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Looking forward on clawbacks

DEC 11, 2023 6 MIN READ

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New listing standards from the New York Stock Exchange and Nasdaq Stock Market came into effect this year, requiring companies to adopt policies providing for the clawback of executive compensation in certain circumstances. We previously discussed these changes in our Osler Update.

The new listing standards apply to substantially all issuers listed on a U.S. stock exchange. These include foreign private issuers as well as Canadian issuers filing under the Multi-Jurisdictional Disclosure System who have debt or equity securities listed on a U.S. stock exchange. The standards required issuers to adopt a clawback policy by December 1, 2023 that complies with the listing standards applicable to certain incentive compensation received by an issuer's executive officers after October 2, 2023. Affected issuers should therefore have developed and be implementing the required policies.

As we move into 2024, issuers listed on a U.S. stock exchange should be evaluating whether to revise their executive employment agreements, equity and non-equity incentive plans and D&O indemnification agreements to align with their clawback policies. They should also consider amendments to their by-laws to clarify that indemnification does not apply to amounts clawed back under the policy. Some issuers may also wish to modify the extent to which incentive compensation is tied to financial performance measures. Canadian issuers that are not listed on a U.S. stock exchange may wish to consider modifying their existing clawback arrangements to more closely align with U.S. stock exchange requirements.

What clawback policies should address

A clawback is required to be triggered under the policy if there is an accounting restatement due to material non-compliance by the issuer with any financial reporting requirement under securities laws. This requirement applies to an accounting restatement to correct an error in previously issued financial statements that is material to the previously issued financial statements. It also applies to a restatement made to correct in the current period an error in previously issued financial statements that, while not material to the previously issued financial statements, would result in a material misstatement if the error were corrected in the current period, or left uncorrected in the current period.

The clawback is required to be applied to both cash and equity incentive compensation received by the executive where the size of the grant, the vesting of the award or the

payment amount is based on satisfaction of a financial reporting measure goal. Financial reporting measures include metrics based on stock price and total shareholder return. The amount to be clawed back is the excess of the amount actually received compared to what should have been received based on the restated financial results. With very limited exceptions, recovery of such excess amount must be pursued by the issuer.

The adoption of the new listing standards prompted a rush by U.S. listed Canadian issuers to adopt compliant policies by the December 1, 2023 deadline. With that requirement generally completed, these issuers now need to consider other implications of the new listing standards. Issuers also need to come to grips with some corresponding changes that were made to related U.S. securities disclosure requirements that will have an impact on compensation disclosure going forward.

Affected issuers subject to new disclosure requirements

New compensation clawback disclosure requirements were adopted in a final rule by the U.S. Securities and Exchange Commission that will apply to issuers in 2024. Issuers will be required to file their clawback policy as an exhibit to their annual report on Form 10-K, Form 20-F or Form 40-F, as applicable.

Further, if a clawback is triggered under the issuer's clawback policy, the issuer will be required to disclose the date of the accounting restatement and the aggregate dollar amount to be recovered under the policy as a result, including details of any estimates used in calculating the amount. If the amount has not yet been determined, the issuer must explain why. If the issuer determines that no amount is recoverable, it must similarly explain why.

Issuers will also be subject to disclosure requirements regarding the aggregate dollar amount that remains to be recovered as at the end of the fiscal year. Finally, if recovery is considered impracticable or the amount to be recovered has not been collected within 180 days, the individual outstanding amounts, including the names of the relevant individuals and the aggregate amount not recovered, must be disclosed.

U.S. domestic issuers must provide such disclosure in both their annual reports and proxy materials. Other issuers need only provide the disclosure in their Form 20-F or 40-F, as applicable.

Further steps that issuers should be taking

Issuers should begin to review and, if appropriate, revise, their executive employment agreements, equity and non-equity incentive plans and D&O indemnification agreements. Such review should aim to align these agreements and policies with the new clawback policy and enhance the issuers' ability to claw back compensation should the policy be triggered in the future. Employers will need to consider whether to include express provisions in their employment agreements and compensation arrangements on a go-forward basis that permit the clawback of compensation where required pursuant to the issuer's clawback policy. This could include forfeiture or cancellation of outstanding entitlements, as well as repayment of cash received.

Issuers would be well advised to consider express provisions permitting amounts to be clawed back not only from incentive compensation that is subject to clawback, but also from any other compensation received or receivable by the executive. In addition to revising D&O indemnification agreements with executives, issuers may wish to consider modifying the

indemnification provisions of their by-laws to clarify that indemnification under the by-laws does not, in accordance with the new listing standards, apply to compensation recovered pursuant to the issuer's clawback policy.

Since the new listing standards only apply where the granting, vesting or settlement of incentive compensation is based on financial reporting measures and does not apply to other incentive compensation arrangements, issuers may wish to consider reducing the weighting ascribed to financial reporting measures for purposes of assessing incentive compensation. Issuers may also wish to increase their reliance on non-financial reporting measures or discretionary judgement instead.

As affected issuers prepare their annual and quarterly financial reports, if a financial reporting error is discovered, even if it is corrected in the current financial statements, the issuer will need to carefully assess its materiality to determine whether the clawback policy has been triggered.

Many Canadian issuers that are not listed on a U.S. stock exchange have already adopted their own clawback policies. Even though not required to do so, these issuers may wish to consider whether to modify their existing policies to more closely align with the requirements prescribed under U.S. stock exchange listing standards. For example, Canadian issuers typically apply their clawback policies to all incentive compensation, while the U.S. listing standards only require the policy to apply to incentive compensation that is subject to a performance goal that is a financial reporting measure. Further, clawbacks are generally triggered under Canadian clawback policies only where previously issued financial statements need to be refiled and are not implicated where a correction of an error can be made in the current period financial statements. Canadian issuers wishing to review their existing plans will have lots of opportunity to see U.S. plans in the future, given that the SEC disclosure requirements mandate the filing of issuers' clawback policies.