Client Advisory

Even More New SEC Rules for 2023

With businesses having to navigate the "new normal" of a post-pandemic economy, the SEC has steadily increased regulations to a level not seen since the Obama administration. Even while the Supreme Court ruled against the EPA for regulatory overreach, the SEC publishes new and complex emissions disclosure rules, amongst other regulatory changes that have been implemented. One of the more recent, described in detail within this Advisory, may be one of the most onerous to individual officers. Though Dodd-Frank included a clawback provision for CEOs and CFOs, this newly finalized and enacted rule flows well beyond the top two officers of a company. Unfortunately, the concept of an uninsurable or non-indemnified clawback is a new reality that many executives should contemplate.

Background

In October of 2022, the SEC adopted final rules implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") requirements under which issuers recover incentive-based compensation in excess of what would have been paid under the restated financials for the three-year period immediately preceding the date the company is required to prepare the accounting restatement were subject to a clawback. The triggering event for the clawback under the Dodd-Frank Act was an accounting restatement attributable to a material noncompliance with reporting requirements under securities laws. This essentially requires companies "to recoup compensation that was previously awarded to certain executives based on false information" regardless of knowledge, intent, or wrongdoing.

Final Rules Adopted

On October 26, 2022, the SEC adopted final rules, seven years after the initial rules were proposed in 2015, impacting publicly listed companies that have incentive-based compensation plans.[ii] "The Securities and Exchange Commission… adopted rules to require securities exchanges to adopt listing standards that require issuers to develop and implement a policy providing for the recovery of erroneously awarded incentive-based compensation received by current or former executive officers." [iii] The final rules require recovery of erroneously awarded compensation as required by Congress under Section 954 of the Dodd-Frank Act.[iv]

Which Companies Need to Comply With the SEC Final Rules?

Any company that is listed on a U.S. national securities exchange will be covered by the SEC final rules, with very few exceptions.

What Can Be Clawed Back?

The recovery is the **difference between what was received and what was due under the restated financials, pre-tax**. As to incentive-based compensation, to the degree it was based upon total shareholder return or stock price, companies may use "reasonable estimates" to determine the impact of the restatement on total shareholder return or the share price and then determine the recoverable amount. The incentive-based compensation subject to the clawback policy includes cash and equity, including stock options awarded as compensation.

Timeline for Compliance

The final rules were published in the Federal Register on November 28, 2022. The exchanges must file proposed listing standards no later than 90 days (February 27, 2023).[v] The exchange's listing standards must be effective within one year of publication (November 28, 2023). Issuers are required to be compliant with the recovery policy by or before January 27, 2024.[vi]

Summary of Key Components of the Rules

- The SEC final rules will impact companies listed on NYSE and NASDAQ that offer incentive-based compensation.
- Applies to **BOTH**: (1) Restatements that correct material mistakes for previously submitted financials and; (2) Restatements that correct errors for previously submitted financials that are not material but would become material if left uncorrected or the error correction was recognized in the current period.
- To trigger the new clawback rules, the restatement **does not** have to be the result of fraud or misconduct. The clawback is to be made regardless of fault, misconduct, or executive officer responsibility.
- Incentive-based compensation is defined as "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure."
- The new SEC rules regarding clawbacks apply to all Section 16 officers of the Securities and Exchange Act of 1934 during the relevant time period for the incentive compensation. An "officer" under Section 16 includes a company's president, principal financial officer, principal accounting officer or controller, any vice-president of the company in charge or 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."
- The new final rules **do not** cover newly appointed officers for periods prior to their employment.

How Companies Can Be Proactive Now

What can companies do now to plan for the upcoming listing standards and required clawback policy?

- Companies need to formulate and implement new policies or amend existing clawback policies remaining cognizant of the timeline and deadlines set by the SEC.
- Companies should evaluate whether they need to change or amend their executive compensation arrangements.
- Keep in mind that clawback policies may need to be implemented and in compliance with the SEC rules by the latter half of 2023.

What Happens If A Company Does Not Comply With the New Rules?

If a company is determined not to be in compliance with adopting and complying with the new rules, the company will be subject to delisting from the national securities exchange.

Insurance Implications

The SEC Final Rules "prohibit issuers from insuring or indemnifying any executive officer against the loss of erroneously awarded compensation."[vii] The SEC Final Rules also state that "while an executive officer may be able to purchase a third-party insurance policy to fund potential recovery obligations, the indemnification prohibition would prohibit an issuer from paying or reimbursing the executive officer for premiums for such an insurance policy."[viii]

"Although reimbursement of insurance premiums by issuers would be prohibited, ***the insurance market may develop an insurance product that would allow an executive officer, as an individual, to purchase insurance against the loss of incentive-based compensation when the material accounting error is not attributable to the executive***. In that event, an executive officer would be able to hedge some of the risk that results from a recovery policy (emphasis added)."[ix]

"The development of this type of private insurance policy for executive officers would also have implications for issuers. Overall, it could make it less costly for an issuer to compensate an executive officer after implementing a recovery policy. If an active insurance market develops such that the executive officer could hedge against the uncertainty caused by the recovery policy, then market-determined compensation packages would likely increase to cover the cost of such policy." The SEC Final rules proceed to state the following on page 170: "While the indemnification provision prohibits issuers from reimbursing a current or former executive officer for the cost of such insurance policy, a market-determined compensation package would likely account for the hedging cost and incorporate it into the base salary of the executive officer's compensation. This increase may be less than the increase in the market-determined compensation packages if an insurance policy was unavailable because an insurance company may be more willing to bear uncertainty than a risk-averse executive."[x]

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Visit McGriff.com or contact:

Lisa B. Frist, JD
Vice President
Claims Account Executive
Executive Risk Advisors
404-497-7590
LFrist@mcgriff.com

David D. Garrett
Executive Vice President
Texas ERA Practice Leader
Executive Risk Advisors
713-273-2631
David.garrett@McGriff.com

Kieran P. Hughes
Senior Vice President
Senior Claims Counsel
Executive Risk Advisors
404-497-7515
Kieran.Hughes@McGriff.com

[i] (Claw) Back to the Future (harvard.edu)
[ii] https://www.sec.gov/news/press-release/2022-192
[iii] https://www.sec.gov/news/press-release/2022-192
[iv] 33-11126-fact-sheet.pdf (sec.gov)
[v] SEC.gov | Listing Standards for Recovery of Erroneously Awarded Compensation
[vi] Endnote 1, (Claw) Back to the Future (harvard.edu)
[vii] Final Rule: Listing Standards for Recovery of Erroneously Awarded Compensation (sec.gov)
[viii] Final Rule: Listing Standards for Recovery of Erroneously Awarded Compensation (sec.gov)
[ix] Final Rule: Listing Standards for Recovery of Erroneously Awarded Compensation (sec.gov)
[x] Final Rule: Listing Standards for Recovery of Erroneously Awarded Compensation (sec.gov)