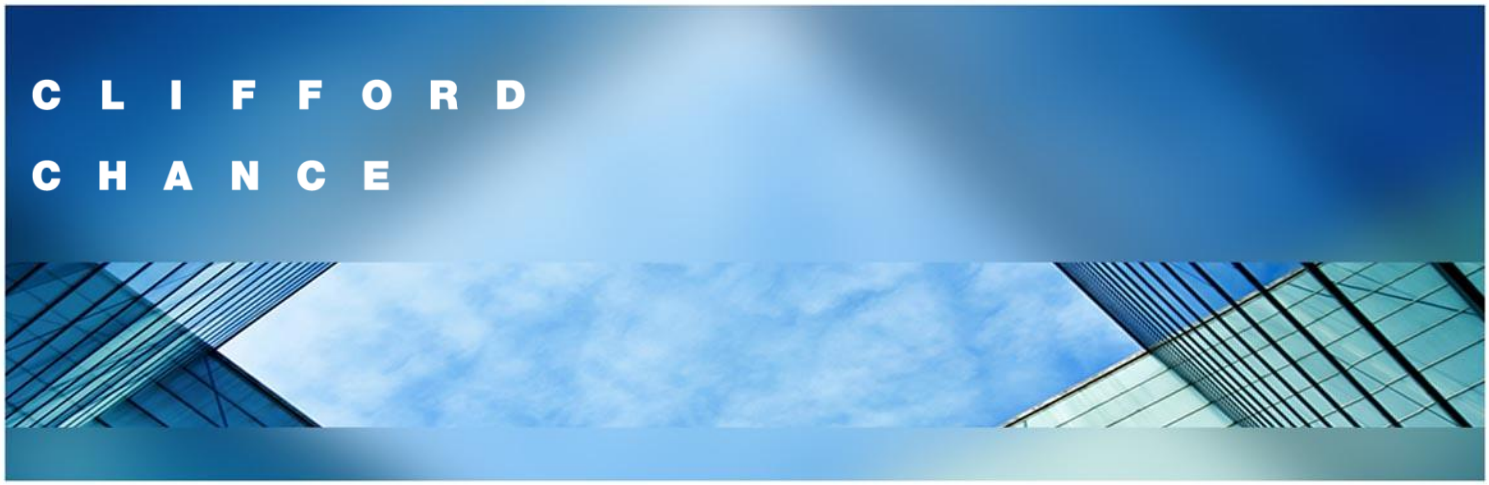

BEWARE THE CLAW: NEW SEC-MANDATED LISTING STANDARDS TO REQUIRE ISSUERS LISTED ON US EXCHANGES TO RECOVER ERRONEOUSLY AWARDED INCENTIVE COMPENSATION FROM EXECUTIVE OFFICERS IN CONNECTION WITH ACCOUNTING RESTATEMENTS

On October 26, 2022, the Securities and Exchange Commission (the "**SEC**") adopted new Rule 10D-1, *Listing standards relating to recovery of erroneously awarded compensation*, together with related rule and form amendments. The adopting release for this SEC rulemaking is available here (the "**Adopting Release**"). Pursuant to this new rule, all national securities exchanges and associations (each, a "**US Exchange**") are directed to adopt listing standards that require each listed company to develop and implement a policy providing for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers. A recovery would be triggered when the listed company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws. Each listed company will be required to file its compensation recovery policy as an exhibit to its annual report and, if a recovery is triggered, to include disclosures related to its policy and recovery analysis.

No later than 90 days following the date on which the Adopting Release is published in the Federal Register, US Exchanges will be required to file with the SEC their proposed listing standards to implement new Rule 10D-1. These listing standards should become effective no later than one year after such publication date. Listed companies that are subject to the new standards will

Key Takeaways

- Rule 10D-1 directs US Exchanges to adopt new listing standards that will require listed companies to adopt policies that would require the recovery of erroneously awarded incentive compensation from current and former executive officers.
- Recovery under these policies would be triggered if a listed company is required to prepare an accounting restatement.
- All companies listed on a US Exchange, including foreign private issuers, controlled companies, registered investment companies, emerging growth companies and smaller reporting companies, will be required to adopt compensation recovery policies.
- Each US listed company will be required to publicly file its recovery policy as an exhibit to its annual report.
- Rule 10D-1 provides only limited impracticability exceptions.

be required to adopt compliant policies no later than 60 days after the effective date of the standards. In addition, a listed company will be required to comply with related disclosure requirements in annual reports and proxy statements filed on or after the date on which it adopts its recovery policy.

BACKGROUND

New Rule 10D-1 implements Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank Act**"), which added Section 10D to the Securities Exchange Act of 1934 (as amended, the "**Exchange Act**"). This legislative provision requires the SEC to direct each US Exchange to establish listing standards that require their listed companies to develop and implement compensation recovery policies. The legislative history of this section, which is discussed in the Adopting Release, indicates that executive officers of listed companies should not be entitled to retain incentive-based compensation that was erroneously awarded on the basis of materially misreported financial information that requires an accounting restatement. Unlike other governance-related provisions of the Dodd-Frank Act, Section 954 does not include any direction for either the SEC or US Exchanges to consider providing exemptions or exceptions for certain classes of issuers.

OVERVIEW OF COMPENSATION RECOVERY REQUIREMENTS

What types of restatements should trigger recovery? After the listing standards called for by new Rule 10D-1 become effective, recovery policies will need to provide an obligation to recover erroneously awarded incentive compensation when a listed company is required to prepare an accounting restatement due to material noncompliance of the listed company with any financial reporting requirement under US securities laws. This includes restatements to correct an error in previously issued financial statements that:

- is material to the previously issued financial statements, or
- would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.

To which persons should a recovery policy apply? Recovery policies will need to apply to the current and former "executive officers" of a listed company, which includes all of the following persons:

- the listed company's president, principal financial officer, chief compliance officer, principal accounting officer (or if there is no such accounting officer, the controller);
- any vice-president of the listed company in charge of a principal business unit, division, or function (such as sales, administration, or finance);
- any other officer of the listed company who performs a policy-making function; or
- any other person who performs similar policy-making functions for the listed company.

Executive officers of a listed company's parent or subsidiary companies are deemed to be "executive officers" of the listed company if they perform policy-making functions for the listed company. For a limited partnership that is listed on a US Exchange, "executive officers" includes officers or employees of the general partner(s) who perform policy-making functions for the limited partnership. For a trust that is listed on a US Exchange, "executive officers" includes officers or employees of the trustee(s) who perform policy-making functions for the trust.

This definition of "executive officer" is specific to Rule 10D-1 and should be used instead of the definition provided in Rule 3b-7 under the Exchange Act.

Recovery policies must provide for recovery regardless of whether an executive officer had any responsibility for the error or resulting restatement.

To which compensation should a recovery policy apply? Recovery policies will need to provide for recovery from any current or former executive officers of incentive-based compensation that was erroneously awarded during the three years preceding the date on which an in-scope restatement was required. Rule 10D-1 broadly defines "incentive-based compensation" to include any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure. The Adopting Release clarifies that incentive-based compensation need not be based solely upon attainment of a financial reporting measure to be considered in scope. The SEC has not exempted externally managed business development companies ("**BDCs**") from the application of Rule 10D-1, despite the fact that the Investment Company Act of 1940 effectively prohibits BDCs from offering certain incentive compensation plans to their officers, on the grounds that "the definition of incentive-based compensation in Section 10D applies to a broader range of incentive-based compensation arrangements."

For this purpose, "financial reporting measures" are broadly defined as measures that are determined and presented in accordance with the accounting principles used in preparing the listed company's financial statements, and any measures that are derived wholly or in part from such measures. Stock price and total shareholder return are also financial reporting measures. There is no requirement that the measure have been included in the financial statements of the listed company or in any of its SEC filings.

Recovery policies should provide that the amount of incentive-based compensation to be recovered is the amount that exceeds the incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts, not taking into account any taxes paid. A listed company may use reasonable estimates regarding the effect of the restatement on stock price or total shareholder return when determining the amount of erroneously awarded compensation, when such compensation was based on stock price or total shareholder return.

Limited impracticability exceptions. A company that is listed on a US Exchange will be required to recover erroneously awarded incentive compensation in compliance with its recovery policy except to the extent that the company qualifies for one of the following three limited impracticability exceptions:

- direct expenses paid to third parties for assistance in enforcing the recovery policy would exceed the amount the listed company is seeking to recover and a reasonable attempt at recovery has been made by the listed company;
- the listed company's recovery of the erroneously awarded compensation would violate home country law that existed at the time Rule 10D-1 was adopted, and the company delivers to its US Exchange an opinion of home country counsel to that effect; and
- recovery by the issuer would likely cause an otherwise tax-qualified retirement plan to fail to meet certain specified requirements of the Internal Revenue Code and related regulations.

SIGNIFICANT CONSEQUENCES OF NEW RULE 10D-1

Many large US listed companies voluntarily adopted and disclosed recovery policies before knowing all of the requirements of new Rule 10D-1. These companies will need to consider whether to amend or replace their existing policies meet the minimum standards provided in Rule 10D-1. In addition, these companies will need to consider the impact of any policy changes on existing executive compensation programs and arrangements.

All companies listed on a US Exchange, even foreign private issuers, smaller reporting companies, emerging growth companies, and controlled companies, will become subject to the new listing standards required by Rule 10D-1. This means that even companies that have been exempt from the SEC's extensive executive disclosure requirements that generally apply to US domestic public companies will need to adopt and implement recovery policies and provide related disclosures. To comply, all types of companies listed on US Exchanges should begin to familiarize themselves with the requirements of Rule 10D-1 and its definitions for "incentive-based compensation," "financial reporting measures" and "executive officer". There is, however, a conditional exemption to the application of Rule 10D-1 to registered management investment companies ("**listed funds**") that have not awarded incentive-based compensation to any current or former executive officer of the fund in any of the last three fiscal years or, in the case of a listed fund that has been listed for less than three fiscal years, since the initial listing.

Incentive-based compensation that is based on multiple performance criteria, some financial and some not, could be subject to recovery. To address ambiguities raised by this broad definition, listed companies will want to consider whether to modify future incentive programs so that incentives that are not based on financial metrics are not aggregated with those that are. Furthermore, some listed companies may consider reducing their reliance on financial metrics for performance compensation. Listed companies could, for example, consider basing incentive compensation on newly popular non-financial ESG-related metrics.

Rule 10D-1's definition for "executive officer" appears to be broader than the generally applicable definition provided in Rule 3b-7 under the Exchange Act, with which many listed companies are familiar. Listed companies will want to consider working with counsel to develop systems and reporting lines for identifying executive officers in their organizations whose incentive compensation could

become subject to recovery pursuant to new listing standards. In addition, they will want to consider working with counsel to develop strategies for recovering incentive compensation received by former executive officers who may have no ongoing relationship with the listed company.

Rule 10D-1 does not permit a listed company to indemnify any executive officer or former executive officer against the loss of erroneously awarded compensation. While an executive officer could seek to purchase third-party insurance against this type of loss, a listed company would be prohibited from paying the premiums for any such insurance or reimbursing an executive officer for their premium payments. Listed companies will want to consider reviewing their insurance and indemnification arrangements to ensure compliance with this new prohibition.

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