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SEC Corner

Securities and Exchange Commission Is Showing Its Claws with an Increased Focus on Recouping Executive Compensation

Scott F. Mascianica and Javan Porter*

In this article, the authors provide an overview of the compensation clawback provision within Section 304 of the Sarbanes–Oxley Act of 2002, a brief history of the Securities and Exchange Commission's use of the provision, and key applicability considerations.

The government's focus on clawbacks is at a fever pitch. At the Practicing Law Institute's recent "SEC Speaks" conference,[1] senior officials within the Division of Enforcement of the Securities and Exchange Commission ("SEC") emphasized the agency's increasing use of the executive compensation clawback provision under the Sarbanes–Oxley Act of 2002 ("SOX").

This comes on the heels of the SEC—once again—reopening comment[2] on a proposed rule for securities exchanges to require listed companies to adopt clawback policies and Deputy Attorney General Lisa Monaco's recent comments[3] around compensation clawbacks.

In response, this article provides an overview of the compensation clawback provision within SOX (Section 304), a brief history of the SEC's use of the provision, and key applicability considerations.

Overview of SOX Section 304

Under SOX Section 304:

> If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer

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and chief financial officer of the issuer shall reimburse the issuer for:

1. any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever occurs first) of the financial document embodying such financial reporting requirement; and
2. any profits realized from the sale of securities of the issuer during that 12-month period.[4]

A review of the legislative history for the provision emphasizes that this remedy was created to address concerns about management retaining "profits they receive as a result of misstatement of their company's financials. . . ."[5] As one court noted, an analysis of the legislative history reveals that the purpose of the statute was not to punish individual wrongdoing, but rather to create an equitable remedy that prevented executives from benefitting from company misconduct. A broader analysis of the Senate legislative history reveals the more expansive purpose behind the provision:

> Recent events have raised concern about management benefitting from unsound financial statements, many of which ultimately result in corporate restatements. The President has recommended that "CEOs or other officers should not be allowed to profit from erroneous financial statements," and that "CEO bonuses and other incentive-based forms of compensation [sh]ould be disgorged in cases of accounting restatement and misconduct."[6]

Title III includes provisions designed to prevent chief executive officers ("CEOs") or chief financial officers ("CFOs") from making large profits by selling company stock, or receiving company bonuses, while management is misleading the public and regulators about the poor health of the company. The bill requires that in the case of accounting restatements that result from material noncompliance with SEC financial reporting requirements, CEOs and CFOs must disgorge bonuses and other incentive-based compensation and profits on stock sales, if the non-compliance results from misconduct.[7]

As one court held, "the amount or reimbursement is not limited to income attributable to the wrongdoing of others."[8] This meshes with the rule's purpose that corporate officers "cannot simply keep their own hands clean, but must instead be vigilant in ensuring there are adequate controls to prevent misdeeds by underlings."[9]

SEC Use of SOX Section 304

Although the provision was implemented in 2002 in response to major corporate and accounting scandals, the SEC was initially reluctant to use the provision.[10] As one court noted, "[f]or reasons best known to the SEC, the Commission has been historically reluctant to utilize § 304 in the ten years since [SOX] was enacted."[11] The SEC first utilized the provision in 2007—and did so with a bang—when it disgorged[12] nearly $470 million from the former CEO and chair of a public health company in connection with a stock backdating matter.

After that the SEC utilized the provision with greater frequency under Chairs Mary Shapiro and Mary Jo White, filing scores of settled and litigated actions involving Section 304 clawback claims. Moreover, the agency started to bring more "standalone" claims under Section 304, meaning the CFO and/or CEO in question were not alleged to have engaged in any wrongdoing.[13] However, under prior SEC Chair Jay Clayton, the SEC utilized the provision far less, bringing only a dozen SOX Section 304 claims and pursuing only one standalone claim during his three-plus years at the helm.

Not surprisingly, the tide has shifted under SEC Chair Gary Gensler. Under his leadership, the SEC has increasingly pursued SOX Section 304 actions, including several high-profile standalone clawback actions totaling millions of dollars.[14] In a recent press release tied to one action, SEC Division of Enforcement Director Gurbir Grewal noted that the SEC is "committed to using SOX § 304 as Congress intended: to incentive a culture of compliance at public companies by ensuring that senior executives are not rewarded when their firms violate core reporting requirements. Executives should be on notice that we view SOX § 304 as broad authority in seeking all forms of compensation that should be reimbursed to the company."[15]

With this in mind, this article will try to answer three of the most pressing questions about SOX Section 304:

1. What, exactly, constitutes "misconduct" under the statute?
2. How are bonuses and trading profits calculated?
3. How have courts interpreted the "restatement" element of this provision, and what does this mean for "Big R"/ "little r" restatements?

What Constitutes "Misconduct"?

The SEC has historically argued—and courts have typically held—that SOX Section 304 does not require CEOs or CFOs to have personally engaged in the misconduct at issue to be required to disgorge profits under the statute.[16] As one district court held, "A CEO [or CFO] need not be personally aware of financial misconduct to have received additional compensation during the period of that misconduct and to have unfairly benefited from it."[17] Instead, as the U.S. Court of Appeals for the Ninth Circuit has held, "it is the issuer's misconduct that matters, and not the personal misconduct of the CEO or CFO."[18]

Concerning the issuer's misconduct, courts have found that it must be "sufficiently serious to result in material noncompliance with a financial reporting requirement under the securities laws."[19] But how serious? What mental state is necessary to reach "misconduct"? This has led several commentators to claim that the contours of "misconduct" remain a mystery. Although there is some truth to the opaque nature of the term, an analysis of SOX Section 304 case law reveals some breadcrumbs.

In a concurring opinion affirming the SEC's ability to utilize SOX Section 304, Ninth Circuit Judge Carlos Bea wrote that "in my view, 'misconduct' requires an intentional violation of a law or standard (such as GAAP [generally accepted accounting principles]) on the part of the issuer, which can be shown by evidence that any employee of the issuer (not only the CEO or CFO) acting within the course and scope of that employee's agency, intentionally violated a law or corporate standard."[20] Judge Bea analyzed the plain, dictionary definition of "misconduct" and the context of SOX Section 304 in light of SOX Section 302 (covering maintenance of internal controls). Judge Bea noted that CEOs and CFOs would be subject to disgorgement if their internal controls fail to prevent or detect "*intentional wrongdoing*."[21]

Additionally, the U.S. District Court for the Southern District of Indiana issued an opinion in 2018 that relied, in part, on Judge Bea's analysis to hold that the "SEC must prove material noncompliance of the issuer, as a result of *knowing wrongdoing*, with [a] financial reporting requirement under the securities laws."[22] The court went a step further to include the U.S. Court of Appeals for the Seventh Circuit's Criminal Pattern Jury Instructions around the definition of "knowingly," which means "that the defendant realized what he was doing and was aware of the nature of his conduct, and did not act through ignorance, mistake, or accident."[23]

Although this question is far from settled,[24] based on the ordinary, contemporary, and common meaning of the term "misconduct" and the existing case law addressing the issue, there is strong support for the view that misconduct requires "intentional" or "knowing" wrongdoing on the part of the issuer.

What Is the SEC's Approach to Calculating SOX Section 304 Disgorgement?

Under traditional violations of the federal securities laws, and in accordance with the U.S. Supreme Court's decision in *SEC v. Liu*, the SEC can typically obtain a reasonable approximation of a wrongdoer's net profits, provided such relief is awarded for the benefit of investors.[25] But the approach to SOX Section 304 calculations is different, a point emphasized by the legislative history.[26] As one commentator noted concerning the difference:

> Say that a CEO owns company stock that he had bought for $2 per share and sells that stock for $10 per share the day before the company's financials are restated. When the restated financials are published, the stock drops to $9 per share as a consequence of the disclosure. Under non [SOX] disgorgement principles, a court would attempt to separate out legal from illegal profits. Measuring the difference between the price at which the sale was effected ($10 per share) and the market price of the stock at a reasonable time after public dissemination of all material information regarding the fraudulent financial statements ($9 per share), the CEO would have to disgorge $1 per share. Under section 304, the CEO pays the company $8 per share, the difference between $10 and $2.[27]

Over the years, however, the SEC has permitted settling parties in certain instances to reimburse only the amount of bonuses or stock sale proceeds attributable to the impact of the misconduct, typically demonstrated through event studies and similar analyses.[28] However, during an exchange with former SEC Commissioner Dan Gallagher at SEC Speaks, SEC Chief Counsel Sam Waldon emphasized that the SEC intends to seek *all* compensation subject to SOX Section 304—not just the amount by which an officer's compensation was inflated because of the misconduct at issue. Using the example above, this would be the $8/share approach versus $1/share.

Accordingly, even though parties may have had success in the past using such tools as event studies to reduce the amount of clawback payments in a settled context, such approaches may not be viewed favorably by this Commission. Although we don't have specific statements on this issue from each of the SEC's Commissioners, available evidence suggests this Commission supports the full recovery approach. For example, in each of the standalone SOX Section 304 actions in 2022, the Commission approved these matters either unanimously or with near unanimous support.[29]

The manner in which the SEC seeks to calculate proceeds subject to clawback takes on amplified importance in light of *Cohen v. Viray*, whereby the U.S. Court of Appeals for the Second Circuit concluded a company cannot indemnify a former executive from any liability under SOX Section 304.[30] The court held that such a result would be an "end run-around" the provision and "fly in the face" of Congress' efforts to hold senior corporate officials accountable.[31]

What Type of Restatement Is Necessary to Trigger SOX Section 304?

According to the plain language of the statute, the provision is triggered when an issuer "is required to prepare an accounting restatement. . . ."[32] Although the SEC has argued that the provision applies when a restatement is merely required—not necessarily when one is actually prepared and filed—multiple courts have found that a material restatement is actually necessary to trigger the provision.[33]

Additionally, in *SEC v. Life Partners Holdings*, the U.S. Court of Appeals for the Fifth Circuit considered an appeal of a district court finding that a company's reliance on its auditor's revenue recognition methodologies—even with a company's "knowing" use of underestimated financial data—did not warrant reimbursement under SOX Section 304.[34] The Fifth Circuit reversed the district court's order, finding that "[a]s the language of the statute makes clear, it is not the actual issuance of a restatement that must be caused by misconduct; rather, it is the requirement of a restatement that must be 'due to the material noncompliance of the issuer, as a result of misconduct.'"[35] The Fifth Circuit found that the company's "restatements were not required solely because of its good-faith reliance on [the company's] auditor," and that company's "knowing use" of materially noncompliant financial metrics also required a restatement.[36] As the Fifth Circuit noted succinctly, the company's "actual motivation in issuing the restatement is of no moment."[37]

Regardless of the motivation for the restatements, if courts continue to find that actual restatements are necessary to trigger the provision, this naturally leads to the question of addressing the age-old concept of materiality. The topic of materiality in the context of restatements is timely in light of recent comments by SEC Chief Accountant Paul Munter[38] highlighting concerns about the increased use of "little r" restatements by issuers compared to "Big R" restatements. Generally speaking, "little r" restatements—also known as "revisions"—occur when an error is immaterial to prior period financial statements but would result in a material error to current period financial statements. By comparison, "Big R" restatements—also known as "reissuances"—occur when an error is material to prior period financial statements. According to Munter, "little r" restatements accounted for 76 percent of all restatements in 2020, up from 35 percent in 2005. The recent memo by the Division of Economic and Risk Analysis[39] in connection with the exchange-listing clawback policy proposal includes similar conclusions.

Along these lines, a recent SOX Section 304 case in the U.S. District Court for the District of Maryland specifically addressed the question of whether a restatement need be "material" to implicate SOX Section 304.[40] In its motion for reconsideration, a defendant noted the prior SOX Section 304 judgment in the SEC's favor was a clear error because a genuine issue of material fact existed as to whether noncompliance with certain financial reporting requirements were material.[41] The court agreed, finding that material noncompliance with regard to a certain period could not be determined at the summary judgment stage.[42]

The materiality threshold for SOX Section 304 clawbacks bears watching for several reasons. First, in light of the increased use of "little r" restatements and concerns from the SEC's Chief Accountant, it remains to be seen if the agency will challenge these type of restatements going forward, potentially triggering "Big R" restatements and opening the door for, among other things, SOX Section 304 exposure. Second, the exchange-listing clawback policy proposal specifically contemplates "little r" restatement triggers.[43] If ultimately adopted, it is possible that "little r" restatements—even if not a trigger for SOX Section 304—could trigger certain aspects of the new rule.

Notes

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1. https://www.pli.edu/programs/the-sec-speaks?t=live&p=333344&utm_source=sfmc&utm_term=%25%25program_name%25%25&utm_content=99145&utm_id=8d2ca580-b58a-4867-9484-2f19b847ec32&sfmc_id=78873092&sfmc_activityid=95c6f5a8-cd3c-4b0f-8bf4-b6e82368e5dc&utm_medium=email&utm_campaign=2020RegJY%20-%208AEM2%20-%20Reminder.

2. https://www.sec.gov/rules/proposed/2022/33-11071.pdf.

3. https://www.justice.gov/opa/speech/deputy-attorney-general-lisa-o-monaco-delivers-remarks-corporate-criminal-enforcement.

4. 15 U.S.C. § 7243(a).

5. Senate Report 107-205, 2002 WL 1443523, at *23 (2002).

6. *See SEC v. Jensen*, 835 F.3d 1100, 1115-1116 (9th Cir. 2016) (comparing legislative history of House Bill 3763 and Senate Bill 2673 in analysis of misconduct required under SOX Section 304).

7. Senate Report 107-205, 2002 WL 1443523, at *23.

8. *SEC v. Baker*, No. A-12-CA-285-SS, 2012 WL 5499497, at *6 (W.D. Tex. Nov. 13, 2012).

9. *Id.*

10. Numerous private plaintiffs did try to utilize § 304 but courts found that no private right of action existed. *See, e.g.*, *In re Digimarc Corp. Derivative Litig.*, 549 F.3d 1223, 1233 (9th Cir. 2008) ("Accordingly, we cannot find in Congress' silence in section 304 an intent to create a private right of action

where it was not silent in creating such a right to similar equitable remedies in other sections of the same Act.”).

11. *Id.*

12. https://www.sec.gov/news/press/2007/2007-255.htm.

13. *SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1074-75 (D. Ariz. 2010). Notably, the House Report on the proposed bill that ultimately became SOX contemplated some scienter requirement before disgorgement could be imposed. H.R. 3763, 107th Cong. (2002). The final law omitted the scienter requirement proposed by the House Committee.

14. *See, e.g.*, *In the Matter of Stephen G. Waldis*, AP File No. 3-20888 (June 7, 2022).

15. Given that repayment does not go to the Treasury or investors, but rather back to the issuer, there have been instances where the SEC has declined to pursue SOX Section 304 claims where executives have voluntarily reimbursed the company. *See, e.g.*, https://www.sec.gov/news/press-release/2016-25.

16. *Jensen*, 835 F.3d at 1115; *SEC v. Microtune*, 783 F. Supp. 2d 867, 886 (N.D. Tex. 2011) (finding that “Section 304 contains no personal wrongdoing element”).

17. *Jenkins*, 718 F. Supp. 2d at 1074-75.

18. *Jensen*, 835 F.3d at 1114.

19. *SEC v. ITT Educ. Serv., et al.*, 303 F. Supp. 3d 746, 788-89 (S.D. Ind. 2018) (quoting *SEC v. Jenkins*, 718 F. Supp. 2d 1070, 1075 (D. Ariz. 2010)).

20. *Jensen*, 835 F. 3d at 1122-23.

21. *Id.* (emphasis added).

22. *ITT Educ. Serv.*, 303 F. Supp. 3d at 789-90 (emphasis added).

23. *Id.*; *see also SEC v. Life Partners Holdings, Inc.*, 854 F.3d 765, 788 (5th Cir. 2017) (finding that restatement was also caused by the issuer’s “knowing use of materially short [life expectancies],” and therefore, “misconduct” had occurred.).

24. *Cf. In re iBasis, Inc. Derivative Litig.*, 532 F. Supp. 2d 214, 224 (D. Mass. 2007) (in dictum, noting “Section 304 does not elaborate on what sort of misconduct is necessary, so the pay back remedy could be applied if any misconduct, however slight, leads to an accounting restatement.”).

25. Note that the recent passage of Section 21(d)(7) of the Exchange Act provides the SEC a separate avenue for obtaining disgorgement. Unlike “equitable disgorgement,” this provision does not include “for the benefit of investors” language. Even under this provision, the SEC has signaled an approach to continue to only seek the net profits from wrongdoers.

26. “For a securities law violation, currently an individual may be ordered to disgorge funds that he or she received ‘as a result of the violation.’ Rather than limiting disgorgement to these gains, the bill will permit courts to impose any equitable relief necessary or appropriate to protect and mitigate harm to investors.” S. Rep. No. 107-205, at 27, 2002 WL 1443523 (July 3, 2002).

27. Rachael A. Schwartz, "The Clawback Provision of Sarbanes–Oxley: An Underutilized Incentive to Keep the Corporate House Clean," The Business Lawyer, Vol. 64, No. 1, at 15 (Nov. 2008).

28. It should be noted that efforts by executives to reduce the amounts owed under SOX Section 304 due to "the small magnitude of the restatement" compared to earnings and assets for the restatement years have not been received favorably by courts. *See, e.g.*, *SEC v. Life Partners Holdings, Inc.*, 1:12-CV-33-RP, 2018 WL 5733137 (W.D. Tex. Sept. 28, 2018).

29. https://www.sec.gov/about/commission-votes/annual/commission-votes-ap-2022.xml.

30. *See Cohen v. Viray*, 622 F.3d 188, 196 (2d Cir. 2010).

31. *Id.* at 195.

32. 15 U.S.C. Section 7243(a).

33. *See, e.g.*, *SEC v. AgFeed Industries*, No. 3:14-cv-00663, 2016 WL 10934942, at *27 (M.D. Tenn. July 21, 2016) (finding that because defendant entity filed for bankruptcy protection instead of filing a restatement, SOX Section 304 did not apply); *SEC v. Shanahan*, 624 F. Supp. 2d 1072, 1078 (E.D. Mo. 2008) (granting summary judgment for defendant on SOX Section 304 claim because issuer did not file a restatement and "the ordinary, contemporary, common meaning of Section 304 is that, before penalties may be imposed, an issuer must be compelled or ordered to prepare a financial restatement, and must actually file the restatement)."

34. 854 F.3d 765 (5th Cir. 2017).

35. *Id.* at 788.

36. *Id.*

37. *Id.*

38. https://www.sec.gov/news/statement/munter-statement-assessing-materiality-030922.

39. https://www.sec.gov/comments/s7-12-15/s71215-20130560-298718.pdf.

40. *See SEC v. Jacoby*, No. CCB-17-3230, 2021 WL 4478722 (D. Md. Sept. 30, 2021).

41. *Id.* at *2.

42. *Id.*

43. "As discussed in the Reopening Release, the Commission is considering whether the term 'an accounting restatement due to material noncompliance' should be interpreted to include restatements that correct errors that resulted in a material misstatement in previously issued financial statements (commonly referred to as 'Big R' restatements) as well as restatements that correct errors that would only result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period (commonly referred to as 'little r' restatements) as triggers for a compensation recovery analysis."