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SEC Enforcement

SEC Clawback Rule Requires Focused, Coordinated Compliance

By David Hill, *Anti-Corruption Report*

The threat of clawbacks of incentive compensation may be a tool to encourage executives to comply with regulations, but clawbacks prompted by the SEC's new "Recovery of Erroneously Awarded Compensation" rule (Rule) require separate treatment from those related to misconduct. While happening in parallel with a DOJ Criminal Division program on recovering compensation from executives found culpable of wrongdoing, and envisioning similar recovery mechanisms, the Rule will need to be addressed on its own terms by affected companies.

Under the Rule, which dates back to the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, but is just now being implemented, listed companies must adopt a clawback policy mandating recovery of excess compensation that was erroneously paid. Recipients to whom this applies are people who were serving as senior company officials within a three-year lookback period leading up to an event requiring a financial restatement. The Rule does not require misconduct to have happened in order to apply. Recovery of the relevant compensation is mandatory.

The final version of the Rule was published on November 28, 2022, but the timing of implementation remained to be finalized at that point. The expected timeline was extended in June, and December 1, 2023, became the date when issuers listed on both the NYSE and the Nasdaq must have their clawback policies in effect.

In a firm webinar, Davis Polk partners Veronica M. Wissel, Adam Kaminsky, Travis Triano and Roshni Banker Cariello discussed how companies can comply with the Rule by the deadline. This article distills their insights.

See "DOJ's Pilot Program on Clawbacks to Foster Individual Accountability Poses Challenges for Companies" (Mar. 29, 2023).

Keep Separate Policies

Companies that would also claw back compensation in incidents of misconduct are well advised to maintain those policies in tandem with policies complying with the new Rule, Wissel said. The same applies to companies where clawbacks might affect employees other than those covered in the Rule, such as those leading officers and directors listed in Section 16 of the Securities Exchange Act of 1934.

"If you have a clawback policy that is broader – for example, you have misconduct triggers or you cover people beyond Section 16 officers – it might make sense to adopt a standalone policy that complies specifically with this Rule," Wissel advised. "Most companies I am talking to are keeping these separate. But a lot of companies that are more recently public have narrow clawback policies that don't go further than this Rule, so they are just replacing them."

Triano has seen similar choices among companies he has worked with. "There's been a push in recent years from institutional investors and advisory firms to have more robust clawback policies," he noted. He mentioned instances where there is a misconduct-based policy that covers events not limited to financial restatement, or coverage populations beyond just executive officers. In companies that have such policies, he observed, the new rule is typically being approached as a separate and additive requirement. "But it's important to take stock of what you have and see how they interact," he warned, adding that companies that have a discretionary policy should make sure there are no duplicative clawbacks.

See "Tone at the Top: Considered Crucial Factor for Successful Corporate Compliance" (May 24, 2023).

Keep It Fair

Kaminsky pointed out that the clawback applies to the pretax amount that was paid out to the executive, not the net amount. Some controversy has arisen over this fact, said Wissel, explaining that if an executive has already paid tax on a bonus, and then that bonus is subject to clawback, it might not be possible for the individual to recoup the tax payment. "This has been bothering people – it's so punitive," she asserted.

One option to avoid this issue, she continued, is a deferral arrangement. Under this, a company would defer payment of the compensation in question until a period has elapsed that corresponds to the lookback period for the Rule.

Kaminsky also raised the point that some companies might decide, voluntarily, to apply the Rule to people other than top executives, for reasons of fairness. "Some companies are deciding to do that on a discretionary basis," Triano confirmed.

See "2022 FCPA Year in Review: Clawbacks, Messaging Apps and More Enforcement to Come" (Dec. 21, 2022).

Compensation and Oversight

Kaminsky suggested that, while the Rule is quite prescriptive, it leaves open some things, such as who has oversight of clawback policy, *e.g.*, the company's board, or its compensation committee. Triano said companies are taking varying approaches on that. "The compensation committee is considered by many companies to be the decider, but some companies are saying this will also involve the audit committee, or other members of the board," he stated. "And, given the materiality of the matter, maybe the full board should approve." He said a good place to start is to see whether any determination can be derived from what the company's committee charters dictate.

In some jurisdictions, Kaminsky remarked, compensation policy may be subject to shareholder approval – a factor possibly making compliance with the Rule more complex.

Managing clawbacks in this new regulatory environment may involve more cooperation between committees within companies, such as the compensation committee and the audit committee, Cariello noted. She said it is a good idea to update internal controls, procedures and governance structure to build in that interaction.

Some companies are examining whether the typical compensation committee charter – granting it jurisdiction over setting executive compensation – is enough to give it jurisdiction over clawback policy, observed Wissel. "On the whole, the answer is yes," she said. Some companies, added Triano, are opting to change compensation committee charters to show explicitly that they have oversight on clawbacks. They want to make it clear in their charter "that the comp committee is in charge of clawbacks, including determining the amount of clawback," he contended.

While a company's compensation committee may appear as a typical internal body that would be entrusted with clawback policy, Wissel pointed out that some companies, including debt-only issuers and foreign private issuers (FPIs), may lack a compensation committee.

While it is unclear who should oversee the clawback policy at FPIs, Kaminsky said the "good news" is that the Rule provides flexibility on this question. This leaves companies free to oversee clawbacks according to what fits their own governance situation, he claimed.

Applying the Rule is more complicated for FPIs, according to Wissel. "They don't have the same infrastructure, the same disclosure requirements, the Section 16 officer designations," she said. "FPIs will need to have a process for figuring out who is going to be in scope. Similar approaches used to identify officers under Section 16 may be possible. They will also have to figure out what [corporate governance] body is going to deal with this."

Applicability Triggers

Wide Net

Triano stressed that companies subject to the Rule still need a clawback policy even if they do not use the type of incentive-based compensation performance measures that would be subject to it. These may add in these measures in the future, “as there is more of a trend toward performance-based incentives,” he said.

Big and Little “R”

Events that may trigger clawbacks under the Rule are restatements of company financials falling into one of two categories, “Big R” restatements and “little r” restatements, the partners explained.

Big R restatements are corrections to errors that have material effects on previously issued financial statements. By contrast, little r restatements are defined with reference to the currently ongoing financial reporting period. They include corrections to errors that would result in material misstatement for the current period.

Enhanced Procedures and Coordination

It may be complicated for companies to determine whether an identified error in reporting would rise to the level of materiality to trigger a clawback under the Rule, Cariello cautioned. “Companies may need to enhance their procedures to make that determination,” she said. Triano noted that one outcome of this is that companies might seek to enhance communication between the compensation committee and the audit committee, potentially triggering communication about restatements.

Both internal officers and external auditors may be involved in the task of identifying relevant restatements. “There is going to be constant communication among those parties as well as enhanced communication with the compensation committee,” Cariello said.

Types of Compensation

As for the types of compensation that are subject to clawback, they are less comprehensive than had been feared. “There had been concern that salaries would be covered, but they will not,” Kaminsky observed.

The clawbacks relate to incentive compensation based on financial reporting measures. Some of these incentives are based on the company’s stock price performance or total shareholder return (TSR). The clawbacks also apply to amounts that are contributed to benefit plans on the basis of financial reporting measures and any earnings accrued on them. The compensation affected by the Rule includes long-term disability, life insurance, supplemental retirement and severance plans.

In addition to salary, some other types of payments that are not subject to the Rule are compensation awarded on the basis of subjective, strategic or operational measures, and discretionarily awarded compensation.

Lookback

The three-year lookback period consists, specifically, of three fiscal years, but will not go back further than FY23.

The point in time from which the three fiscal years are counted back is whichever is earlier out of two dates. One is when company officers conclude, or ought to conclude, that a restatement is needed. The other is when a legally authorized body, such as a regulator or court, directs the company to make a restatement.

See "Revised Monaco Memo Affects Compensation, Clawbacks and Monitorships" (Oct. 26, 2022).

Mandatory Whenever Possible

Clawbacks under the new SEC rule are mandatory, Kaminsky stressed. "You need a good reason why you can't go get it," he said.

"There's an impracticability exception," Triano advised. "If the expenses of seeking a clawback paid to a third party would exceed the amount recoverable, you do not need to claw back those amounts. It's a high bar – you need to show you have made reasonable efforts to claw back and show that the costs would be too high."

However, companies that follow this option – abandoning efforts to secure a clawback while laying out the unsuccessful efforts they made – would be putting themselves at risk of a lawsuit by disgruntled shareholders, Wissel cautioned. Upon perusing the list of measures the company took to attempt a clawback, some shareholders might sue, claiming the company did not try hard enough, she said.

Discretion in How to Recover Payments

Issuers are afforded a degree of discretion on the method of recovery, as long as the outcome is reasonably prompt. Options include a forfeiture of equity awards, an offset against amounts otherwise payable to the executive or a deduction from future pay, as well as a more straightforward repayment by the executive.

“It could just be the executive writing a check,” Wissel said about the flexibility. “It could be an arrangement of salary reduction.”

Disclosures Needed at Certain Points

Triano explained that when it comes to required disclosures prompted by the Rule, there are three relevant inflexion points where these would be required. “One is the adoption of the policy, two is upon any restatement, and the third is about an actual clawback - or a determination that a clawback is impracticable,” he clarified.

Companies should expect to disclose their clawback policies with their upcoming 10-K filings, he continued. A company would not gain anything from announcing its policy earlier than this, he said, since every affected company will be adopting such policies. “Most companies’ policies will look similar because the rule is so prescriptive,” Wissel observed.

Disclosure of any restatement that occurs can be made in the 10-K or in the proxy statement and incorporated by reference into the 10-K (See the Final Rule at 731,32), according to Davis Polk.

See “How the Revised Monaco Memo Alters Deal Making and Strategy” (Oct. 12, 2022).

Calculations Can Be Tricky

Triano mentioned the difficulty, in some cases, of calculating how much needs to be clawed back.

“You would calculate how much was received and how much should have been received, based on the financials,” he said. But when a payout is based on TSR, it might not be such plain mathematics, as it involves making a reasonable estimate of what the company’s stock price would have been, based on the restated financials. “I think that’s going to be a hard exercise, and I don’t know how companies plan to do it,” he offered. “There are no guideposts. Companies are saying they’re going to need assistance from a third party, like a valuation firm. This is one of the most challenging aspects of this rule.”

He also stressed that, in the case of incentives based on certain financial thresholds, a restatement might take it just below that threshold, meaning an entire incentive payment is affected.

See “No Longer a Slap on the Wrist: SEC Penalties and Sentences on the Rise” (Jan. 18, 2023).

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