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Comment Periods Close Again for Proposed Clawback and Pay-for-Performance Rules: A Refresher

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ALERTS

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Two Securities and Exchange Commission (SEC) executive compensation rules on recoupment of incentive compensation in the event of a financial restatement (clawbacks) and the correlation between executive pay and company performance (pay-for-performance), which were originally proposed in 2015 but never adopted, were reopened for public comment on October 14, 2021 and January 27, 2022, respectively. The proposed rules on clawbacks and pay-for-performance were intended to fulfill rulemaking requirements mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). In reopening the comment periods on these rules, the SEC also requested input on certain possible expansions to the original proposals in view of the time elapsed and developments in executive compensation since the original proposals.

As of March 4, 2022, the reopened comment periods on both proposed rules again closed. Although the SEC has not announced its timetable for moving forward, its renewed interest in these proposals suggests that final SEC rulemaking may be forthcoming as early as this year.

Clawbacks

Original Proposal

The SEC's 2015 clawback proposal calls for stock exchanges to require listed companies to have (and disclose) a policy to recover incentive compensation received by any current or former executive officer in the three years preceding an accounting restatement due to a material error in previous financial statements. There is no requirement for misconduct or that the officer be at fault in the restatement. This differs from the clawback policies currently in effect at many companies, which require misconduct before a clawback may be implemented.

The amount of recovery under the 2015 clawback proposal is the amount (pre-tax) received by the executive officer in excess of the amount that would have been paid based on the restated financial statements. Incentive compensation is defined to include compensation based on any financial measure (not just financial statement measures), including stock price or shareholder return.

Other significant aspects of the 2015 clawback proposal include:

- Recoupment is triggered when the board concludes or "reasonably should have concluded" there was a material error in the previous statements (or when a court, regulator or other legal body orders a restatement, if earlier).
- Boards have no discretion to waive the recoupment, allow it to be paid in installments, or indemnify an officer for the amount.

- Most companies would be subject to the rule, including emerging growth companies, smaller reporting companies, and foreign private issuers (but excluding some investment companies).
- The company would be required to file the clawback policy as an exhibit to its annual report and disclose its actions to enforce the policy, including completed, ongoing, and forgone recoveries, the executive officers involved, and the amounts to be recovered.

Questions Posed by the SEC Suggesting Possible Expansion

In its release reopening the comment period for the 2015 clawback proposal, the SEC asked for comments on the following additional questions under consideration, indicating that the SEC may expand certain areas of the original proposal:

- **Types of restatements.** Should the types of restatements triggering a clawback be broadened to include all required restatements made to correct an error in previously issued financial statements (not just those to correct a material error in the previous statements)?
  - The trigger would then include restatements due to errors that were not material to the previous statements but would result in a material misstatement if left uncorrected in the current report or the error correction was recognized in the current period.
  - The SEC noted that some companies reportedly "may not be making appropriate materiality determinations for errors identified" in order to not trigger a clawback, which the expansion of the definition would prevent.
- **"Reasonably should have concluded" standard.** The current standard for triggering the three-year lookback for potential recovery includes that the board either concluded or "reasonably should have concluded" that there was a material error in the previous statements. Does this standard introduce too much uncertainty into the determination? Should the "reasonably should have concluded" part of the standard be removed? Should another standard be applied?
- **Calculation of recovery amount.** Should the SEC add a requirement for companies to disclose how the recoverable amount was calculated?
- **10-K checkbox.** Should the cover of the 10-K include a checkbox indicating whether the filing contains a restatement and whether that restatement triggered a clawback?

Although these potential expansions are only under consideration and are phrased as questions in the SEC's reopening release, it is reasonable to assume that some or all of them may be reflected in the final rule.

Pay-for-Performance

Original Proposal

The SEC's 2015 pay-for-performance proposal called for a new Item 402(v) of Regulation S-K that would require a company's proxy or information statement to include a table of up to five years (three years for smaller reporting companies) showing:

- **Actual compensation for PEO and NEOs.** Executive compensation "actually" paid to the principal executive officer (PEO) and the average compensation "actually" paid to the remaining named executive officers (NEOs).
  - The amount "actually" paid equals the amount in the total compensation column in the summary compensation table (SCT), with a pension adjustment (to include actuarial service cost instead of the change in pension value) and an equity award adjustment (to include fair value on vesting date instead of on grant date).
- **Total compensation for PEO and NEOs.** The total executive compensation reported in the SCT for the PEO and an average of the total compensation amount for the remaining NEOs.
- **Company shareholder return.** The company's annual total shareholder return
- **Peer group shareholder return.** The annual TSR of the company's peers, either the peer group in the company's stock performance graph or its peer group for the purposes of the compensation discussion and analysis. Smaller reporting companies would be exempt from this peer return requirement.

In addition to the new table, companies would be required to describe the relationship between the executives' actual pay and the company's TSR, and the relationship between the company's TSR and the peer group's TSR. This disclosure could be in a narrative, a graphic, or a combination of the two.

Foreign private issuers, registered investment companies and emerging growth companies would not be subject to the new pay-for-performance requirement.

Additional Measures in Pay-for-Performance Rule Being Considered by SEC

In the release reopening the comment period for the pay-for-performance proposal, the SEC indicated that it is considering three additional measures that may be added to the pay-for-performance table contemplated by the 2015 proposal:

- **Pre-tax net income** as determined under generally accepted accounting principles (GAAP)
- **Net income** under GAAP
- **Company-Selected Measure**, which is a measure chosen by the company as its most important performance measure and not already included in the table

The SEC also would require that companies describe the relationship between the compensation actually paid to the executives and these three additional measures (just as it would for company TSR in the 2015 proposal).

The SEC further stated that it is considering requiring companies to designate the top five most important performance measures (in order of importance) that it uses to link executive compensation actually paid during the year to company performance. If a company uses fewer than five, disclosure would be limited to that lesser number. The SEC is considering requiring this disclosure to be in tabular form.

In the reopening release, the SEC proposed 22 questions, primarily relating to the new requirements under consideration as discussed above. Among others, these questions included:

- What disclosure should be required if different measures are important in different years or if measures are different for different NEOs?
- What cost would companies incur in identifying and ranking their five most important performance measures?
- Is there an alternative approach that would reduce the risk of misalignment of the time period in which compensation is actually paid with the time period of the associated financial performance?
- Should performance measures be limited to financial performance measures, or are there alternative performance measures (such as environmental, social, and governance [ESG] measures) that are used in executive compensation and should be included as well?

Next Steps

Companies should continue to monitor for further developments, including the SEC's final rulemaking on the clawback and pay-for-performance proposals. Companies should also consider briefing their boards on the SEC's activity in this area and the expectation of final rulemaking as early as this year.

Companies that have already adopted clawback policies intended to be responsive to the 2015 proposals may wish to review their policies in light of the expansions under consideration.

With respect to the pay-for-performance proposal, companies may begin to think about what measures would be included in their five most important measures linking pay to performance.

For more information on these proposed rules or any related matter, please contact any member of the firm's public company representation or employee benefits and compensation practices.