

The Final Rule on Recovery of Erroneously Awarded Compensation Has Arrived

Brief Overview of the Final Rule

On October 26, 2022, seven years after originally proposed, the Securities and Exchange Commission (SEC) adopted the final rule on recovery of erroneously awarded incentive-based compensation. The final rule implements Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, as amended, which added Section 10D to the Securities Exchange Act of 1934 (Exchange Act).

Section 10D of the Exchange Act consists of two principal requirements:

1. Section 10D(a) of the Exchange Act requires national securities exchanges and associations to prohibit the listing of any issuer that has failed to adopt a recovery policy (as defined below); and
2. Section 10D(b) of the Exchange Act obligates the SEC to adopt rules that require issuers to implement a policy to recover incentive-based compensation erroneously awarded to current or former executive officers of the issuer due to material noncompliance with financial reporting, as described more fully below (recovery policy or policy).

The final rule also amends Items 402 and 601 of Regulation S-K, Form 10-K, Form 40-F, Form 20-F, Form N-CSR, and Schedule 14A to include new disclosure requirements. Under the amended rules, issuers are required to file their recovery policy as an exhibit to the issuer's annual report filed with the SEC. Issuers must also indicate by check box whether the financial statements attached to such annual report include any errors and whether such errors resulted in a restatement. In addition, issuers are required to disclose, among other things,

1. the date on which the issuer was required to prepare an accounting restatement and the dollar amount of erroneously awarded compensation determined based on such restatement;
2. the aggregate dollar amount of outstanding erroneously awarded compensation at the end of the fiscal year and any outstanding amounts due to current or former executive officers for 180 days or longer;
3. the estimates of erroneously awarded compensation attributable to financial performance measures related to stock price and total shareholder return (TSR); and
4. the descriptions of the reasons recovery was deemed impracticable, if applicable and the amount of recovery foregone because of such impracticability.

These disclosures also must be tagged using Inline XBRL.

Transition and Timing of the Final Rule

The final rule applies to all national securities exchanges and national securities associations except those that only trade securities or list securities such as security futures, products, standardized options, or securities issued by unit investment trusts, certain listed funds, and certain registered investment issuers. The compliance period for the final rule requires these exchanges and associations to file their proposed listing standards within 90 days of the final rule's publication in the Federal Register and to make such listing standards effective within one year following publication. Similarly, the final rule's disclosure and recovery policy requirements apply to all issuers, including emerging growth companies, foreign private issuers, and smaller reporting companies. Issuers will be required to comply with these listing standards within 60 days of their effective date or be subject to de-listing.

Accounting Restatements Triggering Recovery Policy



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Related Practice Areas

- Capital Markets & Securities
- Corporate
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- Securities Litigation & SEC Enforcement

An issuer's obligation to comply with its recovery policy is triggered by the preparation of accounting restatements due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws. Such restatements include any required accounting restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements (commonly referred to as, Big R restatements) or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (commonly referred to as, little r restatements).

If a restatement subject to the policy is triggered, the issuer must recover erroneously awarded incentive-based compensation received by a subject executive officer. An issuer is required to prepare an accounting statement the earlier of:

1. the date on which the issuer's board of directors, a committee of the board of directors, 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 material noncompliance with financial reporting requirements under securities laws or
2. the date a court, regulator, or other legally authorized body directs an issuer to prepare such restatement.

In the release announcing the final rule, the SEC suggested that the test to trigger the recovery policy with respect to a Big R restatement would be similar to a determination to file an Item 4.02(a) Form 8-K, with respect to the conclusion by the issuer's board of directors, a committee of the board of directors or officers of the issuer authorized to take such action if the board is not required, that any previously issued financial statements subject to Regulation S-X should no longer be relied upon because of an error in such financial statements. The SEC did not, however, expressly state in the instructions that in the event that recoupment under a recovery policy is triggered, an Item 4.02(a) Form 8-K would also be required since a little r restatement would not trigger an Item 4.02(a) Form 8-K.

Defining Executive Officers and Incentive-Based Compensation

The policies for recovery of erroneously awarded compensation apply to "any current or former executive officer of the issuer who received incentive-based compensation during the three-year look-back period" if such executive officer received the compensation:

1. after they began service as an executive officer, and
2. served as an executive officer during the recovery period.

Executive officers are defined, consistent with Rule 16a-1(f) of the Exchange Act, as "the 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."

"Any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure" is deemed incentive-based compensation and subject to the recovery policy. This includes stock options and other equity awards with vesting schedules dependent on the attainment of certain financial reporting measures. Financial reporting measures are defined as measures in accordance with the accounting principles used in an issuer's financial statements and any measures derived therefrom, including stock price and TSR. Although it may be difficult for issuers to determine the relationship between accounting restatements and certain financial reporting measures, such as stock price and TSR, issuers are encouraged to use reasonable estimates of the effects of the restatements.

Recovery of Erroneously Awarded Compensation Received

The recovery period for erroneously awarded compensation is the "three completed fiscal years preceding the date the issuer is required to prepare an accounting restatement." For example, if a calendar year-end issuer concludes or reasonably should have concluded in November 2024 that an accounting statement of previous financial statements is required and files the restatement in January 2025, the recovery policy would apply to compensation received by current or former

executive officers in 2021, 2022, and 2023. Under the final rules, the SEC determined that erroneously awarded compensation is considered “received” by the executive officer for purposes of the recovery policy in the fiscal year in which the financial reporting measure connected to the incentive-based compensation award is attained.

To determine the amount of erroneously awarded compensation received by the executive officer, the issuer must determine the amount of incentive-based compensation received in excess of the amount that would have been received based on the restatement on a pre-tax basis. For erroneously awarded compensation that is based on TSR or stock price, the issuer must make a reasonable estimate of the effect of the restatement on the financial reporting measure and document the determination of the estimate, and provide it to the applicable exchange.

Limited Discretion to Recover Erroneously Awarded Compensation

An issuer must recover erroneously awarded compensation unless recovery is impracticable, such that

1. recovery was attempted, but the direct cost of recovery would exceed the amount of recovery;
2. recovery violates home country laws established after publication of the final rule in the Federal Register, and the issuer has obtained opinion of home country counsel that recovery would result in such a violation; or
3. recovery violates certain sections of the Internal Revenue Code applicable to tax-qualified retirement plans. However, an issuer is given discretion to determine the means of recovery.

No Indemnification

Further, issuers cannot insure or indemnify executive officers against the costs of recovery of the erroneously awarded compensation. Executive officers may purchase third-party insurance to fund recovery. However, issuers are prohibited from paying or reimbursing executive officers for these insurance policies.

Practical Considerations for Drafting and Amending Recovery Policy

As the national securities exchanges and national securities associations consider revised listing standards and issuers prepare for compliance with the final rule on recovery of erroneously awarded compensation, we urge issuers to consider the following when amending or drafting recovery policies:

1. Reviewing existing employment agreements, offer letters, compensation plans, or award agreements to determine whether such documents need to be revised to incorporate the terms of such policies;
2. Reviewing the structure and practicality of incentive-based compensation arrangements in light of the policies, including the use of financial measures and other measures derived therefrom, as well as performance periods relative to the issuer’s fiscal year;
3. Reviewing the mix of base salary and incentive-based compensation to attract and retain top executive talent; and
4. Educating the issuer’s board of directors and executive officers regarding the terms of the policy.

In addition, issuers should continue to monitor for any additional guidance from the SEC on the new rule.
