

SEC FLASH REPORT

SEC Enforcement of Sarbanes-Oxley Clawback Provisions against an Executive Who Did Not Engage in Wrongdoing Raises the Stakes for Internal Control over Financial Reporting

Increases the Cost of Fraud and Restatements and Exposure to Executives

July 27, 2009

On July 22, 2009, the Securities and Exchange Commission (SEC) asked a court to order the former chief executive officer of a large specialty retailer of auto parts and accessories to reimburse the company and its shareholders more than \$4 million that he received in bonuses and stock sale profits while the company was committing accounting fraud in which he was not personally implicated. Section 304 of the Sarbanes-Oxley Act addresses the forfeiture of certain bonuses and profits. Section 304 states:

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 and chief financial officer 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 first occurs) 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.

The SEC's enforcement action is significant because it is the first action seeking reimbursement under the Section 304 "clawback" provisions from an individual who *is not alleged* to have otherwise violated the securities laws. While there is sufficient ambiguity in the statute, as referenced above, to allow an interpretation that it may be applied regardless of whether the executives are culpable of matters causing a restatement, the question remains whether the SEC can make this action stand in a court proceeding. The context of Section 304 is that it is an integral part of legislation passed by Congress to combat corporate fraud in the aftermath of accounting scandals at Enron Corporation and WorldCom. However, the language of Section 304 doesn't specify whether the executives must be involved in wrongdoing.

The SEC's Policy Change Raises the Stakes

The Commission's press release is posted at <http://www.sec.gov/news/press/2009/2009-167.htm>. In the press release, the SEC's rationale was articulated by the Director of the SEC's Division of Enforcement. He stated that the CEO was the "captain of the ship and profited during the time that [the company] was misleading investors about the company's financial health." He further stated that "the costs of such misconduct need not be borne by shareholders alone." This broad view reflects a literal interpretation of the statute in that it requires a CEO to return personal compensation to the company he or she serves while that company engages in wrongdoing. Needless to say, this change in policy reflects an aggressive stance by the Commission to require a CEO to forfeit profits from a fraud he or she didn't orchestrate. Until now, the SEC has only applied the statute to executives who helped conduct fraud schemes.

Approved by a split vote along party lines, this policy change may indicate that the Commission is applying a higher level of accountability to chief executive and chief financial officers in the wake of the financial crisis. A policy change of this nature would raise the stakes for executives of companies facing potential restatements. It would raise the question whether the SEC would limit the application of the clawback provisions solely to matters involving fraud, or extend it to restatements caused by other types of issues as well. Only time will tell whether this application of the Sarbanes-Oxley clawback provisions will become standard enforcement action whenever there is a restatement. If it does and such actions can be sustained in a court of law, executives may want to factor this risk into their assessment of the risk of fraud and accounting misstatements as well as their evaluation of the effectiveness of internal control over financial reporting.

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