

SEC to Take Up Compensation Recovery (“Clawback”) Disclosure Requirement

On October 14, 2021, the SEC announced that it was reopening the comment period on its proposed rules directing the national securities exchanges to amend their listing standards to require public companies to adopt and disclose their written clawback policy to maintain their listing status. The SEC is seeking further comment and analysis on both the original proposed rules (pending since July 2015), as well a series of additional questions in this [release](#).

This Thoughtful Pay Alert summarizes the key aspects of the SEC’s original proposed rules and highlights certain additional areas where the SEC is seeking comment. For a detailed analysis of the original proposed rules, see our Thoughtful Pay Alert, *SEC Proposes Rules to Implement Compensation Recovery (“Clawback”) Requirement* (July 10, 2015).

Background

As enacted in 2010, the Dodd-Frank Act would require the SEC to direct the national securities exchanges to prohibit the listing of any company that has not adopted a clawback policy providing for the recovery of excess incentive-based compensation from any of its current and former executive officers who received such compensation during the three fiscal years preceding the date on which the company is required to prepare an accounting restatement to correct a material error.

On July 1, 2015, the SEC proposed rules to implement this new requirement. The proposed rules would also require listed companies to disclose specific information about their clawback policy and its enforcement in their annual report on Form 10-K and proxy or information statement. Since then, the clawback provision has remained unfinished, but the new SEC Chair has made it one of his principal objectives to complete the Dodd-Frank rulemaking in the near future.

The Proposed Rules

Under the proposed rules, listed companies would be required to adopt a clawback policy which would apply:

- **Covered Executives** – to current and former executive officers based on the Section 16 definition of “officer”;
- **Triggering Event** – on a no-fault basis if the company is required to prepare an accounting restatement to correct a material error;
- **Compensation Recoverable** – to any cash or equity compensation (including stock options) granted, earned, or vested on the basis, in whole or in part, upon achievement of a “financial reporting measure,” including any measure based on or derived, in whole or in part, from such a financial reporting measure, or stock price and total shareholder return;
- **Recovery Period** – to any incentive compensation received during the three fiscal years preceding the earlier of the date the company concludes that its financial statements contain a material error or a court order requires the restatement; and
- **Amount to be Recovered** – to the amount of incentive compensation received, on a pre-tax basis, that exceeds the amount that would have been received had the compensation been determined based on the accounting restatement.

Recovery would be excused only if it would be impracticable to do so (such as when the costs of recovery would exceed the amount to be recovered). Further, companies would be prohibited from indemnifying current or former executive officers against the loss of recoverable incentive compensation.

SEC to Take Up Compensation Recovery (“Clawback”) Disclosure Requirement (continued)

Additional Comment Requests

While new comments may be submitted on any aspect of the proposed rules, the SEC specifically requested comments on ten additional topics, including information on the costs and characteristics of voluntarily adopted clawback policies and the benefits of such policies. The most important of these additional questions are as follows:

- **Restatements Covered** – The SEC has asked whether the proposed rules should apply where a company’s previously issued financial statements are required to be restated to correct errors that were not material to those previously issued financial statements, but 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. This change would significantly extend the scope of a clawback provision.
- **Measurement of Lookback Period** – As originally proposed, the three-year lookback period would run from the earlier of (a) the date the company concludes, or reasonably should have concluded, that its financial statements contain a material error or (b) the date of a court order requiring a restatement. The SEC has asked whether the “reasonably should have concluded” standard should be deleted because of the uncertainty it adds to the determination.
- **Disclosure of Clawback Calculation** – As originally proposed, companies are required to disclose the recoverable amount, but not how it was calculated. The SEC has asked whether a company should be required to disclose how it calculated the recoverable amount, particularly when the metric for the incentive compensation is based on stock price or total shareholder return and, therefore, is not subject to mathematical recalculation directly from the accounting restatement. We expect that this calculation will present a challenge for clients when faced with having to recover the gain associated with a stock option exercise.

Effective Date

As it now stands, once the SEC adopts its final clawback rules, the national securities exchanges will be required to submit their proposed listing standards to the SEC within 90 days of the date that the final rules are published in the Federal Register, and have their listing standards become effective no later than one year after the date that the final rules are published in the Federal Register. Thereafter, each listed company will have 60 days from the date the listing standards became effective to adopt a compliant clawback policy. Assuming that the exchanges need the full period allowed by the SEC for their listing standards to become effective, it is reasonable to assume that companies will need to have a compliant clawback policy in place sometime by the middle of 2023. It remains to be seen whether this schedule will be maintained under the final rules. Given that so many companies already have clawback policies in place, they may need more time to make any necessary changes to an existing policy or adopt a new policy.

Need Assistance?

Compensia has extensive experience in helping companies understand how the corporate governance and executive compensation-related disclosure provisions of the Dodd-Frank Act affect the design, operation, and disclosure of their executive compensation program. If you would like assistance in analyzing how the implementation of the final clawback rules are likely to impact your current compensation recovery policy, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Jason Borrevik at 408.876.4035, Mark A. Borges at 415.462.2995, or Peter Kimball at 202.321.1234.

SEC to Take Up Compensation Recovery (“Clawback”) Disclosure Requirement (continued)

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