

SEC Reopens Comment Period Regarding Prospective Clawback Rules

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Introduction and Background

The U.S. Congress approved the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) in 2010. One of Dodd-Frank’s key executive compensation provisions requires that all listed companies adopt and disclose a policy for the recoupment of incentive compensation, from its current and former executive officers, in the event a company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities law (colloquially referred to as a “clawback” policy). The amount subject to clawback is “equal to any incentive compensation received during the three-year period preceding the restatement in excess of what would have been paid the executive officers under the accounting restatement.”

In July 2015, the Securities and Exchange Commission (SEC) issued proposed rules requiring that listed companies adopt and disclose a clawback policy as required under Dodd-Frank. The proposed rules lay dormant, however, until October 2021, when the SEC reopened the comment period for the original rules along with 10 new policy questions — the most significant of which was the extension of clawbacks to corrections of errors in prior financial statements that are not material enough to require the reissuance of those statements.

On June 9, 2022, the SEC reopened a new 30-day comment period along with a memorandum prepared by the SEC’s Department of Economic and Risk Analysis (DERA). DERA’s memorandum provided detailed information on (1) the increase in voluntary adoption of compensation recovery policies by companies and (2) estimates of the number of additional restatements that would be subject to the clawback rules if the proposed rules were to include restatements due to material noncompliance (“Big R” restatements) and corrections of errors (“little r” restatements). The memorandum opines that many existing clawback policies do not comply with the Dodd-Frank requirements and most “little r” restatements do not affect net income; therefore, they are unlikely to result in a sharp increase in clawback activity. The memorandum also states that extending clawbacks to “little r” restatements will help improve the accuracy of financial reporting, especially among smaller issuers.

The SEC released an updated regulatory agenda on June 22, 2022, and it expects to issue final clawback regulations by October 2022, which makes it highly likely the rules will be effective in 2023.

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Recap of the Rules

The key provisions of the original and updated proposed clawback rules include the following:

- The rules are applicable to both current and former executive officers who received incentive-based compensation during the three fiscal years preceding the date of the accounting restatement;
- The recovery of incentive compensation must be made on the basis of “no-fault” on the part of an executive officer regardless of their responsibility or lack of responsibility;
- The amount of the recovered incentive compensation, calculated on a pre-tax basis, is the amount that exceeds what the executive officer would have received based on the financial restatement;
- Incentive-based compensation is defined as any compensation that is granted, earned, or vested based upon the attainment of a financial reporting measure, including stock price and total shareholder return (TSR); and
- The proposed rules do not apply to time-vested stock options; time-vested restricted stock; or restricted stock units (RSUs), discretionary bonuses, or base salaries.

The clawback policy must be disclosed as an exhibit to a company’s annual report, proxy statement, or other annual disclosure. The October 21 release strongly suggests companies will be required to disclose the detailed calculations used in determining the amount of the clawback. This could be especially troubling for companies with a stock price hurdle or relative TSR metric, where such calculations are not nearly as clear as quantifying the effect of a restated revenue or profit amount.

It also remains to be seen if the SEC includes “little r” restatements in a final rule, which could significantly increase the number of companies that will have to determine and disclose a clawback event.

SEC Clawback Rules-Implications and Considerations

The SEC’s October 2022 target to finalize the rules is not binding and, like many past regulatory agenda dates, may turn out to be aspirational. However, the June 9, 2022 reopening of the clawback rules for public comment and the inclusion of the DERA memorandum suggests the SEC is determined to push through the rule-making process this year. While an effective date has not been proposed, it is likely to take effect for fiscal years beginning after December 31, 2022. Once finalized, companies subject to the new policy requirement will need to review their existing clawback policies and/or adopt a new policy that complies with the rules.

Some example changes to existing policies might include:

- The inclusion of all active and former executive officers — not just the executive officer(s) whose misconduct led to the restatement.
- The removal of Compensation Committee or Board discretion to pursue a clawback (unless the “impractical to do so” exemption applies) or determine the amount of clawback.
- Assuming “little r” restatements are included in the final rule, policies will need to cover both “big R” and “little r” restatements.

Some commentators have suggested that the finalization of the clawback rules and inclusion of “little r” restatements could have an impact on the selection of future long-term incentive vehicles (time-vested stock options and RSUs are exempt from the rules). In addition, given the difficulty in quantifying the impact of a restatement on stock price and the potential requirement to disclose the calculation, finalization could reduce the use of stock price metrics, such as relative TSR or specific stock price hurdles, for fear of future litigation over such calculations.

Pay Governance will continue to monitor the SEC rule-making process for this item and will provide an update when the new rules are finalized.

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