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SEC again reopens comment period for its Dodd-Frank clawback rule

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On June 8, 2022, the SEC requested comments for the third time on its proposed clawback rule, which is required to be promulgated under the Dodd-Frank Act. As part of this reopening, the SEC released data on the increasing prevalence of clawback policies and estimated the number of additional restatements that would trigger a clawback if the rule were to cover all required restatements correcting errors in previously issued financial statements.

On June 8, 2022, the Securities and Exchange Commission announced that it is again reopening the comment period for its proposed clawback rule, a rule that has been required to be promulgated since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. This new comment period is the SEC's third request for comments on the clawback rule, with comments previously requested on proposals published in July 2015[1] and October 2021[2]. As part of this reopening, which did not include a new version of the proposed rule, the SEC Staff released a memo that contains additional analyses and data that the SEC believes will assist its evaluation of the clawback rule. Specifically, the memo:

- Discusses the increase since 2015 in voluntary adoption of clawback policies;
- Provides estimates of the number of additional restatements that would potentially trigger a clawback if the rule were expanded to include all required restatements made to correct an error in previously issued financial statements (as reflected in the 2021 proposal), rather than just restatements to correct errors that are material to previously issued financial statements (as reflected in the 2015 proposal); and
- Briefly discusses some potential implications for the costs and benefits of the proposed rule.

Background

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 rule, 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.

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  - 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 were 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. Despite these observations, the SEC reopened the comment period in October 2021 in a manner that suggested that it 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 (so-called "Big R" restatements) 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 (so-called "little r" restatements);
- 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; and
- 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.

While the potential expansion of the types of accounting restatements that could trigger a clawback is phrased as a question for comment, the 2021 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.

Why did the SEC reopen the comment period again?

In its Staff memo, the Division of Economic and Risk Analysis (DERA) explains, "After reviewing the comments provided and additional data and research on compensation recovery policies that have become available since the time of the Proposing Release, staff prepared this memo to provide supplemental baseline data and analysis on two points. First, this memo discusses the increase in voluntary adoption of compensation recovery policies by issuers. Second, this memo provides estimates of the number of additional restatements that would trigger a compensation recovery analysis if, as described in the Reopening Release, the rules were extended to include all required restatements made to correct an error in previously issued financial statements."

Prevalence of clawback policies. According to its data, the number and percentage of filers that disclose a clawback policy has roughly doubled relative to the estimates provided in the 2015 proposal. Within the categories of smaller reporting companies (SRCs), emerging growth companies (EGCs), foreign private issuers (FPIs), and multijurisdictional disclosure system filers (MJDS), the increase is larger.

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Given this, the DERA expects that the anticipated benefits of the proposed rule, as well as the anticipated costs of the proposed rule, will be reduced.

"Little r" restatements. According to its data, "little r" restatements may account for roughly three times as many restatements as "Big R" restatements in 2021, after excluding restatements by special purpose acquisition companies (SPACs). Thus, if the final rule were to encompass both types of restatements, it would increase the total number of restatements that could potentially trigger a clawback analysis. However, the DERA observes that "little r" restatements may be less likely than "Big R" restatements to trigger a potential clawback of compensation, because, for example, "little r" restatements may be less likely to be associated with a decline in previously reported net income and on average they are associated with smaller stock price reactions. As a result, if the final rule were to encompass both "Big R" and "little r" restatements, while there would be an increase in the number of restatements that would be included, the overall number of clawbacks may not increase in proportion to the increase in the number of restatements that would be included.

Given this, the DERA notes that the potential inclusion of "little r" restatements may increase both the benefits and the costs associated with the proposed rule. For example, the DERA states, "including 'little r' restatements would likely mitigate the potential for the proposed rules to create an incentive for managers to report misstatements as 'little r' restatements rather than 'Big R' restatements." In addition, the DERA goes on to say, "The inclusion of 'little r' restatements may also increase the benefits and costs associated with potential shifts in managerial compensation." [footnotes omitted]

Next steps

The comment period will be open for 30 days after the SEC's release is published in the Federal Register.

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.

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 final 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 company's stock exchange issues its proposed listing rules.

As previously noted, the SEC's desire to finalize the clawback rule remains high. In view of this, we reiterate that companies may wish to consider taking the following actions:

- 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; and
- For foreign private issuers, identify the list of individuals who would be the company's Section 16 officers for the first time.

In related news

On June 7, 2022, the SEC charged a public company and seven senior employees, including the former CFO, in connection with their roles related to long-running accounting improprieties that ran from 2013 to 2017. In addition, the company's founder and former CEO, while not charged with misconduct, agreed to reimburse the company for more than $1.3 million in stock sale profits and bonuses as well as to return previously granted shares of company stock pursuant to Section 304 of the Sarbanes-Oxley Act (SOX), a clawback rule that pre-dates the Dodd-Frank clawback rule described above.

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While SOX clawbacks are not common, they do occur from time to time. In the SEC's press release, Gurbir S. Grewal, Director of the Division of Enforcement, stated, "Today's action should also put public company executives on notice that even when they are not charged with having a role in the misconduct at issue, we will still pursue clawbacks of compensation under SOX 304 to ensure they do not financially benefit from their company's improper accounting."

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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

Jennifer S. Conway
+1 212 450 3055
jennifer.conway@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

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

[2] For additional information on the first reopening of the comment period for the proposed rule, see our 2021 client update and our 2021 comment letter submitted to the SEC.

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