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Deadline Approaches for National Securities Exchanges to Propose Listing Standards for New SEC Clawback Rules

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National securities exchanges have 30 days from today, until February 27, 2023, to propose listing standards implementing the Securities and Exchange Commission's (the "SEC") new "clawback" rules. The SEC recently adopted a new rule (the "New Rule") and rule amendments to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") aimed at issuers recovering, or "clawing back", erroneously awarded incentive-based compensation paid to current and former executive officers as a result of an accounting restatement. In a surprise to issuers and market participants, the SEC included not only "Big R" restatements but also "little r" restatements as items that require a recovery analysis.

Specifically, the New Rule directs the national securities exchanges to establish listing standards requiring issuers to develop and implement a policy providing for the recovery of incentive-based compensation received by current or former executive officers of the issuer in the event of a required accounting restatement, where compensation is based on the erroneously reported financial information. This broad-ranging rule has a three-year look-back period and applies to issuers listed on a national securities exchange, which will be required to adopt clawback policies (or update existing policies) and make certain disclosures in the event that a required accounting restatement triggers recovery analysis under the New Rule.

Issuers will have 60 days from the effectiveness of their national securities exchange's listing standards to adopt a recovery policy. Therefore, issuers could be required to adopt policies as soon as June 2023.

Application and Mechanics of the New Rule

On the heels of the 2008 economic crisis, Congress passed the Dodd-Frank Act, in part, to prevent excessive risk-taking and to protect investors from unfair and abusive financial practices. As part of that effort, the Dodd-Frank Act added Section 10D to the Securities Exchange Act of 1934, which required the SEC to adopt rules directing the national securities exchanges to establish listing standards that require listed issuers to develop and implement clawback policies meeting certain standards. The SEC first proposed rules pursuant to Section 10D in 2015, which were opened for comment but gained little traction. After a six-year hiatus, the SEC reopened the proposed rules for comment in October 2021 and again in June 2022, to consider shifts in the markets and how companies issue accounting restatements.

Under the New Rule, the national securities exchanges must establish listing standards that require each issuer to:

- develop and implement written policies for recovery of incentive-based compensation based on financial information required to be reported under the securities laws, applicable to the issuers' executive officers, during the three completed fiscal years immediately preceding the date that the issuer is required to prepare an accounting restatement; and
- disclose those compensation recovery policies in accordance with SEC rules.

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Of particular note, the SEC's definition of an "accounting restatement" includes restatements that correct (i) errors that are material to previously issued financial statements (so-called "Big R" restatements), and (ii) errors that are not material to previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period (commonly referred to as "little r" restatements). An accounting restatement does not include an out-of-period adjustment, where an error is immaterial to the previously issued financial statements, and the correction is also immaterial to the current period. The primary difference between "Big R" restatements and "little r" restatement is that the former requires an issuer to file an Item 4.02 Form 8-K and to amend and restate the previously issued financial statements. A "little r" restatement, on the other hand, does not typically trigger a Form 8-K, and corrections are made on subsequent filings that include the prior financial statements.

An issuer is required to prepare an accounting restatement on the earlier of (i) the date the issuer's board of directors, a committee of the board of directors, or the officer or officers (if authorized) of the issuer, 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 or (ii) the date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement. This means that recovery analysis will be triggered in the event of a "little r" and "Big R" restatement, even where the potential recovery amount is minimal.

An issuer will be subject to delisting if it does not adopt and comply with its compensation recovery policy.

Compensation Subject to Recovery

The New Rule requires recovery from any current or former executive officer who, during the three-year look-back period, received incentive-based compensation (including stock options awarded as compensation) in excess of what would have been paid to the executive officer under the accounting restatement, regardless of whether the executive officer was at fault for the error or participated in the preparation of the financial statements. For purposes of the New Rule, the compensation is deemed to be "received" in the fiscal year in which the financial reporting measure is attained, even if the payment of the compensation occurs after the end of that period.

An "executive officer" under the New Rule is defined broadly to include the issuer's 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 as well as any officer who performs a policy-making function (including executive officers of the issuer's parent(s) or subsidiaries who perform such policy making functions for the issuer). Of note, there is no scienter requirement or limitation related to any fault of the applicable officer. Recovery also is not limited to executive officers who were involved in the event leading to the restatement. Further, the New Rule prohibits issuers from indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation.

Incentive-based compensation includes "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure," such as restricted stock, performance shares unit, and stock options, among others. The financial reporting measure that serves as the basis for the compensation is broadly construed to include, among others, revenues, EBITDA, earnings measures, stock price and total shareholder return ("TSR").

To determine the amount of compensation to be recovered (which is calculated on a pre-tax basis), issuers may use a mathematical recalculation directly from the information in an accounting restatement, or, for

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compensation based on stock price or TSR, issuers may determine the amount based on a reasonable estimate of the effect of the accounting restatement on the applicable measure. Issuers shall maintain documentation of that reasonable estimate and provide it to the applicable exchange.

Scope and Exceptions of the New Rule

The New Rule applies to each national securities exchange to the extent that such exchange lists securities, except for a few limited exceptions for those exchanges that list certain securities futures products, standardized options, securities issued by unit investment trusts and securities issued by certain registered investment companies.

With respect to issuers, the New Rule encompasses all issuers listed on a national securities exchange, including emerging growth companies, smaller reporting companies, controlled companies and foreign private issuers. The national securities exchanges do not have the discretion to limit the class of issuers for which the New Rule will apply.

While there is no *de minimis* exception, the New Rule is subject to a few narrowly tailored “impracticality” exceptions. First, the rule requires issuers to recover erroneously awarded compensation unless the direct expenses paid to a third party to assist in enforcing the policy would exceed the amount to be recovered. To qualify for this first exception, the issuer must have made a “reasonable attempt” to recover the compensation and must document the efforts taken in doing so. Second, issuers are not required to recover compensation where such recovery would violate home country law that existed at the time of adoption of the New Rule. For this exception to be available, the issuer must provide an opinion of counsel to that effect to the applicable exchange. The third exception applies where recovery would likely cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.

Reporting and Disclosure Requirements

In addition to adopting a clawback policy meeting the requirements of the applicable exchange listing standards, the New Rule requires registrants to make certain mandatory disclosures relating to the policy and the enforcement of the policy in the event of an accounting restatement that triggers a recovery analysis. A listed issuer will initially be required to file its clawback policy as an exhibit to its annual report (Form 10-K, Form 20-F or Form 40-F, as applicable). Issuers must indicate by check boxes on their annual reports whether the financial statements of the registrant included in the filing reflect a correction of an error to previously issued financial statements and whether any such corrections are restatements that required a recovery analysis.

Thereafter, in the event of an accounting restatement that would trigger the clawback policy’s recoupment provisions as to any erroneously awarded compensation, the issuer must then make disclosures as required by Item 402 of Regulation S-K, relating to the disclosure of executive compensation information, including:

- the aggregate dollar amount of erroneously awarded compensation attributable to such accounting restatement, including an analysis of how the amount was calculated;
- if the restatement concerns a stock price or TSR metric, the estimates that were used in determining the erroneously awarded compensation attributable to such accounting restatement and an explanation of the methodology used for such estimates;

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- the aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed fiscal year;
- if the aggregate dollar amount of erroneously awarded compensation has not yet been determined, a disclosure and explanation of that fact;
- disclosure of the dollar amount of outstanding erroneously awarded compensation due from each current and former named executive officer which remained outstanding for 180 days or longer since the determination of such amount; and
- details about any reliance on any impracticability to recover exceptions and any such erroneously awarded compensation amounts that will not be recovered.

Effectiveness of the New Rule

The New Rule and rule amendments were published in the *Federal Register* on November 28, 2022, and national securities exchanges are required to file proposed listing standards no later than February 27, 2023. The listing standards must be effective no later than November 28, 2023, and listed issuers will be required to adopt a clawback policy no later than 60 days following the effectiveness of the applicable listing standards. If the listing standards are adopted in April 2023, issuers could be required to adopt policies in June 2023. Issuers must begin to comply with the disclosure requirements in proxy statements, information statements and annual reports filed on or after the date the issuer adopts its clawback policy.

Conclusion

Although the national securities exchanges are not required to adopt rules implementing the New Rules for another 30 days, listed issuers can begin preparing for compliance with the New Rule. For those listed issuers with existing clawback policies, a thorough review of such policies should be undertaken at the appropriate time, such that any required changes are made to ensure compliance with the New Rule and the listing standards that are adopted by the applicable exchange. Existing policies may be broader than those required by the New Rule, in which case issuers may prefer to retain their existing policies and adopt a separate, national securities exchange-compliant clawback policy. This would permit issuers to retain flexibility with respect to the application of their broader policies while only subjecting the more limited national securities exchange-compliant clawback policy to the prescriptive and nondiscretionary aspects mandated by the New Rule as well as the filing requirements with the SEC. Registrants without clawback policies will need to adopt one that complies with the applicable listing standards.

In addition, issuers should consider reviewing their incentive-based compensation arrangements to analyze whether an appropriate amount of compensation is tied to financial reporting metrics that could be subject to clawback in the event of an inadvertent misreporting. Finally, because clawing back compensation on pre-tax amounts could be punitive for current and former executive officers, issuers should consider including mandatory deferrals of a portion of incentive compensation so that, in the event of recovery, executive officers may not have to re-pay the amount previously paid in taxes for such compensation.

The New Rule release adopting the amendments can be found [here](#). For further information, please contact a member of the Haynes Boone [Capital Markets and Securities Practice Group](#).