home country law *of the issuer* (note this *does not* extend to the law of the domicile of the executive officer) as in effect on the date the new rule is published in the *Federal Register* (rather than the date the proposed rule was published in 2015) and additional conditions are met (namely, obtaining an opinion of home country counsel, acceptable to the relevant exchange, that recovery would result in a violation of home country law); or
- the recovery of amounts from tax-qualified retirement plans would cause an otherwise tax-qualified retirement plan to fail to meet applicable requirements.

There is no *de minimis* exception.

Any determination that recovery would be impracticable in any of these three circumstances must be made by a committee of independent directors that is responsible for executive compensation decisions. In the absence of a compensation committee, the determination

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[4] Where incentive-based compensation is based only in part on the achievement of a financial reporting measure performance goal, the issuer would first need to determine the portion of the original incentive-based compensation based on or derived from the financial reporting measure that was restated. The issuer would then need to recalculate the affected portion based on the financial reporting measure as restated, and recover the difference between the greater amount based on the original financial statements and the lesser amount that would have been received based on the restatement.

must be made by a majority of the independent directors on the board. Such a determination is subject to review by the relevant exchange.

Boards will have discretion, subject to certain reasonable restrictions, regarding the means of recovery. The SEC notes that, in exercising this discretion, issuers should:

- Act in a manner that effectuates the purpose of the statute, to prevent current or former executive officers from retaining compensation that they received and to which they were not entitled under the issuer's restated financial results.
- Recover erroneously awarded compensation reasonably promptly, because delays in recovering excess payments allow executive officers to capture the time value of money with respect to funds they did not earn, which should instead belong to shareholders. The SEC notes that an issuer may be acting reasonably promptly in establishing a deferred payment plan that allows the executive officer to repay owed erroneous compensation as soon as possible without unreasonable economic hardship, depending on the particular facts and circumstances. Exchanges may adopt more prescriptive approaches to timing and method of recovery.

The new rule is not intended to alter or otherwise affect the interpretation of other recovery provisions, such as Sarbanes-Oxley Act Section 304 (clawbacks of amounts paid to CEOs and CFOs, which does apply to FPIs). To the extent that the erroneously awarded compensation is recovered under a foreign recovery regime, the recovery would meet the obligations of the new rule.

Disclosure

A listed FPI will be required to:

- disclose its compensation recovery policies;
- disclose how it has applied its compensation recovery policies and reflect reductions of compensation in proxy statement disclosure (if complying with the domestic reporting regime);
- if recovery is triggered, to disclose[5]:

  For each restatement:

  - the date on which the issuer was required to prepare an accounting restatement;
  - the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement (including an analysis of how the recoverable amount was calculated);
  - if the financial reporting measure related to a stock price or TSR metric, the estimates used to determine the amount of erroneously awarded compensation attributable to such accounting restatement and an explanation of the methodology used for such estimates;

[5] By reason of new Item 6.F of Form 20-F, compliance by an FPI using the domestic reporting regime satisfies compliance with the executive compensation disclosure requirements of Section 402; other FPIs are exempt from Section 402 requirements as they are not required to provide proxy statement disclosure.

- the aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed fiscal year;
- if the aggregate amount of erroneously awarded compensation has not yet been determined, an explanation of the reasons and inclusion of the foregoing information in the next filing requiring disclosure under Item 6 of Form 20-F;

If recovery would be impracticable:

- for each current and former named executive officer[6] and for all other current and former executive officers as a group, the amount of recovery forgone and a brief description of the reason the listed registrant decided in each case not to pursue recovery;

For outstanding amounts:

- for each current and former *named executive officer*, the amount of erroneously awarded compensation still owed that had been outstanding for 180 days or longer since the date the issuer determined the amount owed; and

- if the issuer concludes recovery is not required under its policies notwithstanding a restatement, a brief explanation of why.

Insurance and Indemnification

The new rules prohibit an issuer from insuring or indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation.

Timing

Each exchange will be required to file its proposed listing standards with the SEC no later than 90 days following the publication of the new rules in the *Federal Register,* and the listing standards must be effective no later than one year following the publication of the new rules in the *Federal Register.*

Each listed issuer will be required to adopt a compensation recovery policy no later than 60 days following the date on which the applicable listing standards become effective. Disclosure would be required in reports issued on or after the date the listed issuer adopts its compensation recover policy.

Each listed issuer is required to comply with the compensation recovery policy for all incentive-based compensation received by current or former executive officers on or after the effective date of the applicable listing standard (as opposed to the effective date of Rule 10D-1). (Notwithstanding the look-back requirement, an issuer need only apply the policy to incentive-based compensation received after the listing standard effective date.) In addition, each listed issuer is required to provide the disclosures required by the rule in the applicable SEC filings required to be filed on or after the date on which the listing standards become effective. As such, issuer compliance is required whether such incentive-based compensation

[6] This reference to "named executive officer" for purposes of Form 20-F disclosure appears to be an oversight, as this term generally is intended to apply to domestic registrants only. FPI compensation disclosure typically is aggregated and, if individual disclosure is triggered, it applies to directors, and members of its administrative, supervisory or management bodies, which does not fully align with "executive officer" as used generally or for purposes of Rule 10D-1.

is received pursuant to a pre-existing contract or arrangement, or one that is entered into after the effective date of the listing standards.

Concluding Thoughts

FPIs are subject to a separate, and far less detailed, disclosure regime when it comes to executive compensation (as noted above, compensation disclosure is typically provided on an aggregated basis) and insiders of FPIs are exempt from the short swing profit disclosure and disgorgement rules applicable to domestic registrants.[7] Both of these regimes require identification of "executive officers." This then means that FPIs will now need to identify their executive officers based on Ruled 10D-1. The new rule also means that FPIs could be required to disclose clawbacks on an individual basis even though home country laws do not require disclosure of individual compensation information.

As noted above, there is only a narrow exception for clawbacks that would violate the law of the issuer's jurisdiction of incorporation. The exception does not extend to other foreign laws, including the laws of the domicile of the relevant executive officers. Also, future legislation that blocks compliance would be irrelevant for purposes of the SEC requirements. FPIs facing recovery in these circumstances might well need to rely on the exception based on impracticability due to cost, a possibility that the SEC specifically recognized in its adopting release.

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[7] Foreign issuers also benefit from exemptions from most corporate governance requirements under listing standards and are able instead to rely on home country standards.