

Dodd-Frank clawback rule applies to subsidiary issuers and guarantors of listed securities

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Each subsidiary issuing or guaranteeing a public company's listed debt securities is itself subject to the clawback rules recently adopted by the NYSE and Nasdaq.

In October 2022, the SEC adopted the final clawback rule mandated by the Dodd-Frank Act requiring public companies to establish and enforce policies to recover excess incentive compensation from executive officers in the event of a financial restatement due to material noncompliance with the securities laws if the compensation was based on misstated financial statements, stock price performance or total shareholder return. The NYSE and Nasdaq adopted listing standards last year to implement the SEC's clawback rule – these standards became effective on October 2, 2023, and listed companies had until December 1, 2023 to adopt a compliant clawback policy. You can read more about the clawback rules in our client updates on the [SEC clawback rule](#) and the [NYSE and Nasdaq listing standards](#).

Application to subsidiaries

A subsidiary of a public company (including an operating company or finance subsidiary) can itself be the issuer of debt securities or a guarantor of debt securities issued by its parent company.

Public companies often use finance subsidiaries (which, in many cases, have no operations or employees) as capital raising vehicles. Typically, these subsidiaries are wholly owned by the listed parent company and issue debt securities that are guaranteed by the parent company. Under SEC rules, where the parent guarantees the debt, the subsidiary is exempt from ongoing SEC reporting (in accordance with Rule 12h-5 under the Securities Exchange Act of 1934), and the parent reporting company is not required to provide separate financial statements to the SEC for the subsidiary (in accordance with the exemption under Rule 3-10 of Regulation S-X).

While there is rarely meaningful trading of debt issued by a subsidiary, for certain regulatory or tax reasons, subsidiary securities are sometimes listed on an exchange, which would arguably make the subsidiary a "listed company." Neither the SEC clawback rule nor the listing standards implementing the rule include an exemption for subsidiaries that have listed debt securities (including guarantees). As a result, a literal reading of the rule means that any subsidiary with listed debt securities is required to adopt a clawback policy, even if for all practical purposes (in particular, where the subsidiary does not file any financial statements), no compensation would ever be subject to recovery under the policy. Absent SEC guidance, we believe that subsidiaries with listed debt securities should assume that the clawback rule applies.

What subsidiaries with listed securities should do

Subsidiaries with listed securities should adopt a clawback policy to comply with the listing standards. The good news is that under both NYSE and Nasdaq listing standards, if the subsidiary is not itself subject to SEC financial reporting requirements, there should be no events that would trigger recovery of compensation under the policy. This is because under the clawback rules, recovery of compensation is only triggered by a financial restatement that the issuer is required

to prepare due to the issuer's (i.e., the subsidiary's) material noncompliance with financial reporting requirements under the U.S. federal securities laws. If the subsidiary issuer is not subject to such financial reporting requirements, then it should never be required to prepare a restatement due to material noncompliance with such financial reporting requirements.

The clawback policy that is adopted could simply state that the parent company's clawback policy applies to the subsidiary to the extent required by the listing standards. We include a sample resolution that could be adapted for this purpose as an Annex to this client update. In addition, there would be no need to file the clawback policy for subsidiaries that do not file an annual report on Form 10-K, Form 20-F or Form 40-F (most finance subsidiaries do not).

Consequences of a failure to comply

We discuss the NYSE and Nasdaq notice and cure provisions in greater detail in our [client update](#), but the consequences of failing to comply with the listing standards include having to issue a press release disclosing the failure to comply within five days of receiving notice of noncompliance from the NYSE or four business days of receiving notice from Nasdaq, as applicable. A failure to timely cure noncompliance will also result in delisting. Subsidiaries with listed securities should therefore adopt a clawback policy as soon as practicable, particularly since the deadline to adopt a policy passed on December 1, 2023.

The NYSE requires listed issuers to submit an affirmation through NYSE Listing Manager confirming that, as of the date of the affirmation, the issuer has adopted a clawback policy. Adoption of a policy consistent with the resolutions in the Annex would allow subsidiary issuers to make the affirmation. Nasdaq currently has no similar affirmation requirement.

Annex

SAMPLE RESOLUTION – SUBSIDIARY COMPENSATION RECOUPMENT POLICY

WHEREAS, [Issuer Subsidiary] (Subsidiary Issuer) is a [wholly owned] subsidiary of [Listed Pubco] that may issue securities that may be traded on [the New York Stock Exchange][Nasdaq][, with Subsidiary Issuer's payment obligations on such securities fully and unconditionally guaranteed by [Listed Pubco]];

WHEREAS, [Listed Pubco] has previously adopted the [Listed Pubco] Compensation Recoupment Policy (the Policy); and

WHEREAS, Subsidiary Issuer [does not have any employees, does not award compensation to any employees and does not include financial statements in its filings with the Securities and Exchange Commission].

NOW, THEREFORE, BE IT RESOLVED, that, to the extent required by [Section 303A.14 of the New York Stock Exchange Listed Company Manual][Rule 5608 of the Nasdaq Stock Market Rulebook] (the Listing Rule), Subsidiary Issuer hereby adopts the Policy, with effect from and after October 2, 2023, solely in respect of any "incentive-based compensation" (as defined in the Listing Rule) awarded by Subsidiary Issuer (Subsidiary Issuer Incentive-Based Compensation) to its "executive officers" (as defined in the Listing Rule), if any, that is "received" (as defined in the Listing Rule), on or after October 2, 2023; and

RESOLVED, FURTHER, that, in the event that Subsidiary Issuer is required to restate its financial statements due to material noncompliance of Subsidiary Issuer with any financial reporting requirement under the U.S. federal securities laws that is required in order to correct (x) an error in previously issued financial statements that is material to the previously issued financial statements or (y) an error that would result in a material misstatement if the error were (A) corrected in the current period or (B) left uncorrected in the current period, Subsidiary Issuer shall reasonably promptly recover any Subsidiary Issuer Incentive-Based Compensation that is required to be recovered under the Listing Rule and the Policy.

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.

Maurice Blanco

+55 11 4871 8402
+1 212 450 4086
maurice.blanco@davispolk.com

Ning Chiu

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

Jennifer S. Conway

+1 212 450 3055
jennifer.conway@davispolk.com

Joseph A. Hall

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

Michael Kaplan

+1 212 450 4111
michael.kaplan@davispolk.com

Kyoko Takahashi Lin

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

John B. Meade

+1 212 450 4077
john.meade@davispolk.com

Richard D. Truesdell, Jr.

+1 212 450 4674
richard.truesdell@davispolk.com

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