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IS THE SEC CLAWBACK RULE UNLAWFUL?

Nasdaq and NYSE-listed companies must have a compensation recovery policy that complies with the Securities and Exchange Commission's clawback rule. The rule requires the clawback of executive compensation after an accounting restatement due to material noncompliance with financial reporting requirements. But the clawback rule exceeds its statutory authorization. The rule mandates clawbacks even after immaterial error corrections and even from non-executive officers. The statute authorizes neither of those types of clawbacks. The rule is unlawful. The SEC should revise the rule to comport with its statutory authority or a court should vacate the rule.

By Joel H. Trotter *

Every company listed on Nasdaq or the NYSE must have adopted a clawback policy that complies with the listing standards mandated by the Securities and Exchange Commission. Under the SEC's mandate, contained in Rule 10D-1, every listed company's clawback policy must require recovery of executive compensation after an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws.

Congress authorized a clawback rule that establishes specific prerequisites for a compensation clawback. But the SEC rule, effective in December 2023, requires clawbacks under circumstances that do not satisfy the statutory prerequisites. Instead, Rule 10D-1 mandates compensation clawbacks under circumstances that exceed Congress's statutory authorization and conflict with the unambiguous statutory text.

In particular, the authorizing statute conditions clawbacks on an issuer's material noncompliance with a financial reporting requirement. In contrast, the SEC's rule requires a clawback after an immaterial error correction that involves no publicly reported material error and therefore no material noncompliance with any financial reporting requirement. The SEC's own calculations indicate that this excess alone broadened the rule's scope by more than four times the scope that Congress authorized. The SEC's rule also broadens the scope of mandatory clawbacks to include a category of persons that the statutory text does not cover.

As a result, the SEC's clawback rule is unlawful. The SEC should revise the rule to comply with Congress's statutory authorization. Otherwise, a court should hold the rule unlawful and set it aside.

I. CONGRESS AUTHORIZED A MUCH NARROWER RULE THAN THE ONE THE SEC ADOPTED

A. The Clawback Rule Congress Authorized

Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (adding Section 10D to the Securities Exchange Act of 1934) mandated SEC rule-making to direct the national securities exchanges to prohibit the listing of any issuer that does not maintain an executive compensation clawback policy that satisfies Section 10D's requirements.

Section 10D authorizes a mandatory clawback policy that requires a listed issuer to recover incentive-based

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