

Legal Update

SEC Reopens Comment Period for Clawback Listing Standard

On October 14, 2021, the US Securities and Exchange Commission (SEC) issued a release reopening the comment period (Reopening Release)¹ on the clawback listing standard rule that it proposed in 2015 (2015 Proposal)². Interested parties may submit comments on any aspect of the 2015 Proposal, as well as on the additional requests for comments raised in the Reopening Release. The new comment period closes 30 days after publication of the Reopening Release in the *Federal Register*.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) added Section 10D to the Securities Exchange Act of 1934, requiring the SEC to direct national securities exchanges and associations to establish listing standards that prohibit the listing of any security of a company that does not adopt and implement a written policy requiring the recovery, or “clawback,” of certain incentive-based executive compensation payments. Although the Dodd-Frank mandated that the SEC adopt a clawback requirement, the 2015 Proposal was never adopted.

The 2015 Proposal proposed new Rule 10D-1 to require listed companies to recover incentive compensation payments from current and former executive officers that are later shown to have been paid in error as a result of an accounting restatement that is necessary to correct a material error of a financial reporting requirement. The clawback would equal the amount by which the incentive-based compensation that the officer received exceeds the amount such officer would have received had the incentive-based compensation been calculated following the accounting restatement. This recovery would apply to erroneously awarded incentive-based compensation that had been received within the three fiscal years preceding the date it was determined that a restatement is required, without regard to whether such officers were at fault for such error. The 2015 Proposal would also require disclosure of such recovery policies and actions taken by listed companies under those policies. For additional information on the SEC’s 2015 Proposal, see our Legal Update, “US Securities and Exchange Commission Proposes Compensation Clawback Listing Standards Requirement,” dated July 16, 2015.³

Developments in clawback policies since 2015 provided an impetus for the SEC to reopen the comment period. In particular, the Reopening Release noted “an increase in the number of issuers disclosing information about their ability to recoup performance-based awards in the event of fraud, restatement of financial statements, or other reasons, and adopting and implementing executive compensation clawback policies addressing these circumstances.”

Requests for Comment

The 2015 Proposal requested comments on more than 100 specific questions, including whether the rule should apply to all listed issuers; whether compensation based on stock price or total shareholder return should be subject to recovery; under what circumstances, if any, should the board of directors be able to exercise discretion regarding the amount to be recovered; and the appropriate approach to determine the three-year lookback period.

While welcoming comments on any element of the 2015 Proposal, the Reopening Release raises additional requests for comments in 10 multifaceted areas:

1. Accounting Restatements. The SEC is requesting comment on whether the term “an accounting restatement due to material noncompliance” should be interpreted to include all required restatements made to correct an error in previously issued financial statements. For example, the SEC is requesting comment on whether the clawback listing standards should be triggered not only by accounting restatements that correct errors that are material to previously issued financial statements, but also by restatements that correct errors that are not material to previously issued financial statements where a material misstatement would result if:

- the errors were left uncorrected in the current report, or
- the correction was recognized in the current period.

This expansion of the types of accounting restatements that could necessitate clawbacks of executive compensation could result in a significant change to the ultimate SEC clawback rule.

2. Three-Year Lookback Period. For purposes of triggering the three-year lookback period, the SEC seeks comment as to whether it should remove the proposed “reasonably should have concluded” standard from the date of the board’s determination that the issuer’s previously issued financial statements contain a material error. In that regard, the SEC also requests comment on whether there is another standard, consistent with the purposes of the rule, that would reduce the expected complexities of applying the “reasonably should have concluded” standard.

3. Defined Terms. The SEC is also seeking comment on whether the clawback rule should rely on existing resources and remove the proposed definitions for “accounting restatement” and “material noncompliance” rather than defining the terms for the purposes of the rule. The SEC is also asking for comment on what guidance, if any, it should provide regarding when incentive-based compensation is “received.”

4. Accounting Restatement Disclosures. If the statutory term “an accounting restatement due to material noncompliance” is interpreted by the SEC to include additional types of restatements as described above, the SEC is seeking comments as to whether “check boxes” should be added to the cover page of Form 10-K to indicate separately (a) whether the previously issued financial statements included in the filing include an error correction, and (b) whether any such corrections are restatements that triggered a clawback analysis during the fiscal year. The SEC also seeks comment on whether additional Form 8-K filing or other disclosure would be useful to investors to explain information surrounding any restatements with respect to the issuer’s decision whether or not to claw back compensation.

5. Costs and Benefits. Noting the increase in voluntary clawback policies, the SEC is asking for estimates or data impacting the costs and benefits incurred under current issuer clawback policies and how they would differ under the proposed rules. Specifically, the Reopening Release asks for information on whether voluntary adoption of clawback provisions resulted in a decrease of incentive-based compensation or an increase in compensation tied to non-financial performance by issuers.

6. Impacts of Revising Scope of Rule. Another SEC request for comment asks for input on the impact of revising the scope of the 2015 Proposal to encompass additional accounting restatements, such as whether it would affect how an issuer conducts an evaluation of whether any misstatement of previously issued financial statements had the effect of increasing management's compensation. The SEC also requests comment on whether revising the scope would capture situations where issuers may have shifted from restating previously issued financial statements to avoid triggering compensation clawback policies and whether there would be situations where the revised scope would be over-inclusive.

7. Calculation of Recoverable Amount. Recognizing that there are a number of possible methods to reasonably estimate the effect of an accounting restatement on stock price, with varying levels of complexity and a range of related costs, the SEC is seeking comment on whether investors would benefit from disclosure of how issuers calculated the recoverable amount, including their analysis of how much compensation is recoverable under the rule and/or the amount that is not subject to recovery. With respect to incentive compensation based on stock price or total shareholder return, the SEC is asking whether issuers should be required to disclose the determination and methodology they used to estimate the effect of a restatement on the stock price or total shareholder return.

8. Investment Companies. The SEC is requesting comment on whether there have been any changes or developments since the 2015 Proposal with respect to payment of incentive-based compensation by listed registered management investment companies that would affect how they are treated under the clawback rules. The SEC is also asking if external, rather than internal, management of an investment company or a business development company should impact how those companies are treated under the rules.

9. XBRL. The SEC is seeking comment on whether Inline XBRL detail tagging of some or all of the compensation recovery disclosures, instead of or in addition to the previously proposed block-text tagging, would be valuable to investors.

10. New Developments. The Reopening Release asks for feedback on developments since the 2015 Proposal that would affect the SEC's consideration of the proposal and its potential economic effects. Specifically, the SEC is seeking comment on whether there are changes in the methodologies and estimates it used to analyze the economic effects of the 2015 Proposal that it should consider now.

Practical Considerations

According to its spring 2021 rulemaking agenda, the SEC plans to re-propose the 2015 Proposal in the spring of 2022. The SEC will need to review comments, both new and old, on the 2015 Proposal before revising and re-proposing its rule. Following the re-proposal, there will be another opportunity for comment before the SEC issues a final rule. Thereafter, the securities exchanges and associations will have to prepare listing standards for submission to the SEC. As a result, it may take some time before listing standards adopted in accordance with Dodd-Frank are finally implemented, even without regard to a possible transition period.

The reopened comment period provides interested parties with a mechanism to provide input on, and perhaps influence, the re-proposal before it is finalized. Those with opinions on any element of clawback policies should consider taking advantage of this opportunity to engage with the SEC on the topic by submitting comments. Because the new comment period will close 30 days after publication in the *Federal Register*, interested persons should start thinking about possible comments right way.

By shedding light on what the SEC is considering for its re-proposed rule, the new requests for comments are worth reading by anyone who has an interest in clawback policies, even if they do not plan to submit comments.

Comments previously submitted on the 2015 Proposal do not have to be re-submitted.

Because many investors and proxy advisory firms view clawback policies as an important corporate governance practice, many listed companies have already adopted corporate clawback policies and others may adopt them before the listing standards envisioned by Dodd-Frank are effective. However, since this is an evolving regulatory area, listed companies need to monitor all clawback developments closely to determine whether amendments to their policies become necessary or advisable as this rulemaking proceeds.

For more information about the topics raised in this Legal Update, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, any of the following lawyers or any other member of our Corporate & Securities practice.

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Endnotes

¹ <https://www.sec.gov/rules/proposed/2021/33-10998.pdf>

² <https://www.sec.gov/rules/proposed/2015/33-9861.pdf>

³ <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2015/07/us-securities-and-exchange-commission-proposes-com/files/get-the-full-report/fileattachment/150716-update-cs.pdf>

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