

## SEC Comment Period Ends for Controversial Proposal Regarding Clawbacks of Executive Incentive Compensation Without Official Action

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On October 14, Chairman Gensler announced that the Securities and Exchange Commission (SEC) would reopen the comment period for the controversial compensation clawback rule that it had [initially proposed in 2015 in response to requirements of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (the "proposed clawback rule"). The proposed clawback rule would direct stock exchanges to require listed companies to implement a clawback policy for incentive-based compensation paid to executive officers when a company has to restate its financials in a wide range of circumstances, including instances where financials were merely found to contain errors due to human or other error. In revisiting the proposed clawback rule, Chairman Gensler [cited recent regulatory and market developments](#), noting, "I believe we have an opportunity to strengthen the transparency and quality of corporate financial statements as well as the accountability of corporate executives to their investors."

The proposed clawback rule, however, would require businesses to claw back incentive-based compensation granted to both current and former executives for as many as three years before a restatement occurs, with companies that do not comply facing delisting from stock exchanges. However, such clawbacks would only be required to go back as far as the calendar year in which the final rule became effective. For example, if the final rule becomes effective in the 2022 calendar year, an issuer would be required to claw back incentive-based compensation based on erroneous financial results ending December 31, 2022. This compliance date would be applicable regardless of when the issuer's stock exchange proposes its corresponding listing rules.

Significantly, the proposed clawback rule would define an accounting restatement as the process of a company revising previously issued financial statements to reflect the correction of errors that materially affect those statements, without delineating the types of errors that might be material to

investors. This approach is significant because it would not capture the types of revisions in which companies address minor errors, by correcting the issue in their subsequent financial statements.<sup>1</sup> Note, however, the SEC's request for additional feedback asked respondents to comment on whether the current definition of restatements requires broadening.

For reference, the proposed clawback rule currently includes the following key components:

- recovery of incentive-based compensation is triggered where a company is required to prepare an accounting restatement due to material non-compliance with any financial reporting requirements under US federal securities laws;
- applicable to any company listed on a national securities exchange or association and to all current or former executive officers (i.e., all "Section 16" officers, including the principal accounting officer) of such company, and more broadly to any other person who performs policy-making functions for such company;
- three-year look-back period from date of restatement;
- recovery on a "no fault" basis, leading to clawbacks regardless if any misconduct occurred or if the executive officer was not responsible for the misstated financial statements;
- compensation granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure, including stock price and total shareholder return, subject to recovery, with the amount recoverable based on what would have been paid absent a restatement;
- potential delisting for failure to adopt, disclose or enforce a clawback policy;
- prohibition of indemnifying against, or paying the premiums for an insurance policy to cover, losses incurred under the clawback policy; and
- certain required disclosures, including: (1) publicly filing the policy with the SEC; and (2) disclosure of events subject to or actions taken as a result of the clawback policy.

In reopening the comment period, the SEC asked that specific consideration be given to certain topics, including:

1. whether the SEC should expand the types of accounting restatements that would trigger application of the proposed clawback rule by interpreting "restatement" under the Dodd-Frank Act to include not only (1) those restatements to correct errors that are material to the previously issued financial statements that formed part of the proposed clawback rule, but also (2) additional restatements required to correct errors that would result in a material misstatement if

the errors were left uncorrected in the current report or the error correction was recognized in the current period;

2. whether recovery should be triggered on (1) the date a company's board, board committee or authorized officer (if board action is not required) concludes, or reasonably should have concluded, that the company's previously issued financial statements contain a material error; or (2) the date a court or regulator directs a company to restate its previously issued financial statements to correct a material error (with the SEC specifically asking commenters to opine on whether the "reasonably should have concluded" standard is too vague); and
3. whether to add check boxes to Form 10-K that indicate (1) whether the previously issued financial statements include an error correction; and (2) whether any such corrections are restatements that triggered a clawback analysis, along with other disclosures that might be useful to investors on restatements generally and the decision whether or not to claw back compensation.

The comment period was open from October 21 through November 22 and, to date, the SEC has not announced whether they will be extending the comment period or reviewing the comments received to date before publishing a final rule. If and when a final rule is adopted, stock exchanges also will be required to issue their own proposed listing rules effecting the policy, which will in turn need to be vetted and approved by the SEC, a process that often takes months.

To prepare for the possibility that the new rule takes effect, public company boards should be informed of the proposed clawback rule and its potential impact on existing incentive-based compensation plans. Companies also should consider how they will need to amend their existing clawback policies (or adopt new ones) to sufficiently address the requirements under the clawback rule, if and when adopted.

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<sup>1</sup> These types of revisions, sometimes called "little r" restatements, accounted for 75.7 percent of all restatements by US-based public companies in 2020, up from 34.8 percent in 2005, according to Audit Analytics. Major restatements, by comparison, represented just 24.3 percent of all restatements in 2020, which is down from 65.2 percent in 2005. However, note that the rise in "little r" restatements has attracted attention from the SEC, and based on recent SEC commentary, it seems likely that "little r" restatements will face greater scrutiny from the SEC in the future. As a result, this enhanced scrutiny may lead to a greater number of major restatements, which, in turn, may lead to an increase in scenarios where companies would need to claw back incentive-based compensation from executive officers.

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