SEC Reopens Comment Period on Executive Compensation Clawback Proposal

Insights
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Potential Expansion of Types of Restatements Triggering Clawback Under Consideration

On October 14, the U.S. Securities and Exchange Commission (SEC or Commission) announced the reopening of the comment period on its executive compensation clawback rule, initially proposed in 2015 to implement Section 954 of the Dodd-Frank Act, which calls for the Commission to direct the U.S. stock exchanges to establish listing standards requiring listed companies to adopt, comply with and provide disclosure about a compensation recovery (or “clawback”) policy applicable to incentive-based compensation received by current and former executive officers in the event of certain financial restatements. In a statement accompanying the announcement, SEC Chair Gary Gensler lauded the decision as “an opportunity to strengthen the transparency and quality of corporate financial statements as well as the accountability of corporate executives to their investors.”

The public comment period will remain open until November 22, during which interested parties may submit comments on all aspects of the 2015 rule proposal, as well as on the new potential changes to the original proposal discussed in the reopening release. Notably, one proposed change would significantly expand the types of financial restatements that could necessitate clawbacks of incentive-based executive compensation.

In this alert, we:

- Highlight practical timing considerations for compliance with a final SEC rule, which, if adopted, could be effective as early as next year;

- Provide background and context on the proposed rulemaking; and

- Summarize key aspects of the original rule proposal, including potential changes under consideration during the reopened comment period.

Timing Considerations

- After the public comment period closes, the SEC will review and consider the feedback received and may modify the proposal before a vote is taken on adoption of a final rule, which could occur in 2022. With a 3-2 Democratic majority, the Commission has the votes to approve.

- As originally proposed, companies would need to comply with the rule following the effective date of the listing standards established by the stock exchanges. These listing standards must be developed and submitted to the SEC within 90 days, and must become effective within one year, after the final SEC rule is published in the *Federal Register*.

- Once the new listing standards are effective, companies would have 60 days to adopt new clawback policies (or amend existing policies not already compliant with the final rule) and would have to provide the required disclosures in their annual reports and proxy statements filed on or after the listing standards' effective date (unlikely before 2023 at the earliest).

- The clawback policies adopted by companies must apply to all erroneously awarded incentive-based compensation that results from achieving financial reporting measures based on or derived from financial information for any fiscal period ending on or after the effective date of the final SEC rule (possible in 2022). This would capture compensation that was granted or awarded *before* the final rule's effective date but that is subject to a performance period that ends after such date. Therefore, in the event of a financial restatement, a company could be required to enforce the clawback obligation before the new listing standards have become effective, and before it has adopted the clawback policy pursuant to which enforcement must be made.

Example. If the SEC's final clawback rule is declared effective in September 2022, any awards based on the attainment of financial results for a company's fiscal year ending December 31, 2022 would be subject to recovery in the event of a financial restatement, because the final rule became effective prior to the end of the awards' performance period. The awards would be recoverable notwithstanding that the new listing standards would not have to be finalized under this example until September 2023, and the company would not be required to adopt the mandated clawback policy for an additional 60 days beyond that (November 2023).

Background

Section 954 of the Dodd-Frank Act, enacted in the wake of the 2008 financial crisis, added Section 10D to the Securities Exchange Act of 1934, which mandates that U.S. stock exchanges adopt listing standards requiring listed issuers to develop and implement a policy providing:

> "(1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
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> "(2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.''

The clawback provision is one of several Dodd-Frank regulations that federal agencies have not completed. The SEC chair has publicly affirmed his commitment to finalizing the Commission's unfinished Dodd-Frank rulemaking responsibilities during his tenure, including the clawback rule and another executive compensation-related rule on "pay-versus-performance," which would require public companies to disclose the relationship between executive compensation actually paid and the company's financial performance. Additionally, the SEC last month advanced another long-delayed Dodd-Frank mandate that would require institutional investment managers to disclose, for the first time, their proxy votes related to executive compensation matters.

The SEC first proposed a draft clawback rule in 2015, but it was never finalized. The Commission noted it was reopening the original proposal to take into account intervening regulatory and market developments, specifically an observed increase in public companies' voluntary adoption and implementation of compensation clawback policies in recent years, together with accompanying disclosures about those policies.

A summary of the original rule proposal follows, which includes discussion of certain potential changes under consideration during the reopened comment period.

Which issuers are subject to the proposed rule?

The proposed rule applies generally to all listed issuers, including emerging growth companies, smaller reporting companies, foreign private issuers and controlled companies (categories of issuers not typically subject to the Commission's executive compensation rules), with only limited exceptions.

Which executive officers are covered by the proposed rule?

The proposed rule applies to a broad universe of "executive officers" that is modeled on the definition of a Section 16 officer, which includes the issuer's president, principal financial officer, principal accounting officer (or controller, if there is no principal accounting officer), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), and any other officer or person who performs a significant policy-making function for the issuer. Executive officers of the issuer's parents or subsidiaries would be deemed executive officers of the issuer if they perform significant policy-making functions for the issuer.

All executive officers are subject to the issuer's clawback policy on a "no-fault" basis, without regard to whether any misconduct occurred, or their culpability or involvement in the preparation of the erroneous financial statements.

Notably, the proposed rule requires recovery of all excess incentive-based compensation earned by persons who serve as executive officers of the issuer *at any time* during any performance period that falls within the applicable three-year lookback period (described below), and not just of the portion of their excess incentive-based compensation attributable to the time they actually served as executive officers.

Which accounting restatements will trigger application of the issuer's clawback policy?

An issuer must recover excess incentive-based compensation "in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws." The proposed rule defines an "accounting restatement" for this purpose as "the result of the process of revising previously issued financial statements to reflect the correction of one or more errors that are material to those financial statements." The SEC does not define what constitutes a "material error," but rather notes that materiality is a facts-and-circumstances determination. The proposed rule, however, does identify the following types of financial restatements that do not represent error corrections and thus would not trigger application of an issuer's clawback policy:

- retrospective application of a change in accounting principle;
- retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization;
- retrospective reclassification due to a discontinued operation;
- retrospective application of a change in reporting entity, such as from a reorganization of entities under common control;
- retrospective adjustment to provisional amounts in connection with a prior business combination; and
- retrospective revision for stock splits.

Potential Expansion of Types of Accounting Restatements Triggering Clawback

In the release reopening the comment period, the SEC requests input on a number of changes to the original rule proposal. Among the more-significant amendments being substantial expansion of the scope of the term "accounting restatement" under Dodd- encompass additional accounting restatements, which the SEC notes is in response t expressed since the 2015 proposal that companies may not be making appropriate m determinations for identified financial statement errors—possibly to avoid triggering co recovery under corporate clawback policies.

Specifically, the SEC is now considering whether the statutory term should be interpre broadly than initially proposed to include *all* required restatements made to correct an previously issued financial statements. This interpretation would capture not only thos restatements to correct errors that are material to the previously issued financial state contemplated in the 2015 proposal, but also additional restatements required to corre were *not* material to the previously issued financial statements but would result in a m misstatement if (a) the errors were left uncorrected in the current report or (b) the erro was recognized in the current period. Under such an interpretation, both types of rest would be considered "accounting restatements" requiring a clawback analysis. Notabl Commission staff asserts in the release that it believes that expanding the scope of "a restatement" in this manner would be an appropriate means of implementing the statu

Moreover, the staff observes that companies do not always label historical financial st "restated" for restatements to correct errors that were not material to previously issue statements, and an Item 4.02 Form 8-K is not typically filed for this type of error. Acco interpretation is adopted as proposed, and "to provide greater transparency around su restatements," the SEC is considering whether to add check boxes to the Form 10-K that indicate separately (a) whether the previously issued financial statements contair filing include an error correction and (b) whether any such corrections are restatemen triggered a clawback analysis during the fiscal year.

The SEC is also seeking comment on whether additional Form 8-K filing or other disc be useful to investors to explain or clarify information surrounding any restatements o decision whether or not to recover compensation.

Which forms of incentive-based compensation are subject to recovery?

The proposed rule defines "incentive-based compensation" as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure," which includes any measure that is "determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures that are derived wholly or in part from such measures, and stock price and total shareholder return."

Financial reporting measures may be presented outside the financial statements (such as in MD&A) and need not be disclosed in an SEC filing. Examples provided include revenues, net or operating income, financial ratios (e.g., accounts receivable turnover and inventory turnover rates), EBITDA, and liquidity and return measures. Measures such as earnings per share, same-store sales, revenue per user and cost per employee are also considered financial reporting measures.

Cash examples of incentive-based compensation that would be subject to recovery include cash bonuses paid from a "bonus pool," the size of which is determined based wholly or in part on achieving goals based on or derived from financial reporting measures. Equity examples of incentive-based compensation that would be subject to recovery include restricted stock, restricted stock units, stock options and stock appreciation rights (SARs) that are granted or become vested based wholly or in part on satisfying goals based on or derived from financial reporting measures.

Which forms of incentive-based compensation are *not* subject to recovery?

"Incentive-based compensation" does not include incentive plan awards that are granted, earned or vested based solely on subjective standards or non-financial strategic or operational goals rather than financial reporting measures, such as opening a specified number of stores, obtaining regulatory approval of a product, increasing market share, consummating a merger or completing a restructuring plan. Other examples include equity compensation (including restricted stock, restricted stock units, stock options and SARs) that vests solely based on continued service, the passage of time or the satisfaction of non-financial reporting measures, discretionary compensation and salary (though salary increases earned wholly or in part based on the attainment of a financial reporting measure may be subject to recovery).

How does an issuer determine the amount of recoverable incentive-based compensation?

The amount of recoverable incentive-based compensation (the "erroneously awarded compensation") is the amount received by a current or former executive officer based on the materially incorrect financial statements that *exceeds* the amount the executive officer otherwise would have received had the incentive-based compensation been determined based on the accounting restatement.

As proposed, the recoverable amount must be computed on a pre-tax, rather than a post-tax, basis (i.e., without regard to any taxes paid by the executive officer). The SEC notes in the proposing release that recovery on a pre-tax basis would permit the issuer to avoid the burden and administrative costs associated with calculating recoverable amounts based on the particular tax circumstances of the individual executive officers.

For incentive-based compensation that is tied to stock price or total shareholder return (TSR), where the amount of erroneously awarded compensation cannot be recalculated directly from the accounting restatement and may involve complex analysis, substantial exercise of judgment or otherwise be administratively burdensome, the recoverable amount may be determined based on the issuer's "reasonable estimate" of the effect of the accounting restatement on the applicable measure. The SEC recognizes that there are a number of possible methods to reasonably estimate the effect of an accounting restatement on the stock price and TSR that have varying levels of complexity and cost. For these measures, the issuer is required to create and maintain documentation regarding its calculation of the reasonable estimate and provide that documentation to the stock exchange on which it is listed.

How an issuer recovers the excess compensation attributable to equity awards depends on the status of the applicable award (whether the awards have been exercised and whether exercised shares remain outstanding):

- If the shares, options or SARs are still outstanding at the time of recovery, the recoverable amount is the number received in excess of the number that should have been received applying the restated financial reporting measure.

- If the options or SARs have been exercised, but the underlying shares have not been sold, the recoverable amount is the number of shares underlying the excess options or SARs applying the restated financial reporting measure.

- If the shares have been sold, the recoverable amount is the sales 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 must be reduced to reflect the applicable exercise price paid.

Potential Additional Public Disclosures of Recoverable Amounts

The proposed rule does not explicitly require disclosure of how issuers calculated the amount. The SEC is now inviting comment on whether additional disclosures beyond initially proposed should be required. For example, the SEC asks if investors would b disclosure of how issuers calculated the recoverable amount, including their analysis amount of the executive officer's compensation that is recoverable under the rule anc amount that is not subject to recovery. With respect to incentive-based compensation stock price or TSR, another SEC request for comment asks whether investors would disclosure regarding the determination and methodology that an issuer used to estim on stock price or TSR, and about any associated costs of such disclosure.

What time period is covered by the clawback policy in the event of an accounting restatement?

Under the proposed rule, the issuer's clawback policy applies to any erroneously awarded incentive-based compensation received by a current or former executive officer during the three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement to correct a material error.

For purposes of determining this three-year lookback period, the date on which an issuer is "required to prepare an accounting restatement" is the earlier to occur of:

- the date the issuer's board, a board committee or authorized officers (if board action is not required) conclude, *or reasonably should have concluded*, that the issuer's previously issued financial statements contain a material error; and

- the date a court, regulator or other legally authorized body directs the issuer to restate such financial statements.

The first proposed date generally is expected to coincide with the date disclosed in the Item 4.02(a) Form 8-K filed (though neither proposed date is predicated on a Form 8-K having been filed).

As proposed, incentive-based compensation is deemed “received” for purposes of triggering the clawback policy in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant of the incentive-based compensation occurs after the end of that period.

Potential Revision to Lookback Trigger Date The SEC is soliciting comment on whether to remove or revise the proposed “reasona have concluded” standard in response to concerns that the use of this phrase introdu element of subjectivity to the rule that would give rise to a degree of uncertainty and c to when an accounting restatement is required.

Does an issuer’s board of directors have discretion not to pursue recovery of excess incentive-based compensation?

An issuer’s board has very limited discretion over whether to recover excess incentive-based compensation. As proposed, erroneously awarded compensation would be recoverable in all instances, with only one limited exception—where recovery is “impracticable,” which is narrowly defined to encompass two specific situations: (i) where the direct expenses paid to a third party to assist in enforcing recovery would exceed the amount to be recovered; and (ii) for foreign private issuers, where recovery would violate the home country law of the issuer.

Reliance on the first exception would be predicated on the issuer first making a “reasonable attempt” to recover the excess incentive-based compensation, documenting this recovery attempt (or attempts), providing such documentation to the stock exchange on which it is listed, disclosing the reasons why it decided to forgo recovery (as discussed below), and its compensation committee or the majority of its independent directors making an affirmative “impracticability” determination.

Reliance on the second exception would be predicated on the foreign private issuer providing the stock exchange with an acceptable opinion of home country legal counsel stating that recovery would violate the foreign private issuer’s home country law in effect prior to the date of the final rule’s publication in the *Federal Register*, and its compensation committee or the majority of its independent directors making an affirmative “impracticability” determination.

Issuers are obligated to recover excess incentive-based compensation “reasonably promptly,” and there is no *de minimis* threshold or exception to the recovery amount.

May issuers indemnify or reimburse executive officers for recovered amounts?

Issuers are prohibited from indemnifying current and former executive officers against the loss of recoverable incentive-based compensation and from paying or reimbursing executives for insurance premiums to cover losses incurred under the clawback policy. The SEC notes in the proposing release that it believes indemnification and insurance premium payment or reimbursement arrangements that permit executive officers to retain compensation they were not entitled to receive based on restated financial statements fundamentally undermine the statute’s purpose.

What filing and disclosure requirements apply with respect to issuers’ clawback policies?

Issuers must file a copy of their clawback policies as an exhibit to their annual reports on Form 10-K, and publicly disclose the substance of their policies and the details of their implementation and recovery efforts.

Proposed new Item 402(w) of Regulation S-K would require that, if at any time during its last completed fiscal year either the issuer completed a restatement that required recovery pursuant to its clawback policy, or there was an outstanding balance of excess incentive-based compensation from the application of the policy to a prior restatement, the issuer must provide the following information, block-text tagged in XBRL format, in its Item 402 disclosure in annual reports and proxy statements:

- for each accounting restatement, (i) the date on which the issuer was required to prepare the restatement; (ii) the aggregate dollar amount of excess incentive-based compensation attributable to the restatement; (iii) the estimates used to determine the excess incentive-based compensation attributable to the restatement, if the financial reporting measure related to stock price or TSR; and (iv) the aggregate dollar amount of excess incentive-based compensation that remained outstanding at the end of its last completed fiscal year;

- the name of each individual subject to recovery from whom the issuer decided during the last completed fiscal year *not* to pursue recovery, the amounts due from each such individual and a brief description of the reason the issuer decided not to pursue recovery; and

- the name of, and amount due from, each individual 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 individual owed.

Any recovered amounts must be deducted from the summary compensation table disclosure relating to the year in which the compensation related to the recovered amounts was reported, and be identified by footnote.

Potential Inline XBRL Tagging Requirements
The SEC is considering whether it should require that specific data points within the n
disclosure be separately detail tagged using Inline XBRL instead of, or in addition to,
tagging previously proposed.

When must issuers comply with the proposed rule?

As proposed, the rule's key compliance milestones are as follows:

- ***Submission of listing standards***. Each stock exchange must develop and file with the SEC its proposed listing standards no later than 90 days following publication of the final SEC rule in the *Federal Register*.

- ***Approval of listing standards***. The stock exchanges' proposed listing standards must be approved by the SEC and be effective no later than one year following publication of the final SEC rule.

- ***Adoption of clawback policy***. Issuers must adopt a new clawback policy (or amend an existing policy not already compliant with the final rule) no later than 60 days following the effective date of the new listing standards.

- ***Clawback disclosure requirements***. Issuers must provide the required disclosures in their annual reports and proxy statements filed on or after the effective date of the new listing standards.

- ***Clawback obligation***. Issuers' clawback policies must apply to all erroneously awarded incentive-based compensation that results from achieving financial reporting measures based on or derived from financial information for any fiscal period ending on or after the effective date of the final SEC rule. This would capture compensation that was granted or awarded *before* the final rule's effective date but that is subject to a performance period that ends after such date. Therefore, in the event of a financial restatement, an issuer could be required to enforce the clawback obligation before the new listing standards have become effective, and before it has adopted the clawback policy pursuant to which enforcement must be made.

What are the consequences of noncompliance with the proposed rule?

An issuer is subject to delisting if it does not adopt a clawback policy that complies with the applicable listing standards, disclose the policy in accordance with SEC rules and comply with the policy's recovery provisions.

The proposed rule does not specify when the recovery must be completed. Rather, the stock exchange on which the issuer is listed would be responsible for assessing whether the issuer was making a good faith effort to promptly pursue recovery in compliance with its own policy.

A stock exchange is not permitted to list an issuer that it has delisted or that has been delisted from another exchange for failing to comply with its recovery policy until the issuer comes into compliance with that policy.

Related Materials

- Reopening Release
  - Press Release
  - Fact Sheet
  - SEC Chair Statement
- Original 2015 Proposing Release
  - Press Release/Fact Sheet
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