INSIGHTS

The Corporate & Securities Law Advisor

VOLUME 37, NUMBER 4, APRIL 2023

POLITICS

CLIMATE DISCLOSURE

BOARD AND OFFICER OVERSIGHT

REGULATION D

SEC ENFORCEMENT

INSIDER TRADING AND WHITE COLLAR CRIME

EXECUTIVE PAY

Wolters Kluwer
www.WoltersKluwerLR.com

INSIGHTS

The Corporate & Securities Law Advisor

Editor-in-Chief
BROC ROMANEK
broc.romanek@gmail.com

EDITORIAL OFFICE
28 Liberty Street,
New York, NY 10005
212-771-0600

Wolters Kluwer
Richard Rubin, Publisher
Jayne Lease, Managing Editor

INSIGHTS (ISSN No. 0894-3524) is published monthly by Wolters Kluwer, 28 Liberty Street, New York, NY 10005. To subscribe, call 1-800-638-8437. For customer service, call 1-800-234-1660 or visit www.wolterskluwerlr.com.

For article reprints and reprint quotes contact *Wrights Media* at 1-877-652-5295 or go to *www.wrightsmedia.com.*

SEC ENFORCEMENT

SEC Enforcement Activity Destabilizes Corporate Governance Related to Incentive Compensation

By Paul N. Monnin and Jason Sigalos

Recent pronouncements and enforcement activity by the US Department of Justice (DOJ) and US Securities and Exchange Commission (SEC) reflect a singular agency focus on the importance of clawing back incentive compensation after instances of executive misconduct, even if how these agencies compel companies to do so may have unintended consequences.

In a September 15, 2022 speech that accompanied the release of updated corporate enforcement policies, Deputy Attorney General Lisa Monaco disclosed that the DOJ will consider whether corporate compensation systems incorporate clawback provisions when deciding whether a company has effectively mitigated actual and potential future misconduct.[1] This was followed by the SEC's October 26, 2022 adoption of final rules obligating exchange-listed companies to adopt policies facilitating the clawback of incentive-based compensation erroneously awarded to current or former executive officers, including instances of corporate misconduct.[2]

On January 9, 2023, the SEC released an administrative enforcement order disclosing that the respondent company had agreed to settle the SEC's contention that it had violated the SEC's proxy rules by failing to disclose its rationale for allowing its former CEO, after admitting to having violated the company's code of conduct, to resign from the company while keeping his equity and incentive compensation.[3]

Collectively, this recent agency activity demonstrates that the leading federal business conduct regulators intend to police corporate decisions regarding (1) whether to claw back executive compensation from former and current executives; and (2) even more intrusively, whether corporate boards have appropriately disclosed their rationale in deciding to forgo their clawback rights.

In the enforcement order, the SEC sanctioned the respondent company for failing to disclose in its 2020 proxy statement that the board had exercised discretion in terminating the former CEO without cause, enabling him to retain nearly $48 million in incentive compensation. This determination was made after an internal investigation revealed the CEO had engaged in a consensual relationship with another employee in violation of company policy.

The SEC charged that the company's failure to disclose in its ensuing proxy statement that it could have terminated the former CEO for cause but instead exercised its discretion to allow him to retain his equity-based compensation violated Exchange Act Section 14(a) and Exchange Act Rule 14a-3, both anti-fraud provisions related to proxy solicitations.

While the company was enjoined from future proxy violations, the SEC did not order any financial remedies in light of the company's substantial cooperation with the SEC's enforcement investigation and given that it was able to claw back the CEO's incentive compensation in a parallel state court action after the company became aware its former CEO had engaged in other, previously undisclosed workplace relationships. But this is a unique circumstance that did not factor into the company's initial exercise of discretion regarding the executive's incentive compensation.

This enforcement action evidences that the SEC, along with the DOJ, may actively inquire into

Paul N. Monnin *and* **Jason Sigalos** *are attorneys of Alston & Bird LLP.*

whether companies clawed back incentive compensation once they learned of executive misconduct, and if they failed to exercise their clawback rights, whether they gave their shareholders insight into their decisionmaking process. Notably, two commissioners dissented from the SEC's enforcement action.[4] They noted that the SEC's use of its proxy rules to expand corporate disclosure obligations for the exercise of clawback rights "creates a slippery slope."

Requiring a corporate board to disclose in a proxy statement how it exercised its discretion by allowing a corporate officer to resign with his incentive compensation intact, even after allegations of misconduct, is plainly a roadmap to a derivative claim. Indeed, the fact of an SEC enforcement order for failure to disclose how a board exercised its clawback discretion suggests that at least an informal enforcement inquiry could follow a future c-suite officer resignation unaccompanied by a clawback disclosure.

Even more destabilizing than the risk of derivative litigation or an enforcement inquiry is the fact that the SEC is expanding settled proxy disclosure requirements through enforcement, rather than rulemaking or formal guidance. This creates a moving target. Companies may choose to disclose more information, potentially including privileged information, about clawback decisions than may be necessary to ward off enforcement. This concurrently, and perversely, increases the risk of a regulatory inquiry into why incentive compensation was clawed back or a derivative demand related to board oversight of the underlying misconduct. Or boards may choose not to part ways with executives who engaged in misconduct to avoid having to address clawback disclosure issues altogether.

The destabilizing regulatory and derivative risk generated by the SEC's recent enforcement action means that companies and their audit committees will have yet one more thing to think about as they conduct internal investigations into suspected executive misconduct. For its part, the SEC has cast the die in favor of disclosure of clawback deliberations regardless of whether this may lead to expanded and expensive enforcement or derivative claim activity.

Notes

1. *https://www.justice.gov/opa/speech/deputy-attorney-general-lisa-o-monaco-delivers-remarks-corporate-criminal-enforcement.*
2. *https://www.alston.com/-/media/files/insights/publications/2022/12/wenzel.pdf?sc_lang=en&hash=731A0365 4BA506D71BA3923DB6B8379B.*
3. *https://www.sec.gov/litigation/admin/2023/33-11144.pdf.*
4. *https://www.sec.gov/news/statement/peirce-uyeda-easterbrook-mcdonalds-202301.*