

SEC Reopens Comment Period on Clawback Rules

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Background

Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), enacted in 2010, resulted in the addition of Section 10D to the Securities Exchange Act of 1934. Among other items, Section 10D requires the Securities and Exchange Commission (SEC) to adopt rules directing the national securities exchanges and associations to prohibit the listing of any security that is not in compliance with Section 10D's numerous provisions and requirements. One of the major provisions of Section 10D is a requirement for a filing company to disclose its policy on the recovery of incentive-based compensation that is received in excess of what would have been received based on the restated financial statements.

In July 2015, the SEC proposed its new rules to Dodd-Frank including the requirement for listed companies to adopt and comply with a compensation recovery policy.¹ In response to the SEC proposal, many companies have developed compensation recovery policies — frequently referred to as clawback policies. However, the SEC did not finalize its 2015 proposal after the comment period. On October 14, 2021, the SEC reopened a 30-day comment period requesting feedback on the proposed rules of the 2015 initial proposal as well as the SEC's latest release regarding compensation clawbacks.² The new SEC release, which is 19 pages in length, can be viewed on the SEC's website.³

Summary of the Proposed Clawback Provisions

The proposed rules, including both the initial rules and the new rules and amendments, require that all listed companies adopt a compensation clawback policy in which the recovery of excess compensation is required in the event of a material misstatement of the company's financial statements. Key provisions of the proposed rules include:

- The rules apply to current and former executive officers who received incentive-based compensation during the three fiscal years preceding the date on which the company is required to prepare an accounting restatement to correct a material error.
- The recovery policy must apply on a “no fault” basis without regard to an executive officer's responsibility for the misstated financial statements or whether any misconduct occurred.
- The amount of incentive-based compensation to be recovered is the amount received by an executive officer that exceeds the amount they would have received had the incentive-based compensation been determined based on the restated financial statements. All recoveries are to be calculated on a pre-tax basis.

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- An exception to the mandatory clawback policy is provided to the extent it would be impracticable to do so — such as a situation where the direct expense of enforcing the recovery would exceed the amount to be recovered — or for foreign private issuers, where recovery would violate home country law. However, a board that waives recovery under this limited discretion provision must subsequently disclose its rationale (see further disclosure implications below).
- Companies are prohibited from indemnifying current and former executive officers against the loss of recoverable incentive-based compensation.
- “Incentive-based compensation” is defined to include any compensation that is granted, earned, or vested based wholly or in part upon the attainment of a financial reporting measure, any measure derived wholly or in part from such financial information, and stock price and total shareholder return. For incentive-based compensation based on stock price or total shareholder return, companies would be permitted to use a reasonable estimate of the effect of the restatement on the applicable measure to determine the amount to be recovered. The rules do not apply to time-vested stock options, time-vested restricted stock / restricted stock units, discretionary bonuses, or salaries.
- The proposed rules also require the filing of the substance of the clawback policy as an exhibit to a company’s annual report, proxy, or other annual disclosure. If the company completed a restatement that required recovery, disclosure of the aggregated dollar amount of the excess incentive compensation attributed to the restatement must be reported as well.

Key New Provisions Requesting Comment

Should the clawback rules be applied to corrections of nonmaterial errors?

The proposed clawback rules only apply to restatements for material errors that require the reissuance of the company’s financial statements (“Big R’ Restatements”). The SEC is asking whether corrections for non-material errors (“small r’ restatements”) should also be subject to the clawback rules. “Small r” restatements only require corrections to the comparative financial statements and retained earnings. This change could significantly extend the reach of clawbacks.

Should the three-year lookback period be triggered based on a strictly objective standard?

The proposed clawback rules include an objective test for triggering the three-year lookback period that relies on the date stated in the company’s 8-K for when the need for a restatement became known or the date of a court order requiring a restatement. The proposed rules also include a subjective standard: “the date the issuer’s board of directors...should have concluded” a restatement was required.¹ The SEC is asking if the “should have concluded” language should be dropped from the final rule.

Should the company fully disclose the calculation of the clawback amount?

The proposed clawback rules do not require the disclosure of the actual clawback calculation: just the recoverable amount. The SEC is asking for comments on whether companies should be required to fully disclose the calculation of the recoverable and non-recoverable amounts, including the detailed assumptions used to calculate the recovery, including the effect of the restatement on stock price and total shareholder return if such metrics were used to determine compensation.

Pay Governance will continue to monitor the progress of the Clawback proposal as it works its way through the regulatory process.

General questions about this Viewpoint can be directed to John Ellerman at john.ellerman@paygovernance.com or Mike Kesner at mike.kesner@paygovernance.com.

¹ “Listing Standards for Recovery of Erroneously Awarded Compensation.” U.S. Securities and Exchange Commission. July 14, 2015. <https://www.sec.gov/rules/proposed/2015/33-9861.pdf>.

² Gary Gensler. “Statement on Rules Regarding Clawbacks of Erroneously Awarded Compensation.” U.S. Securities and Exchange Commission. October 14, 2021. <https://www.sec.gov/news/public-statement/gensler-clawbacks-2021-10-14>.

³ “Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation.” U.S. Securities and Exchange Commission. October 14, 2021. <https://www.sec.gov/rules/proposed/2021/33-10998.pdf>.