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Give it back! Issues for Canadian companies to consider now in light of pending U.S. compensation clawback rules to become effective later this year

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Canadian issuers listed on a U.S. stock exchange must adopt or revise their policies and practices with respect to recoupment of incentive compensation from executive officers in light of new U.S. stock exchange listing requirements that will become effective later this year. Canadian issuers not listed on a U.S. stock exchange should consider whether to modify their approach and the terms of their existing clawback policies or practices in light of the pending rules.

Overview

The United States Securities and Exchange Commission (SEC) adopted a final version of its rule on Listing Standards for Recovery of Erroneously Awarded Compensation [PDF] on October 26, 2022 (the SEC Final Rule). On February 22, 2023, both the New York Stock Exchange and the NASDAQ Stock Market issued for comment substantially identical proposed new listing standards in conformity with the SEC's Final Rule. For convenience, we refer to the requirements of the SEC Final Rule, as well as the proposed listing standards of each stock exchange, as the "Clawback Rules".

The Clawback Rules will require substantially all issuers listed on a U.S. stock exchange to adopt a policy providing for the mandatory clawback of incentive compensation received by executives during the three-year period preceding the date that a financial statement restatement is required by the amount that the compensation actually received by the executives exceeds the amount the executives would have received based on the restated financial statements. The obligation to recoup compensation applies to an executive even if there was no misconduct or omission by the executive. The policy is required to be attached to the annual report filed by the issuer with the SEC. Should a financial restatement occur, the issuer is required to disclose how it has applied the policy to its executives, including the amounts it has recouped from them.

Amendments to the proposed stock exchange rule changes state that the new listing standards will become effective on October 2, 2023 (the Effective Date) Canadian issuers listed on a U.S. stock exchange will have 60 days from the Effective Date to comply with the new requirements and should therefore be prepared to comply with the requirements by December 1, 2023.

Although a significant number of Canadian issuers, including Canadian issuers not listed on a U.S. stock exchange, have adopted compensation clawback arrangements already, the majority of these arrangements contemplate a double-trigger, requiring both (i) a financial

statement restatement and (ii) misconduct on the part of the executive contributing to the restatement to occur, before the clawback will be triggered. Such double trigger policies align with Section 304 of the U.S. *Sarbanes-Oxley Act of 2002* (SOX). However, many Canadian issuers have adopted a "no fault" standard where compensation may be clawed back in the event of a financial restatement, even if the executive did not engage in any misconduct, which is similar to the new Clawback Rules. However, as explained in more detail below, the Clawback Rules differ from typical Canadian practices by limiting board discretion as to whether to pursue recovery, and setting firm standards on the amount of recovery that must be pursued.

We expect the new stock exchange listing requirements will be implemented substantially as proposed and recommend all Canadian issuers listed on a U.S. stock exchange begin work now to be ready to comply by December 1, 2023. In particular:

- Any Canadian issuer listed on a U.S. stock exchange which has not adopted a policy for recoupment of incentive compensation in the event of a financial restatement will need to act promptly to adopt a policy.
- All Canadian issuers listed on a U.S. stock exchange that have recoupment policies will need to modify the terms of such policies to align with the new rules for determining when a clawback is triggered, when incentive compensation is received, and the period of time prior to a financial restatement to which recoupment will apply.
- Most Canadian issuers listed on a U.S. stock exchange will need to modify the terms of some of their equity incentive compensation plans, and some issuers will need to modify the terms of certain outstanding awards made to their executive officers under such plans.
- Canadian issuers subject to the Clawback Rules may consider revising the terms of their executive employment agreements to expressly permit compensation clawbacks.
- Canadian issuers subject to the Clawback Rules may wish to consider adopting changes to the design of their incentive compensation programs since the U.S. rules only apply where the granting, vesting or settlement of incentive compensation is based on financial measures, including stock price and total shareholder return, and do not apply to other incentive compensation arrangements.

Canadian issuers not listed on a U.S. stock exchange should consider whether to modify their practices in light of the U.S. rules and investor expectations, including those relating to determining when a clawback is triggered, when incentive compensation is received, and the period of time prior to a financial restatement to which recoupment will apply.

Highlights

The Clawback Rules will have significant implications for almost all Canadian issuers listed on a U.S. stock exchange and that offer incentive-based compensation that is granted, earned or which vests based wholly or in part on financial reporting measures. Issuers that fail to comply with the Clawback Rules by adopting and disclosing a compliant clawback policy, or that fail to provide required periodic reporting about their compliance with such policies as required under the Clawback Rules, risk their securities being delisted from their U.S. stock exchange once the new rules are in effect.

History

The U.S. *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* required the SEC to adopt rules directing U.S. stock exchanges to adopt listing rules respecting the mandatory clawback of incentive compensation received by executives in the event of a financial restatement. The SEC issued proposed rules in 2015 and Osler issued an update on the proposals in July 2015. No further action was taken by the SEC until the SEC reopened its original proposed rules for comment in October 2021, and again in June 2022. The final SEC rules adopted in October 2022 reflected very few changes from the draft rules originally proposed in 2015.

Who will be subject to the Clawback Rules?

The Clawback Rules will apply to substantially all issuers with securities listed on a U.S. stock exchange, including foreign private issuers, Canadian issuers filing under the *Multi-Jurisdictional Disclosure System* (MJDS), emerging growth companies, smaller reporting companies and controlled companies, and issuers of listed debt and preferred stock. There are limited exceptions for issuers of securities futures products or standardized options, unit

investment trusts and registered management investment companies that have not awarded incentive-based compensation to any executive officer in the last three fiscal years (or, if shorter, since their initial listing).

Which executive officers are subject to the clawback policy?

The clawback policy applies to current and former "executive officers" of the issuer who received incentive-based compensation during the applicable three-year look back period. For this purpose, the SEC has defined "executive officers" as "an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer." Executive officers of the issuer's parent(s) or subsidiaries will be deemed executive officers of the issuer if they perform such policy-making functions for the issuer. Former executive officers would include any individual who served as an executive officer at any time during the performance period for the incentive-based compensation received during the applicable three-year look back period.

In a change from the SEC's original proposal, the Clawback Rules only require recovery of incentive-based compensation received by a person (1) after beginning service as an executive officer and (2) if that person was an executive officer during the three-year look back period. Recovery is not required from an executive officer if that individual was not an executive officer at any time during the performance period for the incentive-based compensation subject to recovery.

When is the clawback obligation triggered?

A clawback will be triggered by an accounting restatement due to material noncompliance by the issuer with any financial reporting requirement under the securities laws, including an accounting restatement:

- To correct an error in previously issued financial statements that is material to the previously issued financial statements, or
- 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.

In a change from its initial proposal, the SEC deliberately chose to expand the scope of the trigger to include the correction of a prior error that would not necessitate a refiling of prior financial statements, when the correction, or the failure to make the correction, would be material to the current period financial statements. In making decisions on whether to restate prior period financial reporting errors, issuers will need to carefully consider the possible compounding effects of an error over subsequent periods and take action before the error can become material.

Financial restatements which do not result from the correction of an error are not captured by the Clawback Rules. For example, restatements due to changes to accounting principles, certain internal restructurings, certain adjustments in connection with business combinations, and revisions due to stock splits are not considered "errors" triggering clawbacks.

An issuer's obligation to recover excess incentive-based compensation is not dependent on if

or when its restated financial statements are filed; instead the obligation is triggered when the issuer "is required to prepare an accounting restatement", which the SEC has defined as the earlier to occur of:

- The date the issuer's board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under applicable securities law, or
- The date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.

The first date generally is expected to coincide with the occurrence of the event described in Item 4.02(a) of Form 8-K [non-reliance on previously issued financial statements], although neither the actual filing of a Form 8-K, nor a determination of the precise amount of the error is required, to trigger the clawback obligation.

The trigger under the Clawback Rules is a "no fault" trigger. Unlike the clawback provisions applicable to the CEO and CFO under SOX, there is no requirement for a finding that the executive engaged in misconduct which contributed to the financial restatement.

Once triggered, recoupment is required from all incentive-based compensation received during the three completed fiscal years immediately preceding the date the clawback is triggered. Where an issuer has changed its fiscal year end during the three-year look back period, the transition period during or following that three-year period is included.

We expect most Canadian issuers listed on a U.S. stock exchange and that have clawback policies will need to revise their policies to align with the trigger under the Clawback Rules.

What compensation is 'incentive-based' and what compensation is not 'incentive-based'?

The Clawback Rules define "incentive-based" compensation as any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. Financial reporting measures are measures that are determined and presented in accordance with the accounting principles (including non-GAAP financial measures) used in preparing the issuer's financial statements and any measures derived wholly or in part from those measures.[1] The Clawback Rules make clear that the SEC considers stock price and total shareholder return (TSR) to be financial reporting measures.

The following chart lists examples of what is, and what is not, considered incentive-based compensation under the Clawback Rules:

Incentive-Based Compensation	Not Incentive-Based Compensation
• Bonuses earned wholly or in part based on satisfying a financial reporting measure performance goal.	• Salaries (other than any portion of a salary earned wholly or in part based on the attainment of a financial reporting measure).
• Bonuses paid from a bonus pool, if the pool size is based wholly or in part on satisfying a financial reporting measure performance goal.	• Bonuses paid solely at the discretion of the compensation committee or board that are not paid from a "bonus pool," the size of which is determined based wholly or in part on satisfying a financial reporting measure performance goal.

• Equity awards (such as restricted stock, restricted stock units, performance share units, stock options and stock appreciation rights) granted or vested based wholly or in part on satisfying a performance goal based on a financial reporting measure.	• Bonuses paid solely upon satisfying one or more subjective standards (e.g., demonstrated leadership) and/or completion of a specified employment period.
• Proceeds received upon the sale of shares acquired under an equity award that was granted or that vested wholly or in part on satisfying a financial reporting measure performance goal.	• Non-equity incentive plan awards earned solely upon satisfying one or more strategic measures, such as consummating a merger or divestiture, or operational measures, such as opening a specified number of stores, completion of a project or increase in market share.
	• Equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more non-financial reporting measures.

Accordingly, time-vesting stock options, restricted share units and restricted shares are not "incentive-based" if the grant amount was not tied to achievement of performance goals or measures.

When is incentive-based compensation deemed to be 'received'?

Incentive-based compensation will be deemed received in the fiscal year during which the financial reporting measure specified is attained (regardless of when granted or paid), even if not all conditions to payment have been satisfied (such as additional service conditions or board certification of performance criteria). Accordingly, even if other conditions to an award exist, if (i) the grant of an award is based, either wholly or in part, on satisfaction of a financial reporting measure, the award will be deemed received in the fiscal period when that measure was satisfied; (ii) an equity award vests only upon satisfaction of a financial reporting measure, the award will be deemed received in the fiscal period when it vests; and (iii) a cash award is earned upon satisfaction of a financial reporting measure, it will be deemed received in the fiscal period when that measure is satisfied.

What is the recoverable amount under the Clawback Rules?

All erroneously awarded compensation is recoverable under the Clawback Rules. Erroneously awarded compensation is "the amount of incentive-based compensation received that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the restated amounts, and must be computed without regard to any taxes paid."

The Clawback Rules require the issuer to recalculate the applicable financial reporting measure based on the restated financial results and recalculate the amount of incentive-based compensation that would have been received based on such recalculated measure. Any negative or positive discretion used in determining the amount originally received by the executive officer also would be applied to the recalculated amount.

Where incentive-based compensation is based only in part on the achievement of a financial reporting measure performance goal, the issuer would first need to determine what portion of the original incentive-based compensation was based on or derived from the financial reporting measure that was restated and the recalculated amount would reflect only the portion affected.

For incentive-based compensation that is based on stock price or TSR, and where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in an accounting restatement, the recoverable amount may be determined based on a reasonable estimate of the effect of the accounting restatement on

the applicable measure. The issuer could use a variety of methodologies with different levels of complexity and costs to obtain such reasonable estimates. The issuer will be required to maintain documentation of the determination of that reasonable estimate and provide such documentation to the relevant exchange.

For incentive-based compensation where the financial reporting measure is applied to a pool from which individual awards are made, if the size of the aggregate pool determined based on applying the recalculated financial reporting measure will be less than the aggregate amount awarded from the pool, a pro rata share of the deficiency will be applied to the incentive-based compensation received by each executive officer or former executive officer from the pool. Put differently, where the financial reporting measure applies to a pool, the Clawback Rules do not provide for differential recovery among executive officers, even where boards may have exercised discretion as to individual grants from a bonus pool.

For non-qualified deferred compensation, the executive officer's account balance or distributions will be reduced by the excess incentive-based compensation contributed to the non-qualified deferred compensation plan and the interest or other earnings accrued thereon under the non-qualified deferred compensation plan.

For equity awards, if the shares, options or stock appreciation rights are still held at the time of recovery, the recoverable amount will be the number received in excess of the number that should have been received applying the restated financial reporting measure, or the value of that excess number. If the underlying shares have been sold, the recoverable amount will be the sale proceeds received by the executive officer with respect to the excess number of shares. In any case in which the shares have been obtained upon exercise and payment of an exercise price, the recoverable amount will be reduced to reflect the applicable exercise price paid.

In all cases, the recoverable amount will be calculated on a pre-tax basis to ensure that the company recovers the full amount of incentive-based compensation that was erroneously awarded. The SEC believes recovery on a pre-tax basis also avoids the burden and administrative costs associated with calculating recoverable amounts based on the particular tax circumstances of individual executive officers. We note that Canadian issuers that have adopted their own compensation clawback policies often take into account tax implications to the affected executive officer, or provide discretion to the issuer to do so, so that the executive officer is not in a worse position than if the compensation had never been awarded. The Clawback Rules do not permit this.

Is the issuer required to pursue recovery and what discretion may be applied?

The issuer must pursue recovery unless:

- It will be impracticable because it would impose undue costs on the issuer or its shareholders.
- In the case of a non-U.S. issuer, it would violate such issuer's home country law in effect prior to November 28, 2022.
- It would cause an otherwise tax-qualified retirement plan to fail to meet the requirements of the Internal Revenue Code.

When assessing whether recovery would entail undue costs, an issuer may forego recovery only if the direct costs of enforcing recovery would exceed the recoverable amounts. Before concluding that it will be impracticable to recover amounts due to costs, the issuer would

first need to make a reasonable attempt at recovery, and will be required to document its attempt and provide such documentation to the relevant stock exchange.

To conclude that it will be impracticable to recover amounts due to home country law restrictions, the issuer would first need to obtain an opinion of home country counsel, acceptable to the stock exchange, that recovery would result in such a violation. The SEC expressly determined not to permit an exception where recovery would violate the laws of the country in which the executive resides if different from the issuer's home country.

Any decision on impracticability would need to be made by the issuer's committee of independent directors that is responsible for executive compensation decisions, and is subject to exchange review.

Subject to any decision on impracticability with respect to any executive officer, the Clawback Rules do not permit issuers to exercise discretion to forego recovery or pursue differential recovery among executive officers. Generally, the issuer cannot settle for less than full recovery unless full recovery is impracticable, but issuers may exercise discretion with respect to how to accomplish recovery as long as it is done reasonably promptly depending on the facts and circumstances of the issuer, the incentive compensation, and the executive officer. Stock exchanges are permitted to adopt more prescriptive rules.

The exception for recovery in the case of certain U.S. tax-qualified retirement plans was added to satisfy the anti-alienation rules and other qualification requirements applicable to such plans under the Internal Revenue Code. There is no exception with respect to non-U.S. retirement arrangements with similar limitations.

What disclosure will be required regarding use of the clawback policy?

The Clawback Rules require listed issuers to disclose their written clawback policies. In addition, the Clawback Rules require disclosure of whether a triggering restatement occurred within the last fiscal year and what actions the issuer is taking in connection therewith. Specifically:

- All 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. As a result, the policy also will be subject to SEC oversight in addition to being a listing condition.
- Pursuant to new Item 402(w) of Regulation S-K, U.S. domestic issuers will be required to disclose in their annual reports and any proxy and consent solicitation materials that require executive compensation disclosure pursuant to Item 402 of Regulation S-K how they have applied their recovery policies, if at any time during the last completed fiscal year either (i) a restatement that required recovery of excess incentive-based compensation pursuant to the listed issuer's recovery policy was completed or (ii) there was an outstanding balance as of the end of the last completed fiscal year of excess incentive-based compensation from the application of that policy to a prior restatement. In such cases, the listed issuer will be required to provide:
    - For each restatement:
        - The date on which the listed issuer was required to prepare an accounting restatement.

        - The aggregate dollar amount of excess incentive-based compensation attributable to such accounting restatement (including an analysis of how that amount was calculated).
        - If the financial reporting measure related to a stock price or TSR, the estimates used in determining the excess incentive-based compensation attributable to the accounting restatement and the methodology used.
        - The aggregate dollar amount of excess incentive-based compensation that remains outstanding at the end of its last completed fiscal year, and
        - If the amount of excess incentive-based compensation has not been determined, an explanation of the reason why.
    - If recovery is considered impracticable, for each current and former named executive officer, and for all other executive officers as a group:
        - The amount not recovered for each such person and group, and a brief description of the reason the listed issuer decided in each case not to pursue recovery, and
        - The name of, and amount due from, each current and former named executive officer from whom, at the end of the issuer's last completed fiscal year, excess incentive-based compensation had been outstanding for 180 days or longer since the date the issuer determined the amount the person owed.
- If an accounting restatement is prepared, but the issuer determines that recovery is not required pursuant to its recovery policy, it must explain why recovery was not required.

Foreign private issuers, including Canadian issuers using MJDS, will be required to provide the same information called for by Item 402(w) of Regulation S-K, as required, to be provided by domestic U.S. issuers, on Forms 20-F or 40-F, as applicable. They will not, however, be required to disclose that information in any proxy or consent solicitation materials with respect to their securities.

- The Summary Compensation Table (SCT) disclosure requirements will require that any amounts recovered pursuant to a listed issuer's recovery policy reduce the amount reported in the applicable column of the SCT for the fiscal year in which the amount recovered initially was reported, and that such amounts be identified by footnote. The "total" column also would be revised in the same way. This requirement will apply to Canadian issuers who satisfy executive compensation disclosure requirements by providing disclosure in accordance with item 402 of Regulation S-K, but not to Canadian issuers who provide executive compensation disclosure in accordance with Canadian requirements under Form 51-102F6.
- Specific data points and block text included within compensation recovery disclosures must be tagged with Inline XBRL, consistent with certain existing and other forthcoming SEC filing requirements.

The cover pages of Forms 10-K, 20-F or 40-F are being amended to include checkboxes about whether the issuer's financial statements have been corrected or restated.

The proposed disclosure requirements will provide information that may facilitate the ability of the plaintiffs' bar to challenge an issuer's administration of its clawback policy, including the issuer's reasonable estimate of amounts to be clawed back, the determination of whether recovery is impractical and delays in achieving full recovery.

How do the new rules interact with Section 304 of the Sarbanes Oxley Act of 2002?

The Clawback Rule and SOX Section 304 could provide for recovery of the same incentive-based compensation. If an executive officer reimburses an issuer pursuant to SOX Section 304, such amounts are to be credited to the extent recovery is also required under the issuer's clawback policy. The reverse is not true, however, and whether or not amounts are collected under the issuer's clawback policy does not alter or affect the interpretation of SOX Section 304, or the collection of amounts thereunder.

Can the executive officer be indemnified or insured against the clawback amount?

The Clawback Rules will prohibit a listed issuer from indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation. The SEC Final Rule acknowledges that an executive officer may be able to purchase a third-party insurance policy to fund potential recovery obligations, but states that the indemnification prohibition will prohibit an issuer from paying or reimbursing the executive for premiums for such an insurance policy. If insurance coverage is provided under a broad Side A DIC policy covering executives, it may be unclear what portion of the premium, if any, should be attributable to such coverage.

What is the timing for final rules and potential next steps?

Amendments to the proposed stock exchange rule changes state that final U.S. stock exchange listing standards implementing the Clawback Rules will become effective on October 2, 2023.. Listed issuers would then be required to adopt a clawback policy no later than 60 days following the Effective Date. Listed issuers should be prepared to have compliant clawback policies in effect on or before December 1, 2023.

Listed issuers will be required to comply with the clawback policy for all incentive-based compensation received by current or former executive officers on or after the Effective Date. Since compensation is received in the fiscal year during which the financial reporting measure specified is attained (regardless of when granted or paid), recoupment will apply to short term incentive compensation for 2023 to the extent dependent on a financial reporting measure, as well as outstanding long term incentive compensation awards granted in 2023 and prior years where vesting is based on achievement of a financial reporting measure, such as performance share units.

We recommend that Canadian issuers listed on a U.S. stock exchange promptly:

- Adopt a clawback policy that complies with the Clawback Rules, or revise their existing policy to do so.
- Revise their equity incentive plans and outstanding performance-based awards to address the Clawback Rules.
- Consider revising executive employment agreements to expressly permit the issuer to clawback compensation pursuant to its clawback policy.
- Revise their existing executive indemnity agreements to specify that indemnification is not

available for the clawback of incentive compensation under the policy or applicable law.

- Consider whether to modify their existing incentive compensation mix and performance measures for executive officers to take into account the Clawback Rules.
- Carefully assess materiality with respect to errors in financial reporting taking into consideration potential future compounding impacts.

We also recommend that Canadian issuers not listed on a U.S. stock exchange begin to consider their approach to the recoupment of incentive compensation payable to executives in light of the Clawback Rules and investor expectations. Given the risk that impacted employees may challenge any repayment obligations imposed pursuant to the Clawback Rules, clawback policies should be reviewed carefully by counsel.

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[1] Financial reporting measures include but are not limited to: revenues; net income; operating income; profitability of one or more reportable segments; financial ratios such as accounts receivable turnover and inventory turnover rates; net assets; EBITDA; funds or adjusted funds from operations; liquidity measures such as working capital and operating cash flow; return measures such as return on invested capital and return on assets.