Will Finalized Clawback Rules include a Broader Accounting Restatement Definition?

On June 8, 2022, the Securities and Exchange Commission once again reopened the comment period on its Proposed Rule on the Dodd-Frank mandatory clawback requirement, in part, to allow for comments on a memo issued by the SEC's Division of Economic and Risk Analysis.

The re-opening of the comment period indicates the SEC continues to evaluate components of the Proposed Rule. In particular, the SEC is examining whether to expand the scope of accounting restatements that could trigger a clawback.

Reopening of Comment Period

The SEC announced the original reopening of the comment period on October 14, 2021, which expired in November 2021.

The SEC re-opened the comment period for the second time on June 8, 2022 after issuance of a memo by the SEC's Division of Economic and Risk Analysis. Among other items, this memo provides estimates of the number of additional accounting restatements that would trigger a potential clawback if the Final Rule was revised to cover ***all required restatements*** correcting errors in previously issued financial statements (see Meridian Client Update dated July 10, 2015).

The SEC believes the information presented in the memo may be informative for evaluating the Proposed Rule. Therefore, the SEC re-opened the comment period for the Proposed Rule primarily to provide the public the opportunity to submit comments on the memo. The 30-day comment period ends on July 14, 2022.

Expanding Definition of Accounting Restatement

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).

The Proposed Rule definition of accounting restatement covers so-called "Big R" restatements, which is a subset of all possible restatements. The SEC is considering whether the Proposed Rule definition of restatement should be revised to cover so-called "little r" restatements. The combination of Big R and little r restatements would cover the full universe of possible required restatements that are required to correct errors in previously issued financial statements. A company's auditor is in the best position to explain the nuances between a Big R and little r restatements.

The memo examines the prevalence of various types of accounting restatements over certain time periods. The Division of Economic and Risk Analysis found that little r restatements were approximately 3 times as common as Big R restatements in 2021 (excluding SPACs). Thus, the memo concludes if the Final Rule includes both type of restatements in the definition of accounting restatement, it would substantially increase the number of restatements that could potentially trigger a recovery of compensation.

Timing and Implementation of Final Rule

The reopening of the comment period suggests the SEC continues to evaluate potential changes to the Proposed Rule. The SEC's recently released Reg Flex Agenda indicates that SEC Chair Gary Gensler intends for the SEC to adopt of a Final Rule by October 2022. However, the SEC is under no legal obligation to meet its published deadlines, and frequently does not.

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