SEC Reminds Public Company Executives That Clawbacks Are a Priority

June 17, 2022

Last week was a busy week for the SEC on the clawback front:

- The Securities and Exchange Commission (the "SEC") reopened the comment period for the proposed clawback rules initially proposed in July 2015, signaling that final rules will follow the end of this third comment period on the proposal. After the final rules are issued and the securities exchanges adopt listing standards in accordance with the SEC's final rules, listed companies will be required to either amend existing clawback policies or adopt new policies in compliance with the exchanges' listing standards.
- The SEC continues to focus on clawbacks, announcing a settlement with a technology company and seven senior employees in connection with accounting-related misconduct leading to four years of accounting restatements. As part of this settlement, pursuant to the clawback provisions of the Sarbanes-Oxley Act of 2002 ("SOX 304"), the company's former CEO—although not personally charged with misconduct—reimbursed the company for prior bonuses and profits from the sale of stock, and returned equity awards.

In this client update, we discuss this recent SEC regulatory and enforcement activity on clawbacks in greater detail. We also offer some advice to our public company clients as we await final clawback rules from the SEC.

DÉJÀ VU: THE SEC RE-REOPENS THE COMMENT PERIOD FOR THE PROPOSED CLAWBACK RULES

On June 8, 2022, the SEC issued a release reopening the comment period for the clawback rules initially proposed in July 2015 to implement the provisions of Section 954 of the Dodd-Frank Act. The 2015 proposed rules would require securities exchanges to establish listing standards that would require public companies to develop, implement and disclose a clawback policy. This reopening release follows on the heels of the SEC's October 2021 reopening of the comment period for the proposed rules,

which closed on November 22, 2021.[1] Last week's re-reopening of the comment period is intended to allow interested persons to comment on the additional analysis and data provided in a memo from the SEC's Division of Economic and Risk Analysis ("DERA").

The SEC's DERA memo highlights the following findings related to the costs and benefits of the 2015 proposed rule:

- First, there has been an increase in the voluntary adoption of clawback policies by public companies. The staff memo notes that, in 2021, more than 46% of all affected filers disclosed the existence of a clawback policy, with an even higher percentage for S&P 500 companies. The SEC concludes that this increase in voluntary adoption of compensation recovery policies would reduce the anticipated benefits and also mitigate the anticipated costs of the proposed rules.

- Second, and perhaps not surprisingly, the total number of accounting restatements that may potentially result in a clawback would be increased if the proposed rules were extended to apply to all required restatements made to correct an error in previously issued financial statements (known as "little r" restatements), rather than only those restatements that correct errors that resulted in a material misstatement in previously issued financial statements (known as "Big R" restatements). The SEC estimates in the DERA memo that "little r" restatements may account for approximately three times as many restatements as "Big R" restatements in the prior year, not including SPAC restatements. The SEC also notes, however, that "little r" restatements may be less likely to trigger a potential clawback because, for example, they are less likely to be associated with a decline in previously reported net income and are accompanied by smaller stock price reactions. The SEC finds that the potential inclusion of "little r" restatements may increase both the benefits and costs of the proposed rules.

In last week's reopening release, the Commission again seeks comment on all aspects of the 2015 proposal, as well as on additional questions posed in the October 2021 reopening release. Similar to last week's DERA memo, the questions set forth in the October 2021 reopening release indicated that the final rules may be broader than the initially proposed rules, including topics such as (a) whether the scope of the proposed clawback rules should be expanded to include restatements beyond "Big R" restatements; (b) whether the final rules should provide better clarity around the events that trigger the three-year lookback period for ascertaining compensation subject to potential clawback; and (c) whether to add check boxes to the cover page of the Form 10-K to

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[1] Our client update on the 2015 proposed rules can be accessed here, and our debrief on the October 2021 reopening of the comment period for the proposed rules can be accessed here.

indicate whether the previously issued financial statements include an error correction and whether such restatements triggered a clawback.

The comment period for this latest reopening release will end 30 days following publication of the release in the Federal Register.

IN OTHER CLAWBACK NEWS: SOX 304 CLAWBACK SETTLEMENT

On June 7, 2022, the SEC announced that it had settled charges against a technology company and seven senior employees, including the former CEO of the company, in connection with accounting-related misconduct that resulted in the restatements of financial results during a four-year period. As part of the settlement, the former CEO, although not charged with misconduct, reimbursed the company for approximately $1.3 million in bonuses and profits from the sale of stock, and returned previously granted equity awards, pursuant to SOX 304. The other parties charged in the action also settled with the SEC and paid civil penalties in connection with their roles in the misconduct.

Under SOX 304, if a public issuer is required to prepare an accounting restatement due to material noncompliance of the issuer, because of misconduct, the CEO and CFO must reimburse the issuer for any bonus or other incentive-based or equity-based compensation received from the issuer during the 12-month period following the filing of the financial statement that the issuer is required to restate, along with any profits realized from the sale of securities of the issuer during that 12-month period. Notably, SOX 304 does not require that the CEO or CFO themselves had engaged in the misconduct to require the disgorgement.

Gurbir S. Grewal, Director of the SEC's Division of Enforcement, announced that the enforcement action should "put public company executives on notice that even when they are not charged with having a role in the misconduct at issue, we will still pursue clawbacks of compensation under SOX 304 to ensure they do not financially benefit from their company's improper accounting."

WHAT'S NEXT?

The SEC's actions last week have certainly put public company executives and boards of directors on notice regarding clawbacks. We offer some thoughts below with our predictions and guidance for the near term.

Final SEC Rules on Clawback Policies Coming…

With respect to the SEC's long-awaited clawback rules to implement provisions of Section 954 of Dodd-Frank, we expect the final rules will be promulgated by the end of the year. However, even if the SEC's final rules are published before year end, it seems unlikely that the securities exchanges' listing standards will be effective for the 2023 proxy season. After the SEC's final clawback rules are adopted, each securities exchange has 90 days to file its proposed listing standards implementing the final rules. The proposed listing standards are subject to SEC approval and must become effective within one year of publication of the SEC's final rules. Public companies then will have 60 days after the applicable listing standards become effective to amend their existing clawback policies or adopt new policies in compliance with the listing standards.

So what should companies with or without existing clawback policies do now?

Companies with existing clawback policies. As noted above, many public issuers already have adopted clawback policies. Clawbacks are often put in place as a matter of corporate governance or as a result of shareholder pressure. For example, shareholder advisory firms, such as Institutional Shareholder Services and Glass Lewis, take into account clawback policies in determining vote recommendations for public companies. After the SEC's final rules are issued, any issuer that has already adopted compensation recovery policies should examine its existing policies against the final rules to identify areas of likely change, including the applicable events that trigger clawback, the number of executives to whom the policy applies, the length of the applicable lookback window and any fault/misconduct requirements. After the securities exchanges adopt final listing standards, any existing clawback policy will need to be amended by the board of directors (or the applicable committee thereof) to comply with the listing standards within 60 days.

Companies without current clawback policies. For those public issuers that are awaiting final guidance before adopting a clawback policy, it may not be the best time to take action, unless otherwise deemed appropriate due to shareholder input or for other reasons. If a decision is made to adopt a clawback policy at this time, the board of directors should be aware that regulatory action is on the way. Once a clawback policy is adopted, there is something of a one-way ratchet on future amendments; shareholders do not want to see these policies become less stringent.

SOX 304 Continues to Apply

In the meantime, although the SEC has used its enforcement authority under SOX 304 infrequently, the provision remains in effect for public companies. Some in the market have speculated that we may see more SOX 304 clawback actions in the near term given the increase in restatements in the SPAC space. This remains to be seen. SOX 304, while

not requiring that the CEO or CFO themselves have engaged in misconduct, do require as a trigger for reimbursement the material noncompliance of the issuer, *as a result of misconduct*, with any financial reporting requirement under the securities laws, which is not necessarily implicated by the SPAC boom. Boards of directors and executive officers, however, should be on notice that this provision may apply in the event of a restatement due to improper accounting. Director Grewal emphasized in last week's press release that "when an issuer and its executives and employees engage in accounting gimmicks, we will use every available tool, including significant corporate penalties and individual accountability, to address such misconduct."

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Please do not hesitate to contact us with any questions.

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