

Meridian Client Update

Are Finalized Clawback Rules on the Horizon?

On October 14, 2021, the Securities and Exchange Commission (SEC) reopened the comment period on its Proposed Rule on the Dodd-Frank mandatory clawback requirement. This may reflect the SEC's intent to adopt a Final Rule sometime during 2022.

The SEC's reopening of the comment period on its Proposed Rule on the Dodd-Frank mandatory clawback requirement is a significant development in the long journey of the Proposed Rule, first issued on July 1, 2015. The SEC may, at long last, be poised to issue a Final Rule in the foreseeable future. To provide clarity on this recent development, this Client Update covers the following areas:

- Reopening of Comment Period
- Summary of Proposed Rule (as originally proposed in 2015)
- Concerns Noted in Prior Comment Period
- New Questions Raised by the SEC
- Timing and Implementation of Final Rule
- Current State of Clawback Practices

Reopening of Comment Period

The Proposed Rule was subject to a comment period that expired in 2015. Since then, the rule lay dormant until the SEC announced the reopening of the comment period on October 14, 2021. The 30-day comment period ends on November 22, 2021.

The SEC notes that the reopened comment period will permit interested parties to submit further comments and data on the Proposed Rule as well as comments in response to new questions raised by the SEC in its reopening release. In addition, interested parties may comment on developments since 2015 when the Proposed Rule was issued, including trends in accounting practices and the potential economic and other effects of the proposal in light of these developments.

The reopening of the comment period suggests that the SEC may be poised to make substantive changes to the Proposed Rule based on prior comments and comments received during this new comment period. It also signals that the SEC is likely prepared to adopt a Final Rule sometime during mid-2022. If so, listed companies would likely have to comply with the mandatory clawback policy sometime during 2023 (see discussion below). Therefore, companies are under no immediate pressure to adopt clawback policies that are (or revise existing clawback policies to be) compliant with Dodd-Frank and the final rule.

Summary of Proposed Rule (as originally proposed in 2015)

The Proposed Rule provides that if a public company must prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, the company must recover from any covered current or former executive officer any “excess incentive-based compensation” received during the three-year period preceding the date the company is required to prepare the accounting restatement. (See Meridian Client Update dated July 10, 2015 for additional details on the Proposed Rule.)

- Accounting restatement would be defined as “the result of the process of revising previously issued financial statements to reflect the correction of one or more errors that are *material* to those financial statements.”
- “Incentive-based compensation” would be defined as any compensation that is **granted, earned or vested** based wholly, or in part, upon the attainment of any “**financial reporting measure**” (i.e., GAAP measures and measures related to total shareholder return and stock price).
- “Excess incentive-based compensation” would be defined as the amount received by an executive officer that exceeds the amount the executive officer would have received had the incentive-based compensation been determined based on the restated financial.
- Clawback of excess incentive compensation would be mandatory, **except** if recovery costs exceed the recoverable amount or recovery would violate home country law of a foreign private issuer.
- Means of recovering excess incentive compensation would be at the discretion of the company (e.g., offsetting amounts recoverable against other compensation due a covered Section 16 officer).
- Disclosure of the mandatory clawback policy would be made as an exhibit to Form 10-K and disclosure of aggregate excess incentive-based compensation attributable to a financial restatement, and certain other related items, would be made in a company’s proxy.

To implement the Dodd-Frank mandatory clawback policy, the SEC would direct the national securities exchanges and national securities associations (“Securities Exchanges”) to establish listing standards that would require each listed company to develop a mandatory clawback policy and disclose the clawback policy in accordance with Section 954 of Dodd-Frank and SEC rules.

Companies listed on one of the Securities Exchanges would be required to implement a compliant clawback policy within 60 days after the effective date of the new listing standard.

Concerns Noted in Prior Comment Period

The initial comments on the Proposed Rule raised the following key concerns on the application of the Proposed Rule:

- The definition of “accounting restatement”
- The definition of incentive-based compensation includes financial reporting measures related to company stock price and total shareholder return on company stock

- The obligation to recover compensation is not triggered upon a clear, objectively determinable date, but, rather, is triggered upon the earlier of (i) the date the board concludes, or *reasonably should have concluded*, that the issuer's previously issued financial statements contain a material error (ii) or the date a court, regulator or other legal body directs restatement
- Recoupment would be required even if it would violate state law (e.g., those that prohibit recovery of previously paid compensation)
- Recovery of incentive-based compensation is on a pre-tax and not after-tax basis
- The Proposed Rule would apply retroactively

New Questions Raised by the SEC

The SEC is requesting comments on a series of questions posed in the release of the reopened comment period. These questions include the following:

- Should the definition of restatement include (1) restatements that correct errors that are material to previously issued financial statements **and** (2) restatements that correct errors that are not material to 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?
- Should the SEC change the standard used to determine when a company is required to issue a restatement that would trigger the three-year lookback period for identifying compensation subject to the clawback rule?
- Should companies disclose the methodology used to calculate recoverable amounts and amounts not recoverable (should disclosure also cover methodologies used to calculate the effect on stock price or total shareholder return)?

Timing and Implementation of Final Rule

The SEC is under no legal obligation to adopt a final rule within a specified time. However, the reopening of the comment period strongly suggests that the SEC, at the direction of Chair Gensler, has prioritized finalizing the mandatory clawback policy. We believe it is possible that the SEC could adopt a final rule as early as mid-2022. However, the SEC's adoption of the Final Rule would only mark the beginning of the implementation process. The Final Rule would become effective only after the completion of the following items:

- Securities Exchanges propose changes to their listing standards to incorporate the mandatory clawback requirement and file the proposed changes with the SEC.
- SEC approves proposed changes to listing standards.
- SEC approved changes to the listing standards become effective ("Effective Date").

Within 60 days of the Effective Date, each listed company must adopt a mandatory clawback policy.

If the SEC adopts the final rule mid-2022, then the date on which listed companies would have to comply with the new listing standards would likely occur sometime in 2023.

Listed companies would have to disclose their mandatory recoupment policy as exhibit to Form 10-K (i.e., date on which a listed company files its first Form 10-K on or after the effective date of listing standard).

Current State of Clawback Practices

Large public companies have not been standing idly by while awaiting the issuance of a Final Rule. Since the passage of Dodd-Frank, these companies have developed and adopted their own clawback policies. In 2021, approximately 98% of large public companies maintained clawback policies according to a Meridian study of 200 S&P 500 companies. Often, these clawback policies are patterned after the Dodd-Frank and Proposed Rule clawback mandate. For example, generally, these policies provide for the recoupment of excess incentive compensation paid to an executive officer during a specified lookback period as a result of an accounting restatement. However, the vast majority of public companies' clawback policies differ from the Dodd-Frank clawback mandate in the following respects:

Feature	Dodd-Frank	Typical Large Public Company Practice
Recovery of Excess Incentive Compensation	Mandatory	Discretionary
Responsibility for Restatement	No fault (excess incentive compensation paid to executive is recoverable regardless of whether executive misconduct was responsible for restatement)	Fault (excess incentive compensation paid to executive is recoverable only if executive misconduct was responsible for restatement)
Definition of Incentive Compensation	Includes compensation linked to share price or total shareholder return goals	Does not include compensation linked to share price or total shareholder return goals

We do not anticipate the reopening of the comment period will cause large public companies to modify existing clawback policies.

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