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Exec Clawback Rule Changes Could Shift SEC Enforcement

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On Oct. 14, the U.S. Securities and Exchange Commission announced that it was reopening the comment period on proposed rules that would require exchange-listed public companies to claw back compensation from all of their executive officers in the wake of financial restatements.

The rules have yet to be adopted by the SEC, even though it was required to do so under Section 954 of the Dodd-Frank Act, a statutory provision that is more than 10 years old.[1] Such rules, if and when they are adopted by the SEC, could be a sea change in the use of clawbacks by exchange-listed companies against their executives, and could be a truly disruptive force in the management of corporations.[2]

While corporate America waits for the clawback shoe to drop after a rulemaking process that could last months, if not years, the SEC, in its role as a civil law enforcement agency, carries on its own obligations to claw back compensation pursuant to another provision of the federal securities laws — Section 304(a) of the Sarbanes-Oxley Act.[3]

There is little doubt that the developments over the coming months related to the Dodd-Frank rulemaking will cause the SEC to reevaluate how it uses Section 304 as an enforcement tool.

This likely reconsideration of Section 304 by the SEC has prompted us to explore the SEC's past use of Section 304 as a remedy in enforcement actions against corporate executives, and what to expect from the SEC's use of Section 304 in the ensuing months or years while the Dodd-Frank rulemaking process is underway.

Background

Section 304 requires CEOs and chief financial officers to return certain incentive-based compensation and stock sale profits to their companies in the wake of restatements of financial results caused by misconduct.[4]

Notably, because some courts have held that the misconduct required to trigger

Section 304 can be the misconduct of any employee or officer of the company, since 2009 the SEC has been enforcing Section 304 against CEOs and CFOs both when charging those individuals with their own misconduct and through so-called stand-alone actions, even if those officers were not found liable or even charged with any misconduct.

The SEC has only brought legal proceedings to enforce Section 304 against 79 CEOs and CFOs from 52 corporations[5] since the law was enacted 19 years ago, and only against 18 officers in the last five years. This is the case even though there are likely hundreds of instances since 2002 where Section 304 enforcement would have potentially been possible.

Uncertainty about whether courts would support the SEC's interpretation of Section 304 might explain the SEC's hesitancy to aggressively enforce Section 304 in the years immediately following the enactment of the provision. But several key court decisions supporting the SEC's enforcement of Section 304 since then have largely mooted such hesitancy, so the SEC's tepid enforcement of Section 304 in recent years is less easily explained.

Perhaps a more likely explanation for the SEC's failure to claw back executive compensation following restatements caused by misconduct is the long-standing disagreement within the securities law community over the fairness of enforcing the clawback provision against CEOs and CFOs not charged by the SEC for securities violations.[6]

However, with the recent change in administration, and in light of the SEC's Oct. 14 announcement that it is working to develop rules requiring exchange-listed companies to claw back compensation from a broader group of executives in the wake of restatements, the newly constituted SEC is likely to take a more aggressive approach toward enforcing the clawback provision in Sarbanes-Oxley.

As a result, we may see a substantial uptick in SEC efforts to claw back incentive-based compensation and stock sale profits from CEOs or CFOs, regardless of whether they have broader culpability in the eyes of the SEC.

Historical Use of Section 304 Clawbacks

The SEC's "first ever use of Section 304"[7] was in 2007, five years after Sarbanes-Oxley was enacted.

During Mary Schapiro's four-year tenure as SEC chair, the commission brought clawback actions against 32 corporate executives, and brought its first Section 304 case as a stand-alone clawback action against a CEO not alleged by the SEC to have been involved in the underlying misconduct.[8] The commission brought six more stand-alone actions during Schapiro's tenure as SEC chair.

Section 304 enforcement shifted significantly under SEC Chair Mary Jo White, who took the agency's helm in April 2013.

While White's SEC brought Section 304 actions against only 16 CEOs and CFOs during her four-year tenure, evenly split between Section 304 stand-alone actions and clawback claims included in traditional enforcement actions, the drop in actions from Schapiro's time at the SEC does not tell the whole story. Facing the real risk of a stand-alone Section 304 enforcement action by the SEC under White's leadership, 11 CEOs and CFOs voluntarily paid back incentive-based compensation or stock sale proceeds to the companies they served in order to avoid SEC legal action.

The commission under Chair Jay Clayton brought 13 Section 304 claims against CEOs and CFOs. Only one of those actions was a stand-alone claim, and just three CEOs voluntarily paid back incentive-based compensation or stock sales proceeds to avoid SEC actions.

The Future of Section 304

Despite the SEC's cautious utilization of Section 304 in the past 19 years, the appointment of Gary Gensler as chair of the SEC could mean renewed focus on Section 304 enforcement.

In fact, early in his career Gensler served as a senior adviser to former Sen. Paul Sarbanes, D-Md., and played a role in drafting the Sarbanes-Oxley Act. As a result, he may have an increased interest in enforcing its provisions.[9]

All early indicators suggest that enforcement under Gensler will be aggressive, and increasing enforcement of Section 304 against CEOs and CFOs will likely see an uptick.

While more aggressive enforcement is likely to lead to more litigation, such litigation does not necessarily translate into more or larger clawbacks. Our research indicates that of the 43 contested Section 304 actions brought against CEOs and CFOs to date, the SEC has obtained clawbacks from only 16 individuals through subsequent settlement or adjudication.

In addition, key aspects of Section 304 enforcement could change as well. For example, the commission might require larger Section 304 settlements, expand its interpretation of the term "misconduct" in Section 304 or bring more stand-alone enforcement actions than brought in the recent past.

Bigger Settlements

In settlements of Section 304 claims, the SEC has traditionally required CEOs or CFOs to pay only the amount of bonuses or stock sales that could be attributed to the increase in stock price caused by the financial misstatements.

To make this determination, the SEC utilizes event studies conducted by in-house economists, which are intended to "isolate the impact of an event, such as a fraudulent statement or a corrective disclosure, on a security's price," according to a 2009 paper on event studies by Mary K. Warren and Sterling P.A. Darling Jr.[10]

These event studies, whether conducted by the SEC's economists or those hired by defense counsel, usually result in Section 304 settlements that are much smaller than what the SEC usually pursues in litigation — the full amount of incentive-based compensation or stock sale proceeds received during the time period relevant under the statute.

Under Gensler, the SEC might insist in certain circumstances on CEOs and CFOs paying the full amount of a potential clawback, or some negotiated amount that is more than the amount of bonuses or stock sale proceeds that is purportedly attributable to misstated financial results. But, as just noted, this does not necessarily mean that the SEC will be successful in obtaining more onerous clawbacks.

Definition of Misconduct

In 2017, the U.S. Court of Appeals for the Fifth Circuit in SEC v. Life Partners Holding Inc. held that a

Section 304 clawback was required because the defendant knowingly used unreliable data, and was materially noncompliant with financial reporting requirements.[11]

Specifically, the Fifth Circuit found that the defendant's

> knowing use of materially underestimated [life expectancy estimates] rendered its financial statements [generally accepted accounting principles] noncompliant and thus also required a restatement.[12]

Following the Fifth Circuit's lead, in 2018 the U.S. District Court for the Southern District of Indiana found in SEC v. ITT Educational Services Inc. that in order to trigger clawbacks under Section 304, "the SEC must prove material noncompliance of the issuer, as a result of knowing wrongdoing, with financial reporting requirements under the securities law."[13]

Mindful of the courts' holdings, and consistent with its overall caution about Section 304 actions, the SEC will generally only pursue a Section 304 clawback if an individual, including an individual other than the CEO or CFO, is charged in an SEC action with an intentional violation of the federal securities laws, or if the individual's intentional conduct is imputed to the company and the company is charged in an SEC action.

The SEC under Gensler might question whether the holdings in Life Partners and other court decisions are as limiting as the SEC has treated them, or it might otherwise reject the SEC's past approach to the question of what constitutes misconduct under Section 304.

For example, must an individual be charged by the government civilly or criminally in order for the SEC to meet the misconduct element of a Section 304 claim? Would the settlement of a private securities action be enough to establish a showing of misconduct? After all, the SEC views its own settlements as a sufficient basis for showing misconduct, even though they are almost always settled on a neither-admit-nor-deny basis.

Second, given that the Fifth Circuit in Life Partners held that knowing noncompliance with financial reporting requirements can suffice to establish misconduct, must the misconduct involve a violation of the federal securities laws, or is a departure from U.S. generally accepted accounting principles a form of misconduct as well?

These questions at least raise the possibility that the SEC under Gensler might look to indicia other than an SEC enforcement action to determine whether misconduct occurred. Of course, such aggressive theories, if pursued by the SEC, might not withstand court scrutiny in a litigated case.

Increase in Stand-Alone Enforcement Actions and Decline in Voluntary Clawbacks

For a period of time, the SEC used the threat of stand-alone Section 304 enforcement actions to force CEOs and CFOs to make voluntary payments to the companies they served. In return, these CEOs and CFOs were able to avoid the damage of public SEC legal actions taken against them.

While it is reasonable to conclude that these voluntary payments accomplish exactly what Section 304 was designed to do, making enforcement actions unnecessary, a majority of the current commissioners might find them to be too lenient on CEOs and CFOs who they see as having benefited from misstated financial statements.

There is also reason to believe that the current commission supports stand-alone Section 304 actions, since four of the five sitting commissioners voted last year in favor of the most recent stand-alone action brought by the SEC.[14]

Given such support for stand-alone actions and a possible aversion to allowing voluntary clawback payments after the commencement of an SEC investigation, a Gensler-led commission may put an end to the perceived leniency afforded to CEOs and CFOs through voluntary payments, and instead bring enforcement actions against executives in most, if not all, instances.

Conclusion

The SEC's adoption of new rules requiring clawbacks from all executive officers of exchange-listed companies who restate their financial results could be a game changer for remedies in both governmental and private securities actions.

However, if ultimately adopted, those rules will not be on the books for many months. Nor will the new rules affect the thousands of public companies that are not listed on exchanges. For these reasons, CEOs and CFOs should not take their eyes off the potential Section 304 claims they might face.

In any SEC investigation involving a restatement, potential defendants should undertake to understand whether Section 304 clawbacks may be possible, and learn the often complicated facts concerning relevant CEO and CFO compensation and stock transactions.

It is also never too early to begin arming yourself with arguments around (1) the definition of "misconduct"; (2) whether a restatement was in fact required; or (3) whether the incentive-based compensation at issue was received within the relevant time period under Section 304 or possible Dodd-Frank rules, if and when they are adopted.

In those rare circumstances where a Section 304 claim appears to be a real possibility, CEOs and CFOs of exchange-listed companies and companies that otherwise have clawback policies should be considering whether and when to approach the company to negotiate a reasonable clawback, increasing the chances of taking Section 304 claims off the table. An economist can help build the arguments that will be necessary to fight back unreasonable clawback claims by the SEC or the officer's company.

All signs indicate that there will be significant changes in the coming months and years in how and when incentive-based compensation will be sought as remedies from the SEC and companies in legal actions. Companies and their executives should be prepared for the bumpy road ahead.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act § 954, 15 U.S.C. § 78j-4.

[2] Press Release, SEC, SEC Reopens Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation (Oct. 14, 2021), https://www.sec.gov/news/press-release/2021-210?utm_medium=email&utm_source=govdelivery; Public Statement, SEC, Statement on Rules Regarding Clawbacks of Erroneously Awarded Compensation (Oct. 14, 2021), https://www.sec.gov/news/public-statement/gensler-clawbacks-2021-10-14?utm_medium=email&utm_source=govdelivery.

[3] Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243.

[4] Id.

[5] Following attempts by shareholders to bring actions against CEOs and CFOs under Section 304, courts determined that there is no private right of action under Section 304, and that only the SEC has the power to enforce the provision. See, e.g., In re Digimarc Corp. Derivative Litig., 549 F.3d 1223, 1231-32 (9th Cir. 2008); Neer v. Pelino, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005) (utilizing the Cort analysis to determine that Section 304 does not contain a private right of action).

[6] See, e.g., Harvey Gilmore, After Ten Years, Sarbanes-Oxley Might Be Statutory Overkill, 25 Loy. Consumer L. Rev. 363, 374-377 (2013).

[7] Press Release, SEC, SEC Settles with Mercury Interactive and Sues Former Mercury Officers for Stock Option Backdating and Other Fraudulent Conduct (May 31, 2007), https://www.sec.gov/news/press/2007/2007-108.htm.

[8] SEC v. Jenkins, 718 F. Supp. 2d 1070, 1073 (D. Ariz. 2010).

[9] Press Release, SEC, Gary Gensler Sworn in as Member of the SEC (Apr. 17, 2021), https://www.sec.gov/news/press-release/2021-65.

[10] Mary K. Warren & Sterling P.A. Darling, Jr., The Expanding Role Of Event Studies In Federal Securities Litigation, 6 NO. 6 Sec. Litig. Rep. 19 (June 2009).

[11] SEC v. Life Partners Holdings, Inc., 854 F.3d 765, 786-789 (5th Cir. 2017).

[12] Id. at 788.

[13] SEC v. ITT Educ. Servs., Inc., 303 F. Supp. 3d 746, 790 (S.D. Ind. 2018).

[14] Final Commission Votes for Agency Proceedings, SEC (2020), https://www.sec.gov/about/commission-votes/annual/commission-votes-ap-2020.xml.