

SEC APPROVES NYSE AND NASDAQ CLAWBACK LISTING STANDARDS – ASSESSING THE IMPLICATIONS FOR CANADIAN FOREIGN PRIVATE ISSUERS

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On June 9, 2023, the U.S. Securities and Exchange Commission (the “SEC”) approved the clawback listing standards (“**Listing Standards**”) of the New York Stock Exchange (“NYSE”), NASDAQ and NYSE American. The Listing Standards that have been approved are substantially identical to the new clawback rules adopted by the SEC (the “**Clawback Rules**”) and will take effect on October 2, 2023. Companies listed on these exchanges will have until December 1, 2023 to adopt compliant clawback policies.

This memorandum summarizes the SEC Clawback Rules and provides guidance for Canadian companies that may be subject to the new SEC Clawback Rules and the Listing Standards adopted thereunder.

SEC Clawback Rules

In October 2022, the SEC adopted Clawback Rules pursuant to Rule 10D of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* of 2010 which mandate that companies that restate their financial results to clawback excess incentive compensation from certain executive officers.

The SEC Clawback Rules require U.S. national securities exchanges (such as NYSE, NYSE American and NASDAQ) to establish listing standards (the “**Listing Standards**”) that require each listed issuer to develop and implement a clawback policy (a “**Clawback Policy**”) for recovery, in the event of an accounting restatement, of incentive-based compensation received by current or former executive officers where that compensation is based on the erroneously reported financial information. The Listing Standards also require the disclosure of the Clawback Policy.

The SEC Clawback Rules are prescriptive and require that an issuer’s clawback policy reflect the following key elements:

- **Application:** The Clawback Rules apply to all issuers, including Canadian issuers, that are traded on a U.S. securities exchange. The rules do not include an exemption for foreign private issuers (“**FPIs**”). SEC did not adopt an exemption for FPIs in order to ensure that U.S. investors in FPIs would benefit from the

clawback rules in the same manner as investors in U.S. domestic companies.

- **Restatement:** The trigger for recovery under the Clawback Rules will be the preparation by an issuer of an “**Accounting Restatement**” resulting from the material non-compliance by the issuer with any financial reporting requirement under securities laws, including:
 - “**Big R**” restatement: any required accounting restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements, or
 - “**Little R**” restatement: that would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period.
- **Misconduct:** Compensation recoupment is required regardless of whether the executive officer engaged in any misconduct and regardless of fault.
- **Compensation Received:** The Clawback Rules apply to compensation “received”—which is defined as occurring when the financial reporting measure was attained regardless of when payment is actually made—during the three-year “recovery period” preceding the date the company is required to prepare the accounting restatement.
- **Incentive Based Compensation:** The Clawback Rules apply to all incentive-based compensation received by an executive officer during the three fiscal years immediately preceding the date that the issuer is required to prepare an Accounting Restatement. “Incentive based compensation” is defined as any compensation that is granted, earned, or vested wholly or in part upon the attainment of a financial reporting measure. “Financial reporting measures” are broadly defined to include measures derived from an issuer’s financial statements, as well as measures based on stock price or total shareholder return.

With respect to elements of incentive compensation that are frequently utilised by Canadian issuers, we expect the Listing Standards to apply to the different elements of executive compensation as follows:

Element of Compensation	Application of SEC Clawback Rules
Base Salary	Not “incentive based compensation” and generally not subject to clawback ^[1]
Annual Cash Bonus	“Incentive based compensation” and subject to clawback
Performance Share Units (PSUs)	“Incentive based compensation” and subject to clawback
Stock Options	Not “incentive based compensation” and <u>generally</u> not subject to clawback, based on continuation of current grant formula and time-based vesting ^[2] and assuming vesting not subject to achievement of Financial Reporting Measure

Pensions	Generally not but it is possible that pensions may include a component of “incentive based compensation” to the extent that pension benefits have been determined based on annual compensation that includes an incentive based bonus that is “erroneously awarded compensation” and subject to clawback.
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- **Financial Reporting Measures:** “Financial reporting measures” are defined as any measures that are determined and presented in accordance with the accounting principles used in preparing the issuer’s financial statements, and any measures derived wholly or in part from such measures. For example, revenue, net income, financial ratios, etc.
- **Amount Subject to Clawback:** The amount of the “erroneously awarded compensation” that must be subject to recovery for each executive officer will equal the amount the incentive based compensation received exceeds the amount that would have been received had it been determined based on the restated amounts, without regard to taxes paid.
- **Disclosure Obligations:** Issuers will be required to file their clawback policy as an exhibit to their annual reports on Form 10-K, Form 20-F or Form 40-F (whichever is applicable). As a result, the policy also will be subject to SEC oversight in addition to being a listing condition. Additionally, if an accounting restatement occurs during fiscal year (or at any time thereafter and prior to the date of the annual report) then the issuer must provide detailed disclosure in the event that it was required to prepare an accounting restatement that required recovery of erroneously awarded compensation pursuant to the Clawback Policy during the fiscal year, such disclosure must include the following matters:
 - the dates of any accounting restatements and the amounts recoverable;
 - the company’s approach to recovery of recoverable amounts;
 - the aggregate recoverable amount that remains outstanding and any outstanding amounts due from any current or former executive officer for 180 days or more; and
 - details regarding the company’s reliance on any impracticality exceptions to recovery.
- **Indemnification:** Indemnification of recovered amounts is prohibited. The new rule does not allow issuers to insure or indemnify any current or former executive officer against the loss of erroneously awarded compensation.

Timelines

As noted earlier, SEC approved the Listing Standards of the NYSE, NASDAQ and NYSE American on June 9, 2023. The Listing Standards will take effect on October 2, 2023. Companies listed on these exchanges will have until December 1, 2023 to adopt compliant policies.

Non-Compliance

NYSE and NYSE American-listed companies that fail to adopt a clawback policy within 60 days of the effective date of the standards (i.e., by December 1, 2023) will be required to issue a press release identifying their delinquency, the reasons for it, and, if known, the date by which they expect to be in compliance. NYSE-listed issuers who fail to recover erroneously awarded compensation reasonably promptly as required by their clawback policies (and fail to qualify for an exception from the clawback requirements) would be subject to an immediate suspension of trading and commencement of delisting procedures.

NASDAQ-listed companies that fail to adopt a clawback policy within 60 days of the effective date of the standards (i.e., by December 1, 2023) will be eligible to submit a plan of compliance to NASDAQ staff within 45 days and will have access to cure rights, in accordance with existing NASDAQ procedures. Under both NYSE and NASDAQ clawback listing standards, listed companies will only be required to claw back incentive awards received (as therein defined) on or after the October 2, 2023 effective date.

Preparing for Implementation

As noted above, publicly listed companies will need to adopt clawback policies that reflect the NYSE or NASDAQ rules in the next few months to ensure they comply with the new Clawback Rules. In this time, issuers should proactively undertake gap-analysis of their current clawback arrangements in order to prepare themselves for increased expectations and new challenges.

- **Application of Clawback Policy:** Public companies, and their compensation committees, will have to consider if the Clawback Policy will apply to any incentive compensation “received” on or after the effective date of the new Listing Standards, even if that compensation was received pursuant to an award granted before adoption of the company’s Rule 10D-1 clawback policy. Therefore, to the extent they have not done so already, companies should be adding a provision to their existing incentive compensation plans and taking any other appropriate measures to enhance the enforceability of their Clawback Policy once adopted.
- **Standalone Policy:** Currently, a number of issuers in Canada include adjustment provisions for clawbacks in each of their incentive plans. Going forward, issuers will need to determine whether to integrate the Clawback Policy with their existing incentive-plans, replace their existing arrangements, or adopt a stand-alone clawback policy that would cover all incentive plans as well as any other elements of compensation structure that may in the future include incentive-based compensation.
- **Executive Agreements:** Issuers will also have to consider executive employment and indemnity agreements will need to be amended to reflect the new requirements, including specifying that compensation is subject to clawback and that indemnification is not available for the clawback of incentive compensation.

Additional Requirements

While the SEC Clawback Rules are far-reaching and extensive, the expectations from other stakeholders and regulators in Canada are rather modest at the moment. There are few legal requirements for mandatory clawbacks in Canada and proxy advisors have also adopted an agnostic approach. That being said, it is likely that once the new Listing Standards are in-effect, Canadian regulators and stakeholders groups will study the SEC Clawback Rules, which may affect or further inform their positions going forward.

1. **Canada:** There continues to be no legal (corporate or securities law) requirement in Canada for clawback arrangements. Canadian executive compensation disclosure rules require summary disclosure of any clawback arrangements affecting named executive officers in the issuer's annual information circular.
2. **Proposed CBCA Amendments:** Certain amendments to *Canada Business Corporations Act* that are not yet in force will require the directors of prescribed corporations (likely publicly traded corporations) to disclose policies in their annual proxy circulars regarding the recovery of incentive payments and other remuneration benefits paid to directors and executive officers in circumstances (still to be defined) where the payments were later found to be "undeserving."
3. **Glass Lewis:** In its Canadian policy guidelines, Glass Lewis notes that it supports the use of clawback provisions to safeguard against unwarranted short- and long-term incentive awards and to similarly encourage executives and senior management to take a more comprehensive view of risk when making business decisions. Such provisions generally allow, at a minimum, for some or all of an annual incentive award to be recouped in the case of a material misstatement of financial results or fraud. The guidelines go on to note that, while the terms and conditions associated with a company's recoupment policy are not exclusively determinative of its recommendations with respect to say-on-pay proposals, the inclusion of appropriately robust policies informs our overall view of a company's compensation program.

In its US guidelines, Glass Lewis notes the interim period between enactment SEC Clawback Rules and the outside date for the adoption of the compliant policies pursuant to the rules. It encourages companies to provide detailed disclosure in the proxy statements evidencing the board's proactive efforts to ensure that the company will be in compliance.

Notwithstanding the new rules, Glass Lewis is also encouraging issuers to adopt clawback policies that are triggered, at a minimum, in the event of a restatement of financial results or similar revision of performance indicators upon which incentive awards were based. It goes on to note that some recoupment policies empower companies to recover compensation without regard to a restatement, such as those triggered by actions causing reputational harm. These developments, Glass Lewis notes, may inform its overall view of the compensation program.

4. **ISS:** In its Canadian guidelines, ISS does not express a preference for or against the presence of clawback policies but will as part of its general review of executive compensation (including incentive plans) review clawback provisions. ISS will vote against a plan if the sum of all reviewed factors (including clawback provisions) indicates that the plan is not in shareholders' best interests.

In its US Guidelines, ISS notes that it determines its recommendations on a case-by-case basis with respect to proposals to recoup incentive or stock compensation. Regarding its support for clawback proposals, ISS notes that it will take into consideration the following factors:

- if the company has adopted a formal recoupment policy;
- the rigor of the recoupment policy focusing on how and under what circumstances the company may recoup incentive or stock compensation;
- whether the company has chronic restatement history or material financial problems;
- whether the company's policy substantially addresses the concerns raised by the proponent;
- disclosure of recoupment of incentive or stock compensation from senior executives or lack thereof; or
- any other relevant factors.

5. **Market Practice:** The market practice in Canada continues to be that clawbacks are triggered if there is a financial restatement and the executive is found at fault relating to such restatement. Most issuers do not seek clawback in the event of misconduct or reputational harm that does not result in the restatement of financial results. Increasingly a number of issuers are adopting clawback policies that are triggered upon a restatement of the financial results or employee misconduct (whether or not there is a financial restatement). The employee misconduct triggers typically include gross negligence, intentional misconduct or fraud.

[1] Salary increases earned as a result of achievement of a Financial Reporting Measure may be considered Erroneously Awarded Incentive-Based Compensation in the event of an Accounting Restatement.

[2] Grants of time-vesting options may be considered Erroneously Awarded Incentive-Based Compensation if the grant was consideration, or partial consideration, for the achievement of a Financial Reporting Measure that is subsequently the subject of an Accounting Statement.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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