Davis Polk

Final clawback rule adopted by SEC

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The SEC adopted the final "clawback rule" mandated by the Dodd-Frank Act requiring public companies to establish and enforce policies to recover excess incentive compensation from executive officers if amounts were "based" on material misstatements in financial reports.

Executive summary and key implications

Executive summary

The final rule[1] directs U.S. stock exchanges and securities associations[2] to adopt listing standards requiring all listed companies, including foreign private issuers, emerging growth companies and smaller reporting companies, to adopt and comply with a written clawback policy. A possible timeline for implementation is outlined below, but we expect that companies will be required to implement clawback policies by the end of 2023 or early 2024, and 2023 financial statements may be affected by the new disclosure requirements.

The clawback policy must require that any incentive compensation (including both cash and equity compensation) paid to any current or former executive officer is subject to recoupment if:

- the incentive compensation was calculated based on financial statements that were required to be restated due to material noncompliance with financial reporting requirements (including both "big R" and "little r" restatements), without regard to any fault or misconduct; and
- that noncompliance resulted in overpayment of the incentive compensation within the three fiscal years preceding the date the restatement was required.

Each listed company must also:

- file a copy of its compliant clawback policy as an exhibit to its annual report; and
- in the event of a restatement, disclose how much incentive compensation was subject to recovery, how much has remained outstanding for at least 180 days since the company determined the amount owed, and, if the company decides not to recover excess incentive compensation (to the limited extent permitted), the reason(s) for this decision.

A listed company that does not comply by either (1) failing to adopt a clawback policy; (2) failing to enforce its clawback policy; or (3) failing to make the required clawback disclosures will be subject to delisting.

Similar to the proposed rule from 2015, the final rule is extremely prescriptive and notably:

- applies to all listed companies, including foreign private issuers, emerging growth companies, controlled companies and issuers of debt and other nonequity securities, with limited exceptions;

- expansively defines executive officers and includes all Section 16 officers (or anyone who served in a Section 16 position during the relevant lookback period);
- broadly construes incentive compensation to include any compensation that is determined based on financial reporting measures, including GAAP and non-GAAP measures, and compensation that is granted or vests based on stock price or TSR;
- requires the clawback to be collected on a pre-tax basis;
- leaves the board of directors little to no discretion to forgo, release or settle amounts subject to recovery and prohibits indemnifying or insuring executive officers;
- mandates detailed disclosure of specified information regarding completed, ongoing and forgone recoveries; and
- subjects companies to delisting for failure to comply with the rule.

Key takeaways and next steps

Before plunging into the details, we note the following higher-level implications and considerations:

- There is an open question of how to reconcile the newly required clawback policy with any existing recoupment policies that companies have adopted over the years in response to investor concerns. Most large public companies have adopted clawback policies, including all S&P 500 companies, and over 99% of the remaining 2,500 companies in the Russell 3000 index. For some companies, there has been a regulatory imperative to do so; other companies adopted their clawback policies after receiving shareholder feedback in favor of a clawback policy.
  - Existing policies are nearly always triggered by some concept of fault and misconduct, and so these are less prescriptive than the newly required clawback policy. On the other hand, many existing policies are broader than the new proposed requirement as they may include a broader group of employees, or may include recoupment triggers that do not require financial restatement, such as misconduct causing reputational harm.
  - Incorporating the new requirements into existing policies may have unexpected implications, such as the need to file and provide disclosure on broader pre-existing clawback policy terms that otherwise would not need to be disclosed.
  - One approach may be to keep the stock exchange mandated clawback policy separate from the other clawback and malus policies in order to limit the prescriptive and nondiscretionary aspects of the new rule to financial restatements.
- Implementing the policy in the event of a financial restatement will prove challenging in terms of: (i) how companies should measure a financial restatement's impact on TSR and stock price metrics; and (ii) how to collect on a clawback when the executive officer has already been paid the compensation and paid tax on the compensation.
  - Given the ubiquity of TSR and stock price metrics in long-term incentive programs (due in large part to the push by institutional shareholders to use those metrics), many companies will need to grapple with how to determine a financial restatement's impact on TSR or stock price, if any.
  - Collecting clawback amounts on a pre-tax basis can be extremely punitive, given that many executive officers in high tax jurisdictions may have a marginal tax rate hovering around 50%. The executive officer's recovery of income tax paid on clawed back income is by no means assured (which the SEC acknowledges). Companies may consider implementing structural protections in their incentive plans, like mandatory deferral of a portion of incentive compensation for a period that covers most of the lookback period, in order to defer taxation.
- The application of the rule to foreign private issuers (FPIs) will raise several challenges. FPIs are exempt from many of the corporate governance and disclosure requirements under SEC rules and listing standards, and the clawback policy requirement will be a notable exception.
  - FPIs are not subject to Section 16 and have not yet analyzed who their "executive officers" would be under that

definition.

- Further, there is a very narrow exception that only exempts clawbacks that would violate the home country law of the company *if* that law was in place before the date of publication of the final rule. In all likelihood, companies that must enforce a clawback will need to make an effort to collect on the clawback even in countries where it would be prohibited, document those efforts, and then determine that recovery is impracticable due to costs. The SEC adopted a view that companies choose to list in the United States and can opt not to if they want to avoid these rules – this attitude marks a retreat from the SEC view over the last several decades to welcome FPIs and assist in their capital formation.
- FPIs would need to disclose individual clawback amounts even when home country law would not require disclosure of individual compensation information.

Operation of the rule - Key questions and answers

The release of the final rule comes more than seven years after the SEC released its proposed Rule 10D-1 and associated rules on July 1, 2015, implementing corresponding provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. After reopening the comment period on October 14, 2021 and again on June 8, 2022, the SEC released its final Rule 10D-1 on October 26, 2022, setting forth the clawback standards applying to listed companies under the Dodd-Frank Act. As of the date of this memorandum, the final rule had not yet been published in the Federal Register.

1. Which companies are covered by the final rule?

A: Every company that is listed on a U.S. national securities exchange is covered by the final rule, with only very limited exceptions.

Any company that has securities listed on a U.S. national securities exchange that is registered under Section 6 of the Securities Exchange Act of 1934 must comply with Rule 10D-1, with only limited exceptions.[3]

Companies subject to the rule include:

- foreign private issuers (FPIs);
- emerging growth companies (EGGs);
- smaller reporting companies (SRCs);
- controlled companies; and
- issuers of debt and other nonequity securities.

2. When is the deadline to implement a compliant clawback policy?

A: Clawback policies may need to be in place by the second half of 2023.

Each securities exchange must issue proposed listing standards within 90 days after publication of the final rule in the Federal Register, and these listing standards must become effective within one year after the final rule's publication in the Federal Register.

Within 60 days after the listing standards are effective, companies must adopt a compliant clawback policy and disclose the clawback policy in their annual reports. The clawback policy must apply to all applicable incentive compensation that is "received" after the listing standard effective date (regardless of whether the incentive

compensation is the subject of a contract or arrangement that existed prior to the effective date of the rule).

Example.

- November 2022: Publication of rule in Federal Register.
- February 2023: Deadline for stock exchanges to propose their version of the rule.
- From March 2023 to November 2023: Window for effective date of stock exchanges' final rule.
- From June 2023 to January 2024: Deadline for company adoption of clawback policy and disclosure in next annual report and proxy statement following adoption

On this timeline, incentive compensation "received" after the effective date of the stock exchanges' listing standards would be subject to clawbacks, regardless of whether companies adopt a clawback policy after that date. If a clawback is triggered then disclosure would be required even if no policy has been adopted yet.

3. What is the earliest year for which a financial restatement may trigger a clawback under a new clawback policy?

A: A restatement of a company's financial statements for any year could trigger a clawback of incentive compensation "received" in 2023 or later.

The final rule requires that clawback policies apply to incentive compensation that is "received" (which, as described below, means the date that the financial measure determining the incentive compensation was achieved) at any time after the listing standards are effective. If the listing standards are effective in 2023 then, incentive compensation earned in whole or in part for the fiscal 2023 financial performance period (assuming a calendar year fiscal year) could be subject to recoupment if fiscal 2023 financial statements are restated. This could also affect awards granted in prior years (e.g., a performance stock unit granted in 2021 that is earned based on 2021-2023 performance, if the relevant financial metrics are attained on or after the effective date of the listing standards).

Notably, companies with longer multi-year performance awards, such as the "mega-grants" that have been granted to a number of newly public company CEOs and founders over the past several years, may be exposed to clawback requirements for restatements affecting any year in that performance period.

Requirements for a compliant clawback policy

4. What events trigger the requirement to recover excess incentive compensation?

A: A company is required to apply its clawback policy to recoup excess incentive compensation to executive officers in all cases where the company is required to prepare a financial restatement to correct a material error.

Compensation recovery policies must be triggered in the event that the company is required to prepare an accounting restatement either:

- correcting an error in previously issued financial statements that is material to the previously issued financial statements ("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 ("little r" restatements).

Out-of-period adjustments correcting errors that are immaterial to the current period and the prior period would not

trigger incentive compensation recovery.

Whether an error is material should be determined by the company with the oversight of the audit committee, based on the relevant facts and circumstances and consistent with SEC guidance for other materiality judgments, such as Staff Accounting Bulletin No. 99 analyses. The SEC stated that the materiality analysis should consider the effects of the error not only on the face of the financial statements, but also on the footnotes to the financial statements, and should include evaluation of both quantitative and qualitative factors.

In the adopting release, the SEC also identified certain changes to a company's financial statements that would not constitute a restatement and thus do not trigger the application of the company's clawback policy under Rule 10D-1. These include:

- 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; and
- retrospective revision for stock splits, reverse stock splits, stock dividends or other changes in capital structure.

5. Which executive officers are covered by the final rule?

A: All individuals who were Section 16 officers during the relevant performance period for the incentive compensation.

For purposes of the Rule 10D-1, executive officers are defined in a manner identical to the Section 16 definition of officers.[4] All Section 16 executive officers are subject to clawback regardless of their responsibility or involvement in the actions that led to the restatement.

A clawback policy must cover incentive 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 recovery period. Compensation "received" while a person is serving in a nonexecutive capacity is not subject to clawback.

A clawback policy must apply to awards granted before an executive officer is hired or appointed (e.g., promotion and new hire grants), so long as the executive officer serves as an executive officer at some point during the performance period applicable to the award and "receives" the award while serving as an executive officer.

6. What are "financial statements" for purposes of the clawback rule?

A: According to the SEC, a "financial statement" includes any statement of financial position (balance sheet), statement of comprehensive income, statement of cash flows, statement of stockholders' equity, related schedules, and accompanying footnotes, as required by SEC regulations.

7. What is a "little r" restatement?

A: A "little r" restatement includes any restatement not requiring an 8-K filing that corrects errors that are not material to previously prepared financial statements but would result in a material misstatement if (i) the errors were left uncorrected in the current report or (ii) the error correction was recognized in the current period.

Whether an adjustment or other change to a financial statement rises to the level of a "restatement" (whether that restatement is a "Big R" restatement or a "little r" restatement) is a decision that is made by a company's accounting team. This determination should be made with the oversight of the company's audit committee and should be informed

by relevant facts and circumstances as well as SEC guidance for other materiality judgments, such as Staff Accounting Bulletin No. 99 analyses.

Example. An executive may have prepared an improper expense accrual (such as an overstated liability) that has built up over five years at $20 per year. Upon identification of the error in year five, the company evaluated the misstatement as being immaterial to the financial statements in years one through four. To correct the overstated liability in year five, a $100 credit to the statement of comprehensive income would be necessary; however, $80 of it would relate to the previously prepared financial statements for years one through four. During the preparation of its annual financial statements for year five, the company determines that, although a $20 annual misstatement of expense would not be material, the adjustment to correct the $80 cumulative error from previously prepared financial statements would be material to comprehensive income for year five. Accordingly, the company must correct the financial statements for years one through four.[5]

8. Which types of incentive compensation are subject to the clawback policy?

A: Incentive compensation subject to the clawback policy includes any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure, including stock price or TSR.

Incentive compensation includes any compensation, including cash and equity (including stock options awarded as compensation), that is granted, earned or vested based wholly or partly upon the achievement of a "financial reporting measure." This includes any measure determined and presented in accordance with the accounting principles used in preparing the company's financial statements (and any measures that are derived wholly or in part from those measures), including GAAP and non-GAAP measures, as well as stock price and TSR (to the extent that improper accounting impacts those measures).

The measure need not be included in any SEC filing and may be presented outside of financial statements, such as in the MD&A. Examples provided by the SEC include (but are not limited to) revenues; net or operating income; profitability of one or more reportable segments; financial ratios; net assets or net asset value per share; EBITDA; funds from operations and adjusted funds from operations; liquidity measures; return measures; earnings measures; sales per square foot or same store sales; revenue per user, or average revenue per user; cost per employee; and any other financial reporting measure that is measured relative to a peer group to the extent the underlying financial reporting measure is subject to an accounting restatement.

Based on this definition, the SEC identified the following types of incentive compensation that could be covered:

- Nonequity 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 wholly or in part on satisfaction of a financial reporting measure performance goal;
- Restricted stock, restricted stock units (RSUs), performance-based restricted stock units (PSUs), stock options and stock appreciation rights (SARs) 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.

9. Which types of incentive compensation are not subject to the clawback policy?

A: Amounts paid to an executive officer that are granted, vested or earned based solely upon the occurrence of nonfinancial events would not be subject to the clawback policy.

Incentive compensation excludes base salary, time-vesting awards or compensation that is awarded solely at the discretion of the board, in each case as long as their grant was not based on the achievement of a financial performance measure. It also does not include compensation awarded based on subjective standards (e.g., demonstrated leadership), strategic measures (e.g., completion of a merger) or operational measures (e.g., attainment of a certain market share or obtaining regulatory approval of a product).

Further, erroneously awarded incentive compensation contributed to tax-qualified retirement plans is not subject to the clawback policy.[6]

10. Are there any exceptions to the requirement to recover incentive compensation?

A: There are three limited exceptions:

- the company reasonably determines that the expense paid to a third party to recover the incentive compensation would exceed the amount of the incentive compensation to be recovered, making recovery impracticable;
- the recovery of the incentive compensation would violate a law of the company's home country that was passed before the final rule is published in the Federal Register, making this exception largely a nullity; or
- the recovery of the incentive compensation would draw from deferred compensation under tax-qualified retirement plans.

There is no exception for *de minimis* amounts.

The company must make a reasonable attempt to recover the incentive compensation prior to determining that it is impracticable, and the company must provide documentation of the attempt to recover in proxy statements or annual financial reports. The SEC noted that only direct costs paid to third parties (such as reasonable legal expenses and consulting fees) could be considered when determining whether to recover those amounts; indirect costs cannot be considered when determining whether the cost of recovery would exceed the amount recovered.

To satisfy the second exception, the company must provide the exchange with an acceptable opinion of home country counsel stating that recovery would violate home country law.

11. Does the board of directors have any discretion with respect to the amount or method of recovery of the incentive compensation by the company?

A: Generally no, but the board may have limited discretion in certain circumstances.

Companies must recover the complete amount of erroneously awarded incentive compensation.

The final rule also does not permit the company's board to pursue differential recovery among executive officers, even in the event that incentive compensation was awarded under a "pool plan" (i.e., incentive compensation in which the amounts awarded to executive officers were discretionary, but the amount of the bonus pool was determined based on restated financial performance measure). Under these circumstances, recovery should be prorated based on the size of the original award. In addition, the company may not settle for amounts less than the full recovery amount unless it is otherwise demonstrated that the recovery of the full amount would be impracticable as discussed above.

A company is permitted to exercise discretion on the method of recovering excess incentive compensation. This may

include recovery over time or from future pay, from compensation owing and then through after-tax funds, forfeitures of equity awards, repayment by the executive officer, cancellation of unvested equity and nonequity awards and offsetting against amounts otherwise payable by the company to the executive officer.

12. When is incentive compensation "received"?

A: Incentive compensation is "received" during the fiscal period in which the performance measure that must be achieved based on the terms of the award is attained (not when it is granted, vested or paid).

An award that is subject to both a financial performance measure and a service vesting condition is considered received during the fiscal period when the performance measure is satisfied, even if (i) the award is paid after the fiscal period and/or (ii) the award remains subject to service vesting conditions. For performance periods that cover multiple fiscal years, the incentive compensation is "received" on the date the performance measure is satisfied (i.e., if a performance period covers fiscal years 2021 through 2023, the incentive compensation is "received" in 2023).

Therefore, a performance award that covers a multi-year period subjects compensation to a greater risk of recovery than separate awards that add up to the same aggregate amount but are each subject to a one-year performance period, since awards will remain within the lookback period covered by the clawback policy for three years following the end of the applicable performance period.

13. What time period is covered by the clawback policy in the event of a financial restatement?

A: Incentive compensation must be subject to recovery if it is "received" during any of the three completed fiscal years immediately preceding the date on which the company was "required" to prepare a financial restatement.

The company is deemed to be "required" to prepare a financial statement upon the earlier of the following:

- the board of directors, a committee thereof, or any of the officers concluded or reasonably should have concluded that the company is required to prepare an accounting restatement due to material noncompliance of the company with any financial reporting requirement; or
- a court, regulator, or other legally authorized body directs the company to prepare an accounting restatement.

The "reasonably should have concluded" reference means that even if the company decides to challenge the need for restatement, the lookback period would be measured from the earliest possible date that the company should have come to that view.

Example. If a calendar year company concludes in December 2027 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2028, the clawback policy would apply to incentive compensation received in 2026, 2025 and 2024.

Note that incentive compensation is subject to the company's clawback policy to the extent that it is "received" while the company has a class of securities listed on an exchange or an association. Thus, any award of incentive compensation granted to an executive officer before the company lists a class of securities would be subject to the clawback policy if the incentive compensation was "received" by the executive officer while the company had a class of listed securities. However, incentive compensation "received" by an executive officer before the company's securities become listed would not be subject to the clawback policy.

14. How does a company determine the amount of incentive compensation that should be recovered from its executive officers?

A: The amount of incentive compensation to be recovered is the difference between what was paid to the executive officer and what would have been paid had the incentive compensation payout been calculated based on the restated financial information.

To determine the excess amount of incentive compensation received by an executive officer, a company would recalculate the incentive compensation that would have been received based on the restated financial reporting measure, and then subtract that amount from the amount of incentive compensation paid based on the erroneous financial reporting measure.

Where incentive compensation is based only in part on the achievement of a financial reporting measure performance goal, the company first would determine the portion of the original incentive compensation based on the financial reporting measure that was restated. The company would then recalculate the affected portion based on the financial reporting measure as restated, and recover the difference.

Similarly, for cash awards paid from bonus pools, the size of the aggregate bonus pool from which individual bonuses are paid would be reduced by applying the restated financial reporting measure, and the individual bonuses would be reduced on a *pro rata* basis (though recoupment is only required from the covered executive officers).

15. How is the recoverable amount calculated for incentive compensation based on TSR or stock price?

A: The excess amount is calculated based on the company's reasonable estimate of the effect of the restatement on the company's stock price

The company must maintain appropriate documentation of the process for arriving at the estimate of the effect of the restatement on the stock price and disclose those findings in proxy statements or annual financial reports and provide that documentation to the relevant exchange or association.

16. How is equity compensation recovered?

A: Recovery of equity compensation will depend on the status of the applicable award.

The company must recover the excess portion of the equity award that would not have been granted, vested or earned based on the restated financials, as follows:

- if the equity award remains outstanding, the executive officer would forfeit the excess portion of the award;
- if the executive officer has exercised the equity award, or if that equity award has settled into shares that the executive officer still holds, the company must recover the number of shares received in excess of the shares that would have been granted under the financial restatement (less any exercise price paid for the shares);
- if the executive officer has sold the underlying shares, the company must recover the proceeds received from the sale of the number of shares received in excess of the shares that would have been granted under the financial restatement (less any exercise price paid for the shares).

17. How should a company effectuate clawbacks of deferred compensation?

A: A company should forgo payment of that compensation.

Enforcing a clawback with respect to amounts that would be treated as nonqualified deferred compensation under Section 409A of the Internal Revenue Code should be done carefully to avoid changing the time and form of payment. However, a company could reduce deferred compensation balances to reflect the clawback, which should not change

the time and form of payment. Companies should query how to calculate the amount subject to clawback and how to incorporate interest and earnings on deferred compensation.

18. What are the consequences of failure to comply with the final rule?

A: A company is subject to delisting from its national securities exchange, and the company may not be listed on a different exchange prior to coming into compliance with the clawback policy required by Rule 10D-1.

The applicable exchange would be required to determine whether the steps taken by a company constitute compliance with the company's clawback policy. Exchanges will also be required to commence delisting proceedings against companies who do not follow the disclosure requirements.

Disclosure obligations

19. What must companies disclose concerning their clawback policy?

A: A company must file its clawback policy as an exhibit to its annual report.

An amendment to Item 601 of Regulation S-K requires companies to file a copy of their stock exchange mandated clawback policies as an exhibit to their annual reports on Form 10-K. FPIs must file a copy of their stock exchange mandated clawback policy as an exhibit to their annual reports on Form 20-F or 40-F. The disclosure requirement does not extend to other clawback policies the company may have in place.

20. What disclosure requirements apply if an executive officer is subject to recovery of excess incentive compensation?

A: The company will be required to provide the date of the relevant accounting restatement and detailed information regarding the recovery of excess incentive compensation.

Forms 10-K, 20-F and 40-F will include new check boxes indicating:

- whether the financial statements of the company included in the filing reflect correction of any error to previously issued financial statements; and
- whether any of those error corrections are restatements that required recovery analysis of incentive compensation.

Where a company is required to recover excess incentive compensation, then the next proxy statement or annual report must disclose:

- the date on which the listed company was required to prepare an accounting restatement;
- the aggregate dollar amount of erroneously awarded incentive compensation attributable to that accounting restatement, including an analysis of how the amount was calculated (or, if the amount has not yet been determined, disclose this fact, explain the reasons and disclose that amount in the next filing in which this disclosure is required);
- if the financial reporting measure for the incentive compensation was stock price or TSR, the estimates used to determine the excess incentive compensation based on the restatement;
- the aggregate dollar amount of erroneously awarded incentive compensation that remains outstanding at the end of the last completed fiscal year (or, if the amount has not yet been determined, disclose this fact, explain the

reasons and disclose that amount in the next filing required to include this disclosure);

- if recovery is impracticable, for each current or former named executive officer (on an individual basis) and for all other current and former executive officers as a group (on an aggregate basis), the amount of forgone recovery and a brief description of the reason the company decided in each case not to pursue recovery; and
- for each current and former named executive officer, disclose the amount of erroneously awarded compensation still owed that had been outstanding for 180 days or longer since the date the company determined the amount owed.

If an accounting restatement does not require recovery, the company must disclose the reason why recovery is not required. If the company is relying on an exception to recovery, that must be disclosed.

21. What disclosure is required in a company's CD&A and associated compensation tables with respect to recovered excess incentive compensation previously paid to a named executive officer and disclosed in a prior proxy statement?

A: Recovered amounts must be deducted from the summary compensation table disclosure relating to the year in which the incentive compensation relating to the recovered amounts was reported, with amounts to be identified through a footnote.

Disclosure is not required to be included in the CD&A. However, the company may provide disclosures in the CD&A so that all compensation recovery information is in a single location in the filing. Where clawbacks impact the Summary Compensation Table, it should be addressed in the CD&A.

Specific data points included within the compensation recovery disclosures, as well as block text tagging of those disclosures, must be tagged in eXtensible Business Reporting Language (XBRL).

Other considerations

21. Is recovery on a pre-tax or post-tax basis?

A: The amount of excess incentive compensation subject to recoupment is calculated on a pre-tax basis (i.e., it does not subtract the portion of the erroneously received incentive compensation paid by the executive officer in taxes).

An executive subject to a clawback will have to repay the cash she received from the company, *plus the amount she paid in taxes*. She may then seek to recover all or some of the taxes she paid from the relevant taxing authority, but whether she will be able to do so will depend on the local laws where she lives; here in the United States, recovery is heavily dependent on the specific facts surrounding the clawback and is by no means assured.

As harsh a result as this may produce, the SEC has taken the position that it is a matter of tax policy outside of the scope of the SEC's rulemaking authority and that, in any event, the risk of a taxing authority not being willing to repay taxes paid on incentive compensation that is later clawed back should be borne by the executive officers rather than the company or the shareholders.

One question is whether companies may consider permitting or requiring executive officers to defer a portion of incentive compensation to hedge against a potential clawback requirement, so that a potential future clawback may draw from deferred amounts that have not yet been taxed.

22. Can the company indemnify or insure its executive officers against the recovery of the officers' incentive compensation?

A: No.

While an executive officer may purchase a third-party insurance policy to fund potential recovery obligations, the company cannot pay for the premiums or reimburse the executive officer for the cost.

23. How do the SEC's new standards differ from existing clawback requirements under Section 304 of the Sarbanes-Oxley Act of 2002?

A: The final rule applies to a broader scope of executive officers and applies even in the absence of any misconduct that results in the financial restatement.

Section 304 of the Sarbanes-Oxley Act (SOX) requires recovery only where a restatement results from company misconduct, and only from chief executive officers and chief financial officers. Further, under SOX, the amount of required recovery is limited to compensation received within the 12-month period following the first public issuance of filing with the SEC of improper financial statements.

24. What happens if companies are required to recover executive compensation under both Section 304 of SOX and Rule 10D-1?

A: If recovery is required under both Section 304 of SOX and Rule 10D-1, any amounts recovered through compliance with Section 304 would be credited toward the amount recovered under Rule 10D-1.

However, recovery under Rule 10D-1 would not preclude recovery under Section 304 to the extent any applicable amounts have not been reimbursed to the company.

25. Are there other developments relating to clawback policies to be aware of?

A: There has been increasing interest in clawback policies as a tool to manage general compliance practices and deter/punish misconduct, even outside the context of a financial restatement.

In a recent speech by Deputy Attorney General Lisa O. Monaco and in an accompanying memorandum, the Department of Justice has indicated that in criminal investigations for corporate misconduct where companies have voluntarily exercised deterrence mechanisms for employee misconduct, including clawing back compensation previously paid to current or former executive officers whose actions or omissions resulted in, or contributed to, the criminal conduct at issue, the DOJ will favorably consider these policies in deciding whether and how to resolve a criminal investigation.[7]

Next steps

It is currently anticipated that companies must have in place compliant clawback policies in 2023, depending on the date the applicable national securities exchange implements clawback rules. In advance of this deadline, companies should consider taking the following actions:

- Notify the company's board of directors and its audit committee and compensation committee of the new requirements for clawback policies.
- Review existing clawback policies (including those set forth in a company's cash and equity incentive plans and

award agreements, as well as any employment agreements) to determine whether to integrate the new requirements into existing policies or to establish a separate stock exchange mandated compliant policy.

- Review performance metrics used in the company's existing incentive programs and consider how the clawback rule might apply to these programs.
- Consider whether to implement deferral features on incentive compensation, either mandatory or elective, to facilitate the enforcement of clawbacks on a pre-tax basis.

Law clerk Mackenzie Bouverat contributed to this update.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Ning Chiu
+1 212 450 4908
ning.chiu@davispolk.com

Jennifer S. Conway
+1 212 450 3055
jennifer.conway@davispolk.com

Jeffrey P. Crandall
+1 212 450 4880
jeffrey.crandall@davispolk.com

Joseph A. Hall
+1 212 450 4565
joseph.hall@davispolk.com

Adam Kaminsky
+1 202 962 7180
adam.kaminsky@davispolk.com

James C. Lin
+852 2533 3368
james.lin@davispolk.com

Kyoko Takahashi Lin
+1 212 450 4706
kyoko.lin@davispolk.com

Emily Roberts
+1 650 752 2085
emily.roberts@davispolk.com

Travis Triano
+1 212 450 3096
travis.triano@davispolk.com

Veronica M. Wissel
+1 212 450 4794
veronica.wissel@davispolk.com

Justin Alexander Kasprisin
+1 212 450 3185
justin.kasprisin@davispolk.com

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[1] The final rule can be located here. The press release announcing the release of the final rule can be located here, and an associated fact sheet can be located here. For a summary on the proposed rule's initial provisions and our initial guidance with respect to the proposed rule, see our client update from July 8, 2015. In addition, for our thoughts on the recent reopening of the comment periods with respect to the proposed rule, see our memoranda from October 18, 2021 and June 13, 2022.

[2] There are effectively no national securities associations. All further references to rules applying to stock exchanges apply also to securities associations, but in practice apply only to stock exchanges in the United States.

[3] Rule 10D-1 will exempt certain registered investment companies or management companies, but only to the extent that those companies have not granted incentive compensation to any executive officer in any of the last three fiscal years (or since the initial listing if the registered investment company has been listed for fewer than three years). However, the SEC noted that listed funds and externally managed business development companies are not exempt from the final rule.

[4] An "officer" for Section 16 purposes includes a company's president, principal financial officer, principal accounting officer or controller, any vice-president of the company in charge of a principal business unit, division, or function and any other officer who performs a policy-making function, and any other person who "performs similar policy-making functions for the company."

[5] This example is provided by the SEC in the final rule.

[6] "Tax qualified plans" may include plans qualified under Section 401 of the Internal Revenue Code. However, the exception would not apply to any nonqualified deferred compensation plans, including wraparound plans.

[7] For discussion of the Department of Justice's new corporate enforcement guidance, see this client update from Davis Polk & Wardwell's White Collar Defense & Investigations practice group.