

SEC reopens comment period for its Dodd-Frank clawback rule

October 18, 2021 | Client Update | 7-minute read

The SEC's renewed request for comments on its clawback rule suggests an aggressive approach to recovery of incentive-based compensation.

On October 14, 2021, the Securities and Exchange Commission [announced](#) that it is reopening the comment period for its [proposed clawback rule](#), which has languished ever since Congress directed the SEC to adopt it in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Dodd-Frank Act directed the SEC to require stock exchanges to obligate each listed company to implement a compensation recovery policy, or "clawback" policy, that provides for the company to recoup incentive-based compensation paid to executive officers.

The SEC's original rule¹, proposed in 2015, included the following key elements:

- The clawback policy must mandate recovery of incentive-based compensation from current and former executive officers who "received" such compensation during the three fiscal years preceding the date on which the listed company is required to prepare an accounting restatement to correct a material error.
 - Incentive-based compensation is any compensation that is granted, earned or vested based wholly or in part on the attainment of a financial reporting measure, including stock price or total shareholder return.
 - Incentive-compensation is deemed received not when it is granted, vested or paid, but rather during the fiscal period when the performance measure that must be achieved under its terms is attained.
 - All listed companies are covered by the proposed rule, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and companies with only listed debt securities.
 - Executive officers include all of a company's Section 16 officers, including the company's principal accounting officer.
- Recovery must be on a "no fault" basis, without regard to whether any misconduct occurred or an executive officer's responsibility for the misstated financial statements.
- The amount of the recovery must be the amount received by the executive officer in excess of the amount that would have been received if the calculation was based on the restated financial statements.
- In addition, each listed company must file the clawback policy as an exhibit to its annual report and disclose the company's actions to enforce the clawback policy, including information regarding completed, ongoing and forgone recoveries, such as the names of involved executive officers and amounts of excess incentive-based compensation attributable to an accounting restatement.
- Recovery is generally mandatory, with limited exceptions that would need to be disclosed.
- Indemnification of recovered amounts is prohibited.
- Noncompliant companies would be subject to delisting.

[Commenters](#) in 2015 observed that the proposed rule was more prescriptive and expansive than required under the Dodd-Frank Act, noting some key concerns that:

- The proposed rule applies not only to incentive-based compensation tied to financial reporting measures, but also to compensation based on stock price performance or total shareholder return;
- Almost all issuers of all listed securities are subject to the proposed rule, including those issuers that are otherwise excluded from other SEC disclosure requirements of executive compensation;
- Boards of directors are afforded little discretion over whether to seek recovery of excessive incentive-based compensation and boards would not be permitted to allow an executive officer to repay in installments under a payment plan;
- The three-year lookback period under the proposed rule could impact executive officers who serve as executive officers for only partial years;
- Recovery of incentive-based compensation is on a pre-tax and not after-tax basis; and
- The obligation to recover compensation is triggered not upon a clear, objectively determinable date, but upon the earlier of (i) the date the board concludes, or *reasonably should have concluded*, that the issuer’s previously issued financial statements contain a material error (ii) or the date a court, regulator or other legal body directs restatement.

Notwithstanding the issues raised during the 2015 comment period, new questions raised in this proposal to reopen the comment period suggest that the SEC may be considering broadening the rule even further. Questions raised by the SEC in its request for comment include the following topics.

- As a result of concerns since 2015 that issuers may not be making appropriate materiality determinations for financial statement errors identified (and even some suspicion that such determinations were meant to avoid triggering corporate clawback policies), whether the SEC should interpret “restatement” under the Dodd-Frank Act to include not only (i) those restatements to correct errors that are material to the previously issued financial statements that formed part of the 2015 proposal, but now also (ii) additional restatements required to correct errors that would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period;
- Since not all types of restatements would require a Form 8-K, further consideration of the event that should trigger the three-year lookback period for identifying compensation subject to the clawback rule.
- Whether to add check boxes to Form 10-K that indicate (i) whether the previously issued financial statements include an error correction and (ii) whether any such corrections are restatements that triggered a clawback analysis, along with other disclosures that might be useful to investors on restatements generally and the decision whether or not to claw back compensation;
- The costs and benefits of clawback policies; and
- Developments since the 2015 proposed rule that should affect the SEC’s consideration of the rule and its potential economic effects.

While the potential expansion of the types of accounting restatements that would trigger a clawback is phrased as a question for comment, the release makes clear that the SEC believes that encompassing all types of restatements as described above would be “an appropriate means of implementing the statute.” This would significantly broaden the number of events when clawbacks may apply or would at least need to be considered by boards, and, even if boards retain some discretion, the resulting decisions on whether or not to claw back compensation will likely need to be disclosed.

Next steps

The comment period will be open for 30 days after the SEC’s release is published in the Federal Register, and is expected to remain open through mid-November.

The SEC will review and consider comments before publishing a final rule. Following publication of a final SEC rule, the stock exchanges will issue proposed listing rules, which will then need to be approved by the SEC. Although we would not expect this process to be complete and the rule to be effective in 2021, effectiveness in 2022 is certainly possible.

The 2015 proposal would require issuers to recover erroneously awarded incentive-based compensation as the result of the attainment of a financial reporting measure based on or derived from financial information for any fiscal period ending on or after the effective date of the new rule. For example, if the final SEC rule is effective in calendar year 2022, an issuer would be required to claw back incentive-based compensation that is based on attainment of financial results for its fiscal year ending December 31, 2022, regardless of when the issuer’s stock exchange issues its proposed listing rules.

Given this renewed interest in finalizing the clawback rule, companies may wish to consider taking the following actions as we move toward final SEC and stock exchange rulemaking:

- Inform their boards or the relevant committee(s) of the reopening of the comment period for the proposed rule and the potential impact of the proposed rule on the company's incentive compensation program, the potential impact on senior-level recruitment (especially from non-public companies), the possibility of increased litigation with respect to incentive compensation and other knock-on effects;
- Consider how the company might integrate these new requirements into existing clawback policies, particularly if the company has an existing clawback policy or clawback provisions in its incentive plans that go beyond the financial restatement requirement;
- Inventory the company's incentive-based compensation plans and the terms of any existing clawback policies arrangements—for this purpose, in-scope plans include stock options, equity plans under which time-vesting awards are granted on the basis of performance, cash or equity plans that pay out on the basis of stock price goals or appreciation, and commission plans;
- For foreign private issuers, identify the list of individuals who would be the company's Section 16 officers for the first time; and
- Consider commenting on the proposed rule, in particular if the data requested by the SEC can be provided.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Ning Chiu

+1 212 450 4908
ning.chiu@davispolk.com

Jeffrey P. Crandall

+1 212 450 4880
jeffrey.crandall@davispolk.com

Joseph A. Hall

+1 212 450 4565
joseph.hall@davispolk.com

Adam Kaminsky

+1 202 962 7180
adam.kaminsky@davispolk.com

James C. Lin

+852 2533 3368
james.lin@davispolk.com

Kyoko Takahashi Lin

+1 212 450 4706
kyoko.lin@davispolk.com

Emily Roberts

+1 650 752 2085
emily.roberts@davispolk.com

Travis Triano

+1 212 450 3096
travis.triano@davispolk.com

Veronica M. Wissel

+1 212 450 4794
veronica.wissel@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.

¹ For additional information on the proposed rule, see our [2015 client update](#) and our [2015 comment letter](#) submitted to the SEC.