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SEC Revives Proposal for Executive Comp Clawback Rules

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Takeaways

- The SEC has reopened comments on a 2015 proposal to require companies to implement policies to recoup executive compensation if they have been forced to restate financials.
- Questions the agency posed in reviving the clawback proposal suggest that, if the rules are finalized in 2022, they may be broader than those proposed in 2015.
- The new rules could require companies to disclose not just how much they have clawed back but how they calculated that amount.

The Securities and Exchange Commission (SEC) recently signaled a renewed interest in implementing the incentive-based compensation recovery (clawback) provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) by reopening the comment period on proposed regulations it issued more than six years ago, but never adopted.

The action, which SEC Chairman Gary Gensler referred to as an "opportunity to strengthen … the accountability of corporate executives to their investors," indicates that the regulations, if finalized in 2022, may be more expansive than those proposed in 2015, potentially requiring companies to adopt new executive compensation clawback policies or revisit existing ones (even if those policies were intended to satisfy the 2015 proposed rules).

2015 Proposal

In July 2015, the SEC issued long-awaited proposed rules to implement the clawback provisions of the Dodd-Frank Act. The proposed Rule 10D-1 would have required stock exchanges to adopt listing standards mandating public companies to develop and implement clawback policies and make disclosures about them.

All listed companies would have been required to have a policy providing for recovery of incentive-based compensation awarded to any current or former executive officer in the three-year period preceding the year in which the company is required to prepare an accounting restatement resulting from material noncompliance with financial reporting requirements. The restatement need not stem from misconduct by an individual executive officer, or from matters under that individual's responsibility, for the individual to be subject to a clawback.

The proposed rule applied to all listed entities, including foreign private issuers and controlled, emerging growth and smaller reporting companies, but certain registered investment companies were excluded.

A company could be subject to delisting if it failed to adopt a clawback policy complying with the listing standard, disclose the policy in accordance with SEC rules or comply with its recovery provisions.

The 2015 proposed rules were never adopted, and no further action was taken by the SEC until it reopened the comment period in October 2021.

Potential Expansion of Rules

In addition to requesting further comments from the public on the 2015 proposed rules, the SEC's October 14, 2021, reopening release sought comment on additional questions, which shed light on what companies can expect when the agency finalizes the rules, which it plans to do in 2022.

- **Range of restatements triggering a clawback.** The SEC asked whether the types of accounting restatements to which the clawback rules would apply should be expanded to include all restatements made to correct an error in previously issued financial statements, rather than only to restatements that correct errors that are *material* to previously issued financial statements.

  In particular, the SEC asked whether its clawback rules should apply to restatements required to correct errors that were not material to previously issued financial statements, but would result in a material misstatement if (1) the errors were left uncorrected in the current report or (2) the error correction was recognized in the current period. The SEC noted in the release that the definition in the 2015 proposed rules would not have picked up these types of restatements and that, as a result, companies might be tempted to take such exclusions into account when making materiality determinations.

- **Three-year period.** The three-year lookback period in the 2015 proposed rules would have run from the earlier of the date (1) the company concludes, or "reasonably should have concluded," that a restatement was required, or (2) of a court order or similar action requiring a restatement.

  The SEC asked whether the standard of "reasonably should have concluded" should be removed or replaced with a different one. In the release, the agency noted concerns that the standard added uncertainty to the determination of the appropriate three-year lookback period.

- **Disclosure of recoverable amount.** The 2015 proposed rules required the issuer to disclose the amount subject to clawback, but not how it determined the amount. The SEC requested comment on whether companies should be required to detail how they calculated the recoverable amount, since a number of methods could be used to make this determination, particularly regarding the impact of an accounting restatement on stock prices or total shareholder return.

Timing of New Rules

The SEC's timeline for finalizing the clawback regulations remains unclear. Even if the agency adopts final regulations in the very near future, the stock exchanges will need to implement them in new listing standards, which would then require approval by the SEC. Thus the effectiveness of the listing standards might potentially occur as late as the first anniversary of the date the SEC finalizes the regulations.

Regardless, companies may want to use this opportunity to review their existing clawback policy (or adopt a new policy, as necessary) and should continue to monitor developments with respect to the finalization of the clawback rules.