

NYSE and Nasdaq release clawback rule proposal

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On February 22, 2023, the NYSE and Nasdaq released their respective versions of a proposed rule that implements the SEC's clawback rule mandated by the Dodd-Frank Act. Both versions hew closely to the SEC's final rule adopted in October.

Executive summary

On February 22, 2023, the New York Stock Exchange and the Nasdaq Stock Market released their respective versions of a proposed rule that implements the SEC's clawback rule mandated by Section 954 of the Dodd-Frank Act. The SEC's final rule, which was adopted in October 2022 as Rule 10D-1 of the Securities Exchange Act of 1934 (the Exchange Act), directed U.S. stock exchanges to adopt listing standards requiring all listed companies, including foreign private issuers (FPIs), emerging growth companies (EGCs) and smaller reporting companies (SRCs), to adopt and comply with a written clawback policy, to disclose the policy and to file the policy as an exhibit to its annual report, as well as to include other disclosures in the event a clawback is triggered under the policy. Our client alert on the SEC's final clawback rule can be found here.

The NYSE expressly states that its proposed rule "is designed to conform closely to the applicable language of Rule 10D-1" and, while Nasdaq was silent, the same is true for its version.

Deadline for compliance

What's next:

- Once published in the Federal Register, there will be a public comment period of 21 days, and then the SEC must approve both listing standards.
- Under the SEC's rule, the stock exchanges are required to have their applicable listing standards effective no later than November 28, 2023 (the date of effectiveness, the Effective Date, which may be earlier than November 28).
- Companies will be required to adopt their clawback policy no later than 60 days following the Effective Date.

If the Effective Date is November 28, 2023, then the deadline to comply will be January 27, 2024.

Both the NYSE and Nasdaq specify that a company is only required to apply its clawback policy to incentive-based compensation received (as defined by the SEC and explained further below) on or after the Effective Date.

Side-by-side comparison of NYSE and Nasdaq rule proposals

The following table provides a side-by-side comparison of the NYSE and Nasdaq rule proposals, both of which follow the SEC’s final rule:

| | NYSE | Nasdaq |
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| What rule did the listing exchanges adopt? | <ul style="list-style-type: none"> — New Section 303A.14 prohibits the initial or continued listing of any security of a company that is not in compliance with the clawback rule. — New Section 802.01F would result in the immediate suspension of trading and immediate commencement of delisting procedures for any company that has not recovered erroneously awarded compensation reasonably promptly after a clawback obligation is incurred. | <ul style="list-style-type: none"> — New Listing Rule 5608 requires companies to adopt a clawback policy, comply with the policy and provide the related disclosures required by the rule and applicable SEC filings. — Amended Listing Rule 5810(c)(2)(A)(iii) would provide that a company that failed to comply with Listing Rule 5608 is required to submit to Nasdaq Staff a plan to regain compliance. |
| What is a clawback policy required to provide? | <p>Every company must have a written clawback policy that provides that the company will recover reasonably promptly the amount of erroneously awarded incentive-based compensation if the company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement under the securities laws.</p> <p>This includes any required accounting restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements, or that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.¹</p> | <p>Same as the NYSE.</p> <p>In the “purpose” section preceding the proposed rule, Nasdaq expressly notes that the clawback of erroneously awarded compensation is required on a “no fault” basis, without regard to whether any misconduct occurred or an executive officer’s responsibility for the erroneous financial statements.</p> |

What compensation is covered by the clawback rule?

The clawback rule applies to all “incentive-based compensation” “received” by executive officers on or after the Effective Date that results from attainment of a “financial reporting measure” based on or derived from financial information for any fiscal period ending on or after the Effective Date.

“**Incentive-based compensation**” is any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure.

Incentive-based compensation is deemed “received” in the company’s fiscal period during which the financial reporting measure specified in the compensation award is attained, even if the payment or grant of the compensation occurs after the end of that period.

“**Financial reporting measures**” are measures that are determined and presented in accordance with the accounting principles used in preparing the company’s financial statements, and any measure that is derived wholly or in part from such measures. Financial reporting measures also include stock price and total shareholder return (TSR).

Same as the NYSE.

In the “purpose” section preceding the proposed rule, Nasdaq expressly notes that equity awards that vest exclusively upon completion of a specified employment period, without any performance condition, and bonus awards that are discretionary or based on subjective goals or goals unrelated to financial reporting measures, **do not** constitute incentive-based compensation.

Whose compensation is in scope and what is the relevant clawback period?

The clawback rule applies to all incentive-based compensation received by a person:

- After beginning service as an executive officer;²
- Who served as an executive officer at any time during the performance period for that incentive-based compensation;
- While the company has a listed class of securities; and
- During the three completed fiscal years immediately preceding the date that the company is required to prepare an accounting restatement.³

Example: If the restatement is required in 2027, then the clawback would apply to compensation received in 2024, 2025 and 2026.

A company's obligation to claw back erroneously awarded compensation is **not** dependent on if or when the restated financial statements are filed.

Same as the NYSE.

In the "purpose" section preceding the proposed rule, Nasdaq expressly notes that the clawback rule applies to all listed companies, including FPIs, EGCs, SRCs, controlled companies and issuers of listed debt whose stock is not also listed, with limited exceptions.

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| <p>What is the date when the restatement is required?</p> | <p>The relevant date is the earlier of:</p> <ul style="list-style-type: none"> — The date the company’s board of directors, a committee thereof or the officer(s) authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the company is required to prepare an accounting restatement; or — The date a court, regulator or other legally authorized body directs the company to prepare an accounting restatement. | <p>Same as the NYSE.</p> |
| <p>What is the amount to be clawed back?</p> | <p>The amount that must be subject to the company’s clawback policy (“erroneously awarded compensation”) is the gross (not after-tax) amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts.</p> | <p>Same as the NYSE.</p> |
| <p>What if the incentive-based compensation is based on stock price or Total Shareholder Return (TSR)?</p> | <p>For incentive-based compensation based on stock price or TSR:</p> <ul style="list-style-type: none"> — The amount to be clawed back must be based on a reasonable estimate of the effect of the accounting restatement on the stock price or TSR upon which the incentive-based compensation was received; and — The company must maintain documentation of the determination of that reasonable estimate and provide such documentation to the NYSE. | <p>Same as the NYSE.</p> |

Are there any exceptions to the clawback requirement?

Yes, if one of the three conditions below is satisfied and the company's committee of independent directors responsible for executive compensation determines (or, in the absence of such a committee, a majority of the independent directors of the board) has determined that clawback would be impracticable:

- The direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered (before doing so, the company must make a reasonable attempt to recover the erroneously awarded compensation, document such reasonable attempt(s) and provide that documentation to the NYSE).
- Clawback would violate home country law if the law was adopted prior to November 28, 2022 (before doing so, the company must obtain an opinion of home country counsel, acceptable to the NYSE, that recovery would result in such a violation and must provide that opinion to the NYSE).
- Clawback would likely cause an otherwise tax-qualified retirement plan, under which benefits are broadly available to employees, to fail to meet the requirements of Sections 401(a)(13) or 411(a) and regulations thereunder.

Same as the NYSE.

Is indemnification permitted?

No, companies are expressly prohibited from indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation.

Same as the NYSE.

What SEC disclosures are required?

Companies must file all disclosures with respect to their clawback policy in accordance with the SEC's requirements.

Same as the NYSE.

In the "purpose" section preceding the proposed rule, Nasdaq expressly provides that each company is required to file its clawback policy as an exhibit to its Exchange Act annual report. In addition, the SEC's rules under Item 402 of Regulation S-K require companies to report the following if, during the prior fiscal year, either a triggering restatement occurred or any balance of excess incentive-based compensation is outstanding:

- The date on which the company was required to prepare an accounting restatement and the aggregate dollar amount of erroneously awarded compensation attributable to such restatement (including an analysis of how the clawback amount was calculated) or, if the amount has not yet been determined, an explanation of the reasons and the disclosure of the amount and related disclosures in the next filing that is subject to Item 402
- The aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of its last completed fiscal year;
- If the financial reporting measure is related to a stock price or TSR, the estimates used to determine the amount of erroneously awarded compensation attributable to such statement and an explanation of the methodology used for such estimates;
- If clawback would be impracticable, for each current and former named executive officer (NEO) and for all other current and former executive officers as a group, the amount of clawback forgone and a brief description of the reason the company decided in each case not to pursue clawback; and
- For each current and former NEO, 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.

What happens if a company does not comply?

If the NYSE determines that a company has not clawed back erroneously awarded compensation, as required by its policy, reasonably promptly after such obligation is incurred, trading in all listed securities of the company would be immediately suspended and the NYSE would immediately commence delisting procedures. The NYSE will determine whether the steps a company is taking constitute compliance with its clawback policy.

If a company fails to adopt its required clawback policy by the Effective Date, the company would be required to notify the NYSE in writing within five days. The NYSE will then promptly send written notification to the company of certain procedures, including contacting the NYSE to discuss the status of the policy and issuing a press release disclosing the occurrence of the delinquency.

If a company does not adopt a compliant clawback policy, disclose the policy as required or comply with the policy's clawback provisions, then it will be subject to delisting.

Nasdaq will determine whether the steps a company is taking constitute compliance with its clawback policy. The company's obligation to claw back compensation reasonably promptly will be assessed on a holistic basis with respect to each accounting restatement prepared by the company. Nasdaq will consider whether the company is pursuing an appropriate balance of cost and speed in determining the appropriate means to seek recovery, and whether the company is securing recovery through means that are appropriate based on the particular facts and circumstances of each executive officer who owes a recoverable amount.

A noncompliant company is required to submit to Nasdaq Staff a plan to regain compliance, and the administrative process for such deficiencies will follow the established pattern used for similar corporate governance deficiencies and would allow Nasdaq Staff to provide the issuer up to 180 days to cure the deficiency; thereafter, Nasdaq Staff will be required to issue a delisting letter.

First set of clawback rule C&DIs

In addition, on January 27, 2023, the SEC Staff issued its first set of Compliance and Disclosure Interpretations (C&DIs) relating to Rule 10D-1 (in the "Exchange Act Rules" section of the C&DIs):

- C&DI 121H.01 (and companion C&DIs in the "Exchange Act Forms" section of the C&DIs) clarifies that, while the new check boxes to the cover page of Form 10-K, Form 20-F and Form 40-F (indicating whether the form includes the correction of an error in previously issued financial statements and a related clawback analysis) became effective on January 27, 2023, companies are not required to provide such disclosure until they are required to have a clawback policy under the applicable listing standard (based on the timing of compliance in relation to the Effective Date described above).
- C&DI 121H.02 (and a companion C&DI in the "Exchange Act Forms" section of the C&DIs) notes that Item 6.F of Form 20-F (captioned "Disclosure of a registrant's action to recover erroneously awarded compensation") provides for individualized disclosure of a company's NEOs. It clarifies that FPIs that file on domestic forms and provide executive compensation disclosure under Item 402 should provide individualized disclosure for their NEOs to the extent required by Form 20-F. For FPIs that use Form 20-F, individualized disclosure is required about members of their administrative, supervisory or management bodies for whom the FPI otherwise provides individualized compensation disclosure in their filing.
- Similarly, C&DI 121H.03 (and a companion C&DI in the "Exchange Act Forms" section of the C&DIs) notes that Item

B.(19) of Form 40-F (captioned “Recovery of erroneously awarded compensation”) provides for individualized disclosure for a company’s NEOs. It clarifies that such individualized disclosure is required about executive officers for whom the company otherwise provides individualized disclosure in the filing.

- In perhaps the most substantive of the C&DIs, C&DI 121H.04 notes that the clawback rule is intended to apply broadly and that, for any plan that takes into account incentive-based compensation (other than a tax-qualified plan), a company would be expected to claw back the amount contributed to the notional account based on erroneously awarded compensation and any earnings accrued to date on that notional amount. This would apply to long-term disability plans, life insurance plans, supplemental executive retirement plans and other compensation, if it is based on incentive-based compensation.

Next steps

In advance of the compliance deadline, companies should consider taking the following steps:

- Discuss the new requirements for clawback policies with the company’s board of directors and its compensation committee.
 - Given that an accounting restatement is a triggering event, it may also be important for the audit committee, in addition to the compensation committee, to understand the rule.
 - It will also be important for the relevant functions within the company (e.g., Finance, HR, Legal, etc.) to discuss and establish procedures and practices, so that they are coordinated if there is an accounting restatement or the possibility of one.
- Review existing clawback policies (including those set forth in cash incentive plans, 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 stand-alone policy.
 - While there are pros and cons for both an integrated policy versus a stand-alone policy, one benefit of a stand-alone policy is that it may be easier to file as an exhibit with the SEC
- Review performance metrics used in the company’s existing incentive compensation 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.

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.

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¹ A restatement that corrects errors that are material to previously issued financial statements is commonly referred to as a “Big R” restatement, and a restatement that corrects errors that are not material to previously issued financial statements but would result in a material misstatement if the errors were left uncorrected in the current period or the error correction was recognized in the current period is commonly referred to as a “little r” restatement.

² An “executive officer” is based on the definition of “officer” used for Section 16 of the Exchange Act. While the NYSE and Nasdaq use slightly different language, the term effectively means the company’s president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice president in charge of a principal business unit, division or function (such as sale, administration or finance) or any other officer or person who performs a “policy-making” function for the company. Executive officers of the company’s parent(s) or subsidiaries are deemed executive officers of the company if they perform such policy-making functions for the company. The term “policy-making function” is not intended to include policy-making functions that are not significant.

³ The NYSE proposed rule provides that, in addition to these last three completed fiscal years, the clawback policy must apply to any transition period (that results from a change in the company’s fiscal year) within or immediately following those three completed fiscal years; however, a transition period between the last day of the company’s previous fiscal year end and the first day of its new fiscal year that comprises a period of 9-12 months would be deemed a completed fiscal year.