

THE SEC NEW OFFICER CLAWBACK RULE: WHAT SHOULD BE ON YOUR COMPLIANCE AND COMPENSATION RADAR

On Oct. 26, 2022, the U.S. Securities and Exchange Commission (SEC) adopted a rule (2022 Rule) imposing new disclosure obligations and executive compensation policies and practices on most companies that have securities listed for trading on national securities exchanges, such as the NYSE and NASDAQ. The 2022 Rule is titled “[Listing Standards for Recovery of Erroneously Awarded Compensation](#)” and implements a rulemaking mandated under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).

The concept of “clawback” first entered the lexicon of U.S.-based public companies in 2002 upon the enactment of the Sarbanes-Oxley Act. That law required CEOs and CFOs to pay back to their companies prior year incentive-based compensation and profits from any stock sales for the 12 months preceding their company’s restatement of a prior period caused by misconduct of anyone within the company. Congress spoke again with the enactment of Dodd-Frank, mandating that the SEC enact rules governing clawbacks of incentive-based compensation. The rules envisioned under Dodd-Frank would require an issuer to recover the portion of previously granted executive compensation that would not have been earned had there been no material error in the issuer’s reported results. Dodd-Frank directed the extension of the look-back period to three years and included all executive officers, not just the CEO and CFO. The SEC proposed Rules in 2015 but failed to adopt them. In anticipation of the 2015 rule’s adoption, many public companies adopted internal policies and procedures that would address seeking to “claw back” incentive-based executive compensation that mirrored the requirements of Dodd-Frank and the 2015 proposed rules.

The 2022 Rule greatly expands the anticipated scope of the required policies and imposes new disclosure obligations on issuers designed to ensure compliance with the new rule. The SEC’s 200-page-plus adopting release explains its policy decisions and intent behind the new regulation. Here are key takeaways of the 2022 Rule:

PEOPLE

Jill R. Polk

SERVICES AND INDUSTRIES

Securities Regulation and Litigation

- **Who must comply?** Any entity that has any security registered (equity, debt or other) and listed on any national exchange is subject to the 2022 Rule. According to the SEC, the new standards apply “without regard to the type of securities issued, including issuers of listed debt or preferred securities that do not have listed equity.”
- **What must be disclosed?** Issuers must disclose their compensation recovery policies as an exhibit to their annual reports, indicate in their annual reports whether the financial statements for that year contain a corrected error that required a recovery analysis, and disclose any actions taken pursuant to their recovery policies.
- **What triggers clawback obligations?** Under Sarbanes-Oxley, a restatement of a prior period’s financial statements triggered a clawback obligation if any misconduct within the company caused the restatement. The 2022 Rule applies to any restatement of an error, regardless of the cause. In addition to typical restatements of a prior period’s results, the 2022 Rule defines “restatement” to include “little r” restatements. Clawback obligations arise if there are corrections in the current reported financial results, whether or not they were material in the prior reported periods where: (i) the prior period corrections could have material impact on the current financial period if not corrected; or (ii) the correction of the prior error would be material to the company’s financial results in the current period. The SEC did concede, however, that out-of-period adjustments that are immaterial to the prior and current reporting periods do not trigger a duty to conduct compensation recovery analysis. The SEC also expressly noted that when assessing the materiality of the error, the issuer must weigh the impact on executive compensation as part of its qualitative factor assessment.
- **What time period applies?** The 2022 Rule obligates the issuer to seek a recovery from any “executive officer” receiving incentive-based compensation during the three-year period leading up the restatement decision. The SEC rejected comments that called for a bright-line rule that the three-year look-back period begins as of the date of the restatement decision. Instead, the period begins when the restatement decision was made or should have been made.
- **Who must repay the issuer?** The 2022 Rule’s definition of “executive officer” goes beyond the definition contained in Section 16 of the Exchange Act. In addition to traditional Section 16 officers, the rule covers an issuer’s principal accounting officer (or controller if there is no such accounting officer), as well as any officers of the issuer’s parent or subsidiary companies if they have important roles in the financial reporting process or policy making functions. There is no requirement that the “executive officer” in question had any role in the errors that

led to the restatement.

- **What must be recovered?** Under the 2022 Rule, all incentive-based compensation that is based, in whole or part, on any financial metric, including non-GAAP measures, is subject to recovery. If a restatement event occurs, the issuer must determine whether the compensation under the corrected numbers would have resulted in a smaller amount of incentive compensation. The issuer then must seek to recover the difference between the compensation paid and what the compensation would have been without the accounting errors. The recovery amount must be “computed without regard to taxes [the executive] paid.”
- **What discretion does an issuer’s board have in collection?** The 2022 Rule essentially strips a board of directors of any discretion whether to seek reimbursement. The SEC expressly rejected the application of the business judgment rule. The issuer is obligated to seek the recoverable amount, regardless of how small or whether it would be a cost-effective use of company resources to recover those amounts. While the 2022 Rule would exclude recovery that would be “impracticable,” the SEC views that few issuers would be able to meet this exclusion. The issuer would have to first make reasonable efforts to obtain recovery, even in those situations where the cost of recovery would exceed the expected recovery amount. Recovery would meet the impracticable standard if enforcement of the obligation would be banned by the home country in which the executive lives and in the case of certain retirement compensation.
- **When do issuers have to begin compliance?** Listed issuers have some time to prepare. The 2022 Rule will become effective 60 days after publication in the Federal Register, but listed issuers are not required to comply with the new rules until the corresponding national securities exchanges adopt and implement the required clawback listing standards. Exchanges have one year from the effective date of the 2022 Rule to have their updated listing standards in place. Issuers must adopt their mandated recovery policies within 60 days of the revised listing standards. Thereafter, the issuer must make the required disclosures in its proxy and periodic reports going forward.

Given the plain text of Dodd-Frank, the broad scope of the 2022 Rule and a variety of potential shortcuts taken in the adoption process, the question of whether the SEC overstepped its permissible regulatory authority will have to wait for the inevitable judicial challenges. Until then, issuers of U.S.-listed securities will have to begin the process of implementing new policies and procedures to ensure compliance with the 2022 Rule, mandated disclosures and the overall impact on the issuer’s executive compensation process. On top of that, the 2022 Rule creates multiple points that an issuer’s good faith



Armstrong
Teasdale

decisions can be challenged with the benefit of perfect 20/20 SEC hindsight.

Armstrong Teasdale's robust Securities Regulation and Litigation team has in-depth experience in this space, including time working for the SEC's Division of Enforcement. Please contact your regular AT lawyer or one of the authors listed below with any questions, or for further assistance.