

McGuireWoods

Final SEC Clawback Rules

SEC Takes Aim at “Erroneously Awarded Compensation”

Dodd Frank §954 – Clawback of Incentive Compensation

- **§954 of Dodd Frank Act (2010)**: Requires national securities listing exchanges to establish standards that require all public companies to adopt, comply with & disclose written clawback policies
 - Policies must provide for recovery of any incentive compensation received by any current or former executive officers within 3 years prior to the date on which a company is required to prepare a financial restatement
 - Clawback triggered to the extent incentive compensation paid based on erroneous financial data exceeds the amount that would have been paid under the restated financials
- **Rulemaking History**
 - **July 2015**: SEC proposed rules – generally met with negative reaction due to complexity
 - **October 2021**: SEC reopens comment period on 2015 proposed rules and requests additional comments on a variety of items
 - **June 2022**: SEC again reopens comment period on 2015 proposed rules – ostensibly to address concerns regarding economic impact analysis
 - **October 2022**: SEC releases §954 final rules that largely track 2015 proposed rules

Overview of Final SEC Clawback Rules

Covered Companies	<ul style="list-style-type: none"> ▪ Virtually all publicly-traded companies <ul style="list-style-type: none"> ▪ Smaller Reporting Companies, Emerging Growth Companies and Foreign Private Issuers all covered 	<ul style="list-style-type: none"> ▪ Narrow Exemptions – listing of certain security futures products, standardized options, securities issued by Unit Investment Trusts and securities issued by certain Registered Investment Companies <ul style="list-style-type: none"> ▪ Certain Listed Funds – have not granted incentive compensation within the past 3 fiscal years exempted
Covered Accounting Restatements	<ul style="list-style-type: none"> ▪ Big “R” Restatements – corrects an error in a previously issued financial statement that is material to previously issued financial statements ▪ Little “r” Restatements – corrects errors that are not material to previously issued financial statements, but would result in a material misstatement if (1) left uncorrected in current report or (2) error correction was recognized in the current period 	<ul style="list-style-type: none"> ▪ Holistic Materiality Determination – well-reasoned, holistic, objective approach from a reasonable investor’s perspective based on total mix of information required to determine materiality <ul style="list-style-type: none"> ▪ No requirement to disclose materiality analysis ▪ Refer to accounting rules’ definitions of “accounting restatement” and “material noncompliance”
Covered Executive Officers	<ul style="list-style-type: none"> ▪ Section 16 Officers – President, Principal Financial Officer, Principal Accounting Officer (if none – Controller), any VP in charge of a principal business unit / division / function & any other officer who performs a policy-making function or any other person with a similar policy-making function <ul style="list-style-type: none"> ▪ Applies to both current and former executive officers ▪ May include executive officers of parent / subsidiary entities 	<ul style="list-style-type: none"> ▪ No Fault Application of Clawbacks – no requirement that executive officer was involved in / had fault with respect to the accounting restatement triggering clawback ▪ Pre-Executive Officer Compensation Excluded – clawback does not apply to compensation received by an individual prior to becoming an executive officer
3-Year Look Back Rule for Clawbacks	<ul style="list-style-type: none"> ▪ 3-Year Look Back Period – incentive compensation received by executive officers during 3-year look back period subject to clawback in the event of an accounting restatement ▪ Measurement Date for Look Back Period – 3-year period begins at the earlier of (1) the date the board concludes or reasonably should have concluded that prior financial statements include a material error or (2) the date a regulator directs a restatement 	<ul style="list-style-type: none"> ▪ Notice from independent auditor factors into whether board reasonably should have determined a material error exists ▪ Date of initial court order / regulator action sets the start date for the 3-year look back, but clawback only applied once the order is final and non-appealable ▪ Example: Calendar year company determines an accounting restatement is required in November 2024 and files restated financial statements in January 2025; the 3-year look back period applies to covered incentive compensation received in 2021, 2022 and 2023

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<p>Covered Incentive Compensation</p>	<ul style="list-style-type: none"> ▪ Clawback only applies to incentive-based compensation, including stock options <ul style="list-style-type: none"> ▪ Final rules require <i>principles-based determination</i> ▪ Incentive Compensation – compensation granted, earned or vested based wholly or in part upon attainment of any financial reporting measure covered ▪ Financial Reporting Measures – those found in financial statements (GAAP) or derived in whole or in part from such measures (non-GAAP)– TSR & stock price included <ul style="list-style-type: none"> ▪ Includes any financial measure relative to a peer group 	<p>Financial Reporting Measure Examples: revenues, net income, operating income, profitability or one or more segments, financial ratios (e.g., accounts receivable turnover and inventory turnover rates), net assets or net asset value per share, EBITDA, 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., EPS), sales per square foot or same store sales, revenue per user / average revenue per user, cost per employee, tax basis income</p>
<p>Examples of Incentive Compensation</p>	<p>Covered Incentive Compensation</p> <ul style="list-style-type: none"> ▪ Non-equity incentive plan awards <i>earned wholly or in part on satisfying financial reporting measure goal(s)</i> ▪ Bonuses paid from a bonus pool, the size of which is determined based wholly or in part on satisfying financial reporting measure goal(s) ▪ Cash awards based on satisfaction of a financial reporting measure ▪ Restricted stock, RSUs, PSUs, stock options, SARs that are granted or become vested based wholly or in part on satisfying financial reporting measure goal(s) ▪ Proceeds received upon sale of shares acquired through an incentive plan that were granted or vested based wholly or in part on satisfying financial performance measure goal(s) 	<p>Exempted Forms of Compensation</p> <ul style="list-style-type: none"> ▪ Salaries ▪ Discretionary bonuses / bonuses paid based on subjective standards or completed work periods ▪ Non-equity incentive plan awards earned upon satisfying <i>strategic measures</i> (e.g., consummating a merger) or <i>operational measures</i> (e.g., opening a specified number of stores, completion of a project, increase in market share) ▪ Equity awards for which the grant is not contingent on achieving any financial reporting measure and vesting is <i>based solely on completing a specified employment period and/or attaining nonfinancial reporting measures</i>
<p>When Incentive Compensation is Received for 3-Year Look Back Period</p>	<ul style="list-style-type: none"> ▪ Received at Performance Attainment – incentive compensation deemed received for purposes of 3-year look back period when the financial measure is attained <ul style="list-style-type: none"> ▪ <i>Delayed payment not relevant</i> 	<ul style="list-style-type: none"> ▪ Multiple Performance Measures – incentive compensation subject to multiple performance measures may be deemed received even if not all goals are attained during the applicable 3-year look back period

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<p>Amounts Subject to Clawback</p>	<ul style="list-style-type: none"> ▪ Erroneously Awarded Compensation – amount received that exceeds amount that would have been paid based on the restatement <ul style="list-style-type: none"> ▪ Reasonable estimates permitted for incentive compensation based on TSR / stock price ▪ Companies must maintain documentation of reasonable estimates and must provide copies to their listing exchange ▪ Pre-Tax Clawback Calculations – clawback amounts calculated on a pre-tax basis <ul style="list-style-type: none"> ▪ Covered executive officers likely have little ability to recover taxes previously paid on amounts subject to clawback 	<ul style="list-style-type: none"> ▪ Cash Awards – difference between amount of cash received and the amount that should have been received under restated financials ▪ Cash Awards from Bonus Pools – pro rata portion of any deficiency from reduced size of bonus pool due to restatement ▪ Equity Awards <ul style="list-style-type: none"> ▪ If shares, options or SARs still held, clawback excess of amount received over amount should have received per restated financials ▪ If options or SARs have been exercised, clawback excess shares received
<p>Limited Discretion to Decline Pursuing Clawbacks</p>	<ul style="list-style-type: none"> ▪ Companies generally must enforce clawbacks ▪ Exceptions <ul style="list-style-type: none"> ▪ Impracticable – direct cost of recovery exceeds amount of recovery ▪ Violates Home-Country Laws – must be in effect at effective date of the final rules; legal opinion required ▪ Involves Tax-Qualified Plans (e.g., 401(k) Plan) 	<ul style="list-style-type: none"> ▪ Attempted Clawback Required – companies must attempt to clawback incentive compensation before determining impracticable <ul style="list-style-type: none"> ▪ Must also document rationale for determining impracticability and provide documentation to listing exchange ▪ Executive retirement plan (NQDC plan) amounts may be subject to clawback
<p>How to Effect Clawbacks</p>	<ul style="list-style-type: none"> ▪ Broad Discretion – companies may decide manner in which clawbacks are accomplished <ul style="list-style-type: none"> ▪ May utilize compensation structures that account for the possibility of future clawback – e.g., mandatory deferrals of payments ▪ Appear to also contemplate forfeiture of other amounts otherwise payable to a covered executive officers – e.g., currently outstanding awards or nonqualified deferred compensation 	<ul style="list-style-type: none"> • Prompt Recovery Efforts – companies must pursue clawback efforts “reasonably promptly” • Payment Plans Permitted – final rules contemplate entering into deferred payment plans with executive officers to repay clawback amounts to avoid <i>unreasonable economic hardship</i>

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<p>Disclosure Obligations</p>	<ul style="list-style-type: none"> ▪ Filed Publicly – companies must disclose their clawback policies as an exhibit to SEC filings – Form 10-K exhibit ▪ Summary Compensation Table (SCT) Disclosure – Must reduce amounts previously shown to reflect clawbacks with accompanying footnote disclosure ▪ No Related Party Transaction Disclosure – clawbacks do not trigger related-party transaction disclosures ▪ Separate from CD&A – not included in CD&A ▪ New 10-K / 20-F / 40-F “Check Box” Requirement <ul style="list-style-type: none"> ▪ Reflect correction of an error to previously issued financial statements; and ▪ Identify whether corrections require clawbacks ▪ Must also describe any determination that an accounting restatement did not trigger a clawback 	<ul style="list-style-type: none"> ▪ Detailed SCT Disclosures – (1) date of required restatement and aggregate amount subject to clawback, (2) aggregate amount of clawback outstanding at FYE, (3) if stock price / TSR performance measure, estimates used to determine clawback amount, (4) any forgone clawback amounts due to impracticability and rationale – including explanation of expenses paid to a third party to assist in recovery of the clawback amounts, and (5) for each current and former Named Executive Officer (NEO), amounts outstanding for 180 days or more since the determination date of the clawback amounts ▪ Non-NEOs – aggregated disclosures of impracticability exception permitted for non-NEOs ▪ Additional Disclosures – required to identify home-country laws / tax-qualified retirement plan rules prohibiting clawbacks ▪ XBRL tagging requirements
<p>Indemnification / Insurance Prohibited</p>	<ul style="list-style-type: none"> ▪ Indemnification / Insurance Not Permitted – companies may not indemnify or pay for insurance coverage on behalf of covered executive officers to provide relief from amounts subject to clawback 	<ul style="list-style-type: none"> ▪ SEC believes such measures frustrate purpose of §954
<p>Effective Dates / No Grandfathering</p>	<ul style="list-style-type: none"> ▪ Companies should have decent runway before final rules become effective <ul style="list-style-type: none"> ▪ Listing exchanges must file their clawback standards within 90 days following publication of Final Rules to the Federal Register (not yet occurred) ▪ Listing standards must be effective no later than 1 year following publication of Final Rules to the Federal Register ▪ Companies must adopt compliant clawback policies within 60 days following the effective date of the applicable listing exchange standards 	<ul style="list-style-type: none"> • No Grandfathering – incentive compensation awarded prior to effective date of listing exchange standards subject to clawback if received after such effective date • De-Listing Possible for Noncompliance – failure to timely adopt a compliant clawback policy and comply with its requirements may result in delisting

Final SEC Clawback Rules – Next Steps

- ❑ **Familiarize key stakeholders** with Final Rule (*feel free to use these slides!*)
 - ❖ Board / Compensation Committee, Executive Officers, Legal, Tax, HR, Accounting, etc.
 - ❖ Develop processes to coordinate restatement analysis and clawback calculations
- ❑ **Review and revise existing clawback policies** to bring into compliance with Final Rule
 - ❖ Monitor release of listing exchange standards
 - ❖ Given highly-prescriptive nature of Final Rule, review & revisions can commence now
- ❑ **Review compensation programs & determine those subject to Final Rule**
 - ❖ Consider adjustments to compensation programs to eliminate exposure – e.g., discretionary bonuses vs. formulaic financial performance programs / separate incentive programs to “wall-off” exposure
- ❑ **Update plans & award agreements** subject to Final Rule to facilitate clawbacks
 - ❖ Consider state, local and non-U.S. legal requirements (obtain home-country legal opinion, if applicable)
 - ❖ Consider design changes to ensure funds available to easily effect clawbacks, if needed
 - ❖ Mandatory deferrals, subject existing NQDC plan balances to clawbacks, provide for forfeiture of currently-outstanding awards to satisfy clawbacks, etc., apply clawbacks to non-incentive compensation amounts (salary / discretionary bonus / time-based award reductions)
- ❑ **Review and update Proxy disclosures** to reflect clawback policy / compensation program updates
 - ❖ Existing disclosures likely will become stale given changes to legal requirements

Questions or Comments?