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SECURITIES LITIGATION | A SPECIAL REPORT

Litigators who focus on securities enforcement and appellate law take the pulse of the courts this week on significant trends involving the U.S. Securities and Exchange Commission. More and more cases test the constitutionality of the agency's administrative law judges, and the commission is fashioning a new norm for clawbacks that target executive bonus compensation. Plus, a look at the challenges posed by securities that are listed on more than one exchange.

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Bonus Compensation Clawbacks Are New Norm

Top executives are forced to give back money even when the SEC doesn't allege personal misconduct.

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In an emerging trend, chief executive officers and chief financial officers of companies settling U.S. Securities and Exchange Commission financial reporting cases are personally paying back bonuses and other incentive-based compensation, despite the absence of accusations of personal misconduct or formal SEC actions against them individually.

Already in 2016, several top executives have returned compensation—from tens of thousands to millions of dollars—after their companies allegedly engaged in accounting improprieties.

These payments reflect increasing acceptance of a new reality where the SEC expects chief executives and chief financial officers to be financially accountable for any misconduct—fraudulent or not—resulting in a restatement, even where they are not directly involved.

And if those executives do not voluntarily return all incentive-based compensation received in the year following a restated period, they will likely face an SEC enforcement action.

Moreover, the SEC is not content to limit reimbursement to top executives. Under a recently proposed rule, numerous other officers will soon be in the clawback crosshairs.

This increased demand for executive compensation clawbacks is particularly significant as the SEC pursues accounting misconduct with a renewed vigor. The heightened focus on financial reporting fraud is reflected in the SEC Division of Enforcement's recent case filings, comprising about 20 percent of the division's 2015 filings, compared to 13 percent in 2013.

If recent announcements portend a trend, the SEC will routinely pursue clawbacks in accounting cases.

STRICT LIABILITY FOR CEOS AND CFOS

An emphasis on voluntary clawbacks is the latest development in the SEC's evolving enforcement of Sarbanes-Oxley Section 304.

Section 304, enacted in 2002, provides that if an issuer "is required to prepare an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," the chief executive and chief financial officer shall reimburse the issuer for any bonus or other incentive-based or equity-based compensation received, and any profits from selling the issuer's securities, during the year following issuance of the financial report.

Section 304 provides for clawing back such compensation regardless of whether the chief executive or chief financial officer was involved in any misconduct, or whether that misconduct involved fraud.

For years the SEC exercised its discretion to enforce Section 304 sparingly, and only when chief executives and chief financial officers were personally implicated in misconduct.

That changed in 2009 when the SEC sued Maynard Jenkins, former chief executive of CSK Auto Corp., seeking to claw back more than $4 million in compensation, without any allegation that Jenkins was personally involved in the company's financial misconduct.

"CEOs should know that they can be deprived of bonuses or stock profits they received while accounting fraud was occurring on their watch," Robert Khuzami, then-director of the SEC's Division of Enforcement, said in a statement.

Jenkins moved to dismiss, but the district court denied Jenkins' motion, holding that Section 304 "require[s] only the misconduct of the issuer, but do[es] not necessarily require the specific misconduct of the issuer's CEO or CFO." This decision confirmed the SEC's power to effectively impose strict liability on chief executives and chief financial officers to encourage those executives to be particularly attuned to internal controls and financial reporting.

As the SEC has recently refocused its efforts on financial reporting, it has repeatedly asserted this clawback authority, whether the targeted chief executive or chief financial officer was complicit in misconduct or not.

In 2014, the SEC sought repayment of $2.5 million from Saba Software Inc.'s chief executive based on allegations that two vice presidents falsified Saba's books and records. The commission last year followed up with a separate clawback action against two former Saba chief financial officers. Also in 2015, the former chief executive and chief financial officer of Computer Sciences Corp. agreed to return more than $4 million based on allegations that the company had concealed losses.

Companies and their top executives have apparently gotten the commission's message.

Although SEC press releases this year continue to reflect an emphasis on clawbacks, in many cases the SEC is not bringing formal Section 304 actions because companies have already reclaimed the funds.

The former Logitech International S.A. chief executive, for example, was not named in the SEC's complaint against Logitech and other officers. But the SEC nevertheless noted in its April 19 press release that, pursuant to Section 304, the chief executive "returned $194,487 in incentive-based compensation and stock sale profits received during the period of accounting violations."

Similarly, in announcing Monsanto Co.'s agreement to pay an $80 million penalty to resolve charges alleging that the company misstated its earnings, the SEC noted that "it wasn't necessary

for the SEC to pursue a clawback action under Section 304" because the chief executive and chief financial officer already "reimbursed the company $3,165,852 and $728,843, respectively, for cash bonuses and certain stock awards they received during the period when the company committed accounting violations."

The SEC acknowledged that its investigation found no personal misconduct by either officer.

Nor did the SEC allege any misconduct by Marrone Bio Innovations Inc.'s chief executive or former chief financial officer when it charged the company and its former chief operating officer with inflating financial results. Again, the SEC simply noted that both had reimbursed the company for their incentive-based compensation in the period following the company's misstated financials "[a]s required by Section 304(a)."

At the same time, the SEC affirmed that chief executives and chief financial officers who do not voluntarily pay can expect to be named in enforcement actions. Thus, the SEC's March 15, 2016, cease and desist order against ModusLink Global Solutions Inc. named the former chief executive and chief financial officer, and concluded that, although the SEC "does not allege that [either] participated in misconduct," their failure to reimburse the issuer violated Section 304.

Both were ordered to repay incentive-based compensation and return shares or the cash equivalent value received.

EXPANDING NO-FAULT CLAWBACKS

Consistent with its increased emphasis on Sarbanes-Oxley clawbacks, on July 1, 2015, the SEC proposed a rule implementing Section 954 of the Dodd-Frank Act. Proposed Rule 10-D1 directs national securities exchanges to require listed companies to adopt, implement and disclose broad clawback policies. Those policies must dictate recovery of "excess incentive-based compensation" paid to "executive officers" during the three years prior to restatement of a material error, without regard to whether the officer committed any misconduct.

The recoverable amount under proposed Rule 10-D1 is more circumscribed than under Section 304. "Excess" compensation under the proposed rule includes only compensation awarded because the company appeared to achieve a financial benchmark that was not actually reached based on the restatement, whereas Section 304 requires reimbursement of any incentive-based compensation.

But in other ways Rule 10-D1, which may become effective as early as the end of this year, goes further than Section 304.

"Executive officers" subject to clawbacks under the proposed rule include not only the issuer's president and principal financial officer, but also the company's principal accounting officer, vice presidents in charge of principal business units, and any other person performing significant policy-making functions.

Rule 10-D1 would also mandate clawbacks over a longer period: three years prior to the date the company, a court or a regulator determines that a restatement is required—versus only one year following the erroneous financial report under Section 304.

The SEC has not only established a new norm where top corporate executives are repaying incentive-based compensation without SEC intervention, but also aims to subject more executives to similar clawbacks over a longer time.

While ratcheting up the personal cost of restatements may further incentivize executives' attention to financial reporting, it expands the SEC's power to impose liability on executives for conduct in which they played no role. The effectiveness of this policy in preventing financial reporting misconduct remains to be seen.

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