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CLARIFYING THE ORIGINAL CLAWBACK: INTERPRETING SARBANES–OXLEY SECTION 304 THROUGH THE LENS OF DODD–FRANK SECTION 954

J. ROYCE FICHTNER,* PATRICK HEASTON,** AND LOU ANN SIMPSON***

I. Introduction 1
II. Sarbanes–Oxley Section 304 and its Ambiguities 4
III. The Dodd–Frank Section 954 Clawback 8
IV. Section 304 Ambiguity: When is the Issuer Required to Issue a Restatement? 10
V. Section 304 Ambiguity: Defining "Material Noncompliance"..................... 14
VI. Section 304 Ambiguity: When is Incentive-Based Compensation Deemed "Received"? 17
VII. Significant Questions Left Unanswered in Section 304............................. 19
A. Misconduct.. 20
B. Calculating Profit for Stock Sales 21
VIII. Conclusion 22

I. INTRODUCTION

In the early 2000s, major accounting scandals involving reporting violations and audit failures, which dominated the national headlines, sent the United States financial markets into turmoil.[1] The pervasive nature of these scandals and the fact that many of these companies published glowing financial statements materially overstating their true financial positions resulted in a loss of investor confidence.[2] Many investors paid a heavy price when the truth was re-

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1 JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 10 (6th ed. 2009) (stating that approximately a dozen large public companies collapsed during the crisis).

2 *Enron's Plan Would Repay a Fraction of Dollars Owed*, N.Y. TIMES, July 12, 2003, at C2. Shareholders in the Enron Corporation, which was once listed as number seven on the Fortune 500

vealed.[3] Adding salt to the wound, several corporate officers reaped the rewards of the overstated results by receiving large incentive-based bonuses, while simultaneously selling their personal shares of stock in their companies at higher-than-justified prices.[4] Congress and President George W. Bush reacted to the controversy by passing the Public Company Accounting Reform and Investor Protection Act, better known as the Sarbanes–Oxley Act (SOX), in July of 2002.[5] SOX contained many new corporate governance rules that mandated tighter internal controls, increased disclosure requirements, and boosted civil and criminal penalties for misreporting.[6] One section was specifically drafted to prevent CEOs and CFOs from profiting from erroneous financial statements.[7] Section 304 created an explicit procedure, whereby the SEC could disgorge or claw back a CEO or CFO's incentive-based compensation or stock gains when such profits were based on inflated financial statements later required to be restated to reflect the company's true financial position.[8]

Although the SEC has successfully used the clawback on a handful of occasions, overall it has been reluctant to use the tool.[9] Some have noted that this reluctance may be attributable to ambiguous language, undefined terms, and open questions surrounding how to apply the clawback to certain types of incentive-based compensation.[10]

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list, saw the outstanding value of all common stock in the company decrease from $68 billion to less than half a billion dollars. Kenneth N. Gilpin, *Enron's Collapse: The Investors; Plenty of Pain to Go Around for Small Investors, Funds, Workers and Creditors*, N.Y. TIMES, Dec. 4, 2001, at C8 ("That is the inevitable consequence of a stock that lost 99.5 percent of its market value in a year. Carol M. Coale, an analyst at Prudential Securities, said that Enron had a market value of almost $68 billion at its peak but that number was about $344 million as of yesterday's close.").

[3] Lyman P.Q. Johnson & Mark A. Sides, *Corporate Governance and the Sarbanes–Oxley Act: The Sarbanes–Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1153 (2004) (explaining that Congress passed the Sarbanes–Oxley Act in response to an "eroded public confidence").

[4] *See, e.g.*, John Patrick Kelsh, *Section 304 of the Sarbanes–Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 BUS. LAW. 1005, 1005–06 (2004).

[5] *Id.* at 1007–08. The House voted 423–3 and the Senate voted 99–0. *Id.*

[6] Jesse M. Fried, Symposium: *Hands-Off Options*, 61 VAND. L. REV. 453, 459 (2008).

[7] S. REP. NO. 107-205, at 23 (2002) ("The bill therefore requires CEOs and CFOs to certify their companies' financial reports, outlaws fraud and deception by managers in the auditing process, *prevents CEOs and CFOs from benefitting from profits they receive as a result of misstatements of their company's financials*, and facilitates the imposition of judicial bars against officers and directors who have violated the securities laws." (emphasis added)).

[8] Sarbanes–Oxley Act of 2002 § 304(a), 15 U.S.C. § 7243(a) (2012) [hereinafter SOX].

[9] *See* Gretchen Morgenson, *Clawbacks Without Claws*, N.Y. TIMES, Sept. 10, 2011, at BU1, http://www.nytimes.com/2011/09/11/business/clawbacks-without-claws-in-a-sarbanes-oxley-tool.html.

[10] J. Royce Fichtner et al., *The Unfulfilled Promise of Sarbanes–Oxley Section 304: A Call for Pervasive Enforcement*, 14 DEPAUL BUS. & COMM. L.J. 49, 51 (2015). *See* Elaine Harwood & Laura Simmons, *The Tenth Anniversary of SOX: Its Impact and Implications for Future Securities Litigation and Regulatory Enforcement Activity*, 10 BLOOMBERG BNA CORP. ACCOUNTABILITY

When the stock market crashed again in the fall of 2008, Congress began to pursue the idea of creating another clawback program.[11] In 2010, President Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) in order to strengthen corporation governance and avoid oversight issues that had surfaced during the latest crisis.[12] Section 954 of the Dodd–Frank Act, entitled "Recovery of Erroneously Awarded Compensation," created a new co-existing[13] clawback program that tasked the individual boards of directors, rather than the SEC, with enforcement. Specifically, section 954 required listed companies to create and enforce their own clawback policies, and put the stock exchanges in charge of monitoring compliance and sanctioning those companies failing to enforce their own clawback policy.[14]

Much of the ambiguous language in the section 304 clawback is repeated in the newer section 954 clawback. However, when Congress drafted the section 954 clawback, Congress specifically directed the SEC to issue regulations to implement the program.[15] Recently, the SEC issued those proposed regulations.[16] Because of the similar language in the two clawbacks, many of the regulations appear applicable to the section 304 clawback as well.

This article will analyze section 304 and identify eight ambiguities that plague its application. The article will then discuss the new section 954 clawback and the proposed regulations that appear to provide clarity to some of the more ambiguous questions surrounding the application of section 304. Finally, it will point out those ambiguities still lacking significant clarification.

REP. 1, 2 (2012) (showing that the number of restatements filed by publically traded firms quickly rose from 163 in 2001 to 681 in 2006).

[11] S. REP. NO. 111-176, at 136 (2010).

[12] Pub. L. No. 111-203, 124 Stat. 1376 (2010); *see also* Binyamin Appelbaum & David M. Herszenhorn, *Financial Overhaul Signals Shift on Deregulation*, N.Y. TIMES, July 15, 2010, at A1, http://www.nytimes.com/2010/07/16/business/16regulate.html?adxnnl=1&ref=financial_regulatory_reform&adxn nlx=1284934684-Ea8YFikIeLLs0O5a4h+3Cw; *see also* INVESTORS' WORKING GROUP, U.S. FINANCIAL REGULATORY REFORM: THE INVESTOR'S PERSPECTIVE 22 (2009), https://www.calpers.ca.gov/docs/governance/2009/us-financial-regulatory-reform.pdf.

[13] William R. Baker III et al., *A Tale of Two Clawbacks: The Compensation Consequences of Misstated Financials*, 1070 LATHAM & WATKINS CLIENT ALERT 1, (Aug. 10, 2010), http://www.lw.com/upload/pubContent/_pdf/pub3662_1.pdf; Listing Standards for Recovery of Erroneously Awarded Compensation, Securities Act Release No. 33-9861, Exchange Act Release No. 34-75342, 80 Fed. Reg. 41144, 41160 (July 1, 2015) (to be codified at 17 C.F.R. §§ 229, 240, 249, 274) (http://www.sec.gov/rules/proposed/2015/33-9861.pdf, at 63) [hereinafter Listing Standards] ("[R]ecovery under Rule 10D-1 would not preclude recovery under Section 304 to the extent any applicable amounts have not been reimbursed to the issuer.").

[14] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[15] Deborah Lifshey et al*.*, *Summary of Clawback Policies Under Dodd–Frank Reform Act*, NYSE (July 23, 2010), https://www.boardmember.com/Print.aspx?id=5146.

[16] Listing Standards, *supra* note 13.

II. SARBANES–OXLEY SECTION 304 AND ITS AMBIGUITIES

The text of the section 304 clawback appears succinct and straightforward. In the event a company is required to prepare an accounting restatement because of misconduct, the CEO and CFO shall reimburse the company for any bonus or other incentive-based or equity-based compensation received during the year following the issuance of the erroneous financial statement, as well as any profits realized from the sale of the company's securities during those same twelve months.[17] The complete statute reads as follows:

> 304. FORFEITURE OF CERTAIN BONUSES AND PROFITS
>
> (a) Additional compensation prior to noncompliance with commission financial reporting requirements. 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 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 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.
>
> (b) Commission exemption authority. The Commission may exempt any person from the application of subsection (a), as it deems necessary and appropriate.[18]

Subsection (a) explains when the clawback is applicable, noting that the CEO and CFO "shall" reimburse the issuer if it "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."[19] The last half of subsection (a) describes the monies the CEO or CFO must return to the company.[20] Notably, the clawback applies to any incentive-based pay received in the twelve-month period following the original misstatement as well as any profits realized from the sale of stock during that period.[21] However, beneath the surface lie eight distinct ambiguities. As discussed below,

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[17] 15 U.S.C. § 7243 (2012).
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*

the first of these ambiguities has been conclusively settled through subsequent court decisions. The second appears to be settled, though there is no controlling precedent on the issue. This article will address how the proposed section 954 regulations provide guidance on several of the remaining ambiguities.

The first glaring ambiguity is that the statute does not specify who, beyond the SEC, may pursue a section 304 claim; it does not address whether issuers or shareholders may pursue section 304 claims to recover incentive-based compensation.[22] While issuers have shown no interest in pursuing section 304 claims,[23] numerous shareholder groups have brought such claims to disgorge bonuses and stock profits from CEOs and CFOs.[24] All of these attempts failed because courts have universally concluded that section 304 does not contain a private right of action.[25] The seminal case on this issue is *Neer v. Pelino*,[26] where a federal district court determined that Congress did not intend to create, either expressly or by implication, a private cause of action.[27] The other noteworthy decision is the case of *In re Digimarc*, where the Ninth Circuit dismissed a shareholder derivative claim under the same analysis.[28] Absent extraordinary action by the Supreme Court, this issue appears to be settled.[29] The SEC has the exclusive right

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[22] Fichtner et al., *supra* note 10, at 55.

[23] *See* Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 IOWA J. CORP. L. 721, 732 (2011).

[24] *See, e.g.*, Pedroli ex rel. Microtune, Inc. v. Bartek, 564 F. Supp. 2d 683, 685–86 (E.D. Tex. 2008); In re iBasis, Inc. Derivative Litig., 532 F. Supp. 2d 214, 223–25 (D. Mass. 2007); Kogan v. Robinson, 432 F. Supp. 2d 1075, 1077 (S.D. Cal. 2006); In re BISYS Grp. Inc., 396 F. Supp. 2d 463, 464 (S.D.N.Y. 2005); Neer v. Pelino, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005).

[25] *Microtune, Inc.*, 564 F. Supp. 2d at 685–86; *In re iBasis, Inc. Derivative Litig.*, 532 F. Supp. 2d at 223–25; *Kogan*, 432 F. Supp. 2d at 1082; *In re BISYS*, 396 F. Supp. 2d at 464; *Neer*, 389 F. Supp. 2d at 657.

[26] 389 F. Supp. 2d 648 (E.D. Penn. 2005).

[27] *Id.* at 653 (quoting Touche Ross & Co. v. Redington, 442 U.S. 560, 575 (1979)). The court utilized the Supreme Court's analysis in *Cort v. Ash* to determine whether section 304 contains a private right of action. 422 U.S. 66, 78 (1975). In *Cort*, the Supreme Court used a four-part test to determine "whether a private remedy is implicit in a statute not expressly providing one." *Id.* The Supreme Court explained that the test contained a following series of questions:

> "First, is the plaintiff 'one of the class for whose especial benefit the statute was enacted,'— that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?"

Id. (citations omitted).

[28] *In re* Digimarc Corp. Derivative Litig., 549 F.3d 1223, 1232 (9th Cir. 2008).

[29] All other reported decisions on this matter conclude that section 304 does not expressly or impliedly create a private right of action for shareholders of the issuer. *See, e.g.*, *Microtune, Inc.*, 564 F. Supp. 2d at 685–86; *In re iBasis, Inc. Derivative Litig.*, 532 F. Supp. 2d at 223–25; *Kogan*,

to pursue a section 304 clawback.[30]

The second prominent ambiguity is whether the CEO or CFO must be personally involved in the misconduct to face disgorgement. Section 304 does not specify that the misconduct necessary for a section 304 claim must be directly attributable to the CEO or CFO.[31] Instead, the statute merely requires that the statement be "a result of misconduct."[32] The key case in this area involves a section 304 action against Maynard Jenkins, the CEO of CSK Auto Corp (CSK).[33] In 2007, CSK issued an accounting restatement detailing instances of accounting fraud and explaining how an audit committee investigation had uncovered an ineffective control environment, which allowed for the inappropriate override of existing procedures and internal controls.[34]

The SEC filed a section 304 action against Jenkins even though there was no evidence that Jenkins had personally participated in, or had knowledge of, the accounting fraud.[35] The federal district court rejected the argument that Jenkins' lack of personal involvement in the misconduct exempted him from disgorgement[36] and, as noted by legal scholars, established section 304 as a "no fault" clawback.[37] The court found that the plain language of section 304, justified by its legislative history, subjects the CEO to disgorgement even if he or she was unaware of the misconduct leading to the erroneous financial statements.[38] Subsequently, two federal district courts also found that section 304 claims are not dependent on proof of personal misconduct by the CEO or CFO.[39] These three rulings are persuasive; however, none constitute binding legal precedent. Neither the Supreme Court nor any circuit court has ruled on this issue. While it appears settled, it is conceivable that future appellate decisions could redefine whether a CEO or CFO could be held liable under section 304, absent any proof

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432 F. Supp. 2d at 1082; *In re BISYS*, 396 F. Supp. 2d at 464; *Neer*, 389 F. Supp. 2d at 657.

[30] *See In re Digimarc Corp. Derivative Litig.*, 549 F.3d at 1238.

[31] *See* 15 U.S.C. § 7243(a) (2012).

[32] *Id.*

[33] SEC v. Jenkins, 718 F. Supp. 2d 1070, 1072 (D. Ariz. 2010).

[34] CSK Auto Corp., Annual Report (Form 10-K) 3 (May 1, 2007), https://www.sec.gov/Archives/edgar/data/1051848/000095015307000933/p73759e10vk.htm.

[35] *Jenkins*, 718 F. Supp. 2d at 1070. The SEC alleged that officers had actually concealed the scheme from Jenkins. *Id.* at 1072–73.

[36] *Id.* at 1074.

[37] *SEC's First Use of SOX "Clawback" Against Uncharged Executive*, GIBSON DUNN (July 27, 2009), http://www.gibsondunn.com/publications/pages/SECsFirstUseofSOXClawbackAgainstUnchargedExecutive.aspx.

[38] *Jenkins*, 718 F. Supp. 2d at 1075–78.

[39] *See* SEC v. Baker, No. A–12–CA–285–SS, 2012 WL 5499497 (W.D. Tex. Nov. 13, 2012); SEC v. Microtune, Inc., 783 F. Supp. 2d 867, 886 (N.D. Tex. 2011) ("Section 304 contains no personal wrongdoing element . . . .").

of personal misconduct.[40]

Even though the preceding court decisions add some clarity to the section 304 clawback, many questions persist. The first half of the six remaining ambiguities springs from the following phrase in section 304(a): "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 of the issuer shall reimburse the issuer . . . ."[41] First, there is no significant guidance for when an issuer is "required to prepare an accounting restatement."[42] Does the phrase make section 304 applicable only in situations where the issuer filed a restatement, or could liability attach if the issuer should have issued a restatement, but failed to do so? Second, there is no guidance as to what qualifies as a "material noncompliance" with financial reporting requirements.[43] Finally, the term *misconduct* lacks a definition. It is uncertain whether its enforcement provisions are limited to circumstances where someone knowingly prepared erroneous financial statements, or whether it also applies to circumstances where the mistakes were the result of mere carelessness.[44]

The next ambiguity concerns how to interpret language identifying that the clawback applies to "any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the [twelve]-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement."[45] Specifically, it is unclear how to determine when a CEO or CFO has "received" an incentive-based compensation.[46] It is not clear whether the term "received" applies to when the bonus or incentive-based compensation was earned, granted, vested, or paid to the CEO or CFO.[47]

The remaining two ambiguities deal with how to calculate the total reimbursement amount for "any profits realized from the sale of securities of the issuer" during the twelve-month period following the erroneous statement.[48] Does the disgorgement apply only to securities acquired as a result of service to the

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[40] At least one commentator has pointed out that there is a legitimate argument surrounding the question of whether section 304 is an equitable disgorgement and therefore improper without proof of actual wrongdoing. Daniel R. Bryer, *The Culpability of Corporate Officers Under the Clawback Provision of Sarbanes–Oxley in a Post-Jenkins World*, 12 J. BUS. & SEC. L. 1, 15–17 (2011).

[41] 15 U.S.C. § 7243(a) (2012).

[42] *See id.*

[43] *See id.*; *see also infra* Part V.

[44] *See* 15 U.S.C. § 7243(a) (2012); s*ee also infra* Part VII.A.

[45] 15 U.S.C. § 7243(a)(1) (2012).

[46] *See id.*; *see also infra* Part VI.

[47] *See* discussion *infra* Part VI.

[48] 15 U.S.C. § 7243(a)(2) (2012).

issuer, or does it apply to all of the issuer's securities, even those acquired prior to the CEO or CFO's employment with the issuer? A corresponding question is how to calculate the basis of profits realized during the twelve-month period.[49] Should the court use the security's original purchase price or its price immediately prior to the filing of the erroneous financial statement?

The following sections will describe the new section 954 clawback created by the Dodd–Frank Act and the SEC's proposed regulations interpreting and implementing the clawback. Remaining sections will predict how these proposed regulations could answer some of the questions still surrounding section 304.

III. THE DODD–FRANK SECTION 954 CLAWBACK

Section 954 of the Dodd–Frank Act creates a broader clawback than section 304, making it applicable to more than just a company's CEO and CFO.[50] It directs the SEC to promulgate regulations that require listed companies to develop and implement clawback policies to recover incentive-based compensation that executive officers "would not have received if the accounting was done properly."[51] The trigger for the disgorgement is a required restatement of previously issued financial statements due to material noncompliance with financial reporting requirements.[52] The boards of directors and stock exchanges, rather than the SEC, are tasked with enforcing these clawback policies.[53] Specifically, section 954 amends the Securities Exchange Act of 1934 by adding the following:

> (a) LISTING STANDARDS. - The Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with the requirements of this section.
>
> (b) RECOVERY OF FUNDS. - The rules of the Commission under subsection (a) shall require each issuer to develop and implement a policy providing -
>
> > (1) for disclosure of the policy of the issuer on incentive-based compensation that is based on financial information required to be reported under the securities laws; and

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[49] *See* discussion *infra* Part VII, Section B.

[50] *See* 15 U.S.C. § 78j-4 (2012); *see also* Stewart Muglich, *Dodd–Frank Wall Street Reform and Consumer Protection Act*, CLARK WILSON LLP 6–7 (Nov. 2011), https://www.cwilson.com/publications/securities/dodd-frank-wall-street-reform-and-consumer-protection-act.pdf.

[51] CHRIS DODD, COMM. ON BANKING, HOUSE, AND URBAN AFFAIRS, THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010, S. REP. NO. 111-176, at 135 (2d Sess. 2010).

[52] 15 U.S.C. § 78j-4 (2012).

[53] *Id.*

> (2) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.[54]

Section 304 and section 954 share similar purposes and use similar language. Both seek to prevent certain individuals from benefiting from their companies' misstatements made within "any financial reporting requirement under the securities laws."[55] Both also require these individuals to disgorge "incentive-based" compensation "received" after their company issues erroneous financial statements later "required" to be restated due to "material noncompliance."[56]

However, the two clawbacks differ in several fundamental ways.[57] As discussed above, section 304 and subsequent case law clearly establish that the SEC is the only entity tasked with enforcing the clawback.[58] Section 954, on the other hand, directs each national exchange-listed company to create its own clawback policy that becomes applicable when the company prepares a required accounting restatement as a result of material noncompliance with financial reporting requirements.[59] Section 954 also requires the company to enforce this policy, with specific language dictating that the national securities exchanges must prohibit the listing of any company that does not develop and implement such a clawback policy.[60] Section 304 only applies to CFOs and CEOs, while section 954 applies to current and former "executive officers."[61] Section 304 is

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[54] *Id.* (footnote omitted).

[55] S. REP. NO. 107-205, at 23 (2002) ("The bill therefore requires CEOs and CFOs to certify their companies' financial reports, outlaws fraud and deception by managers in the auditing process, prevents CEOs and CFOs from benefitting from profits they receive as a result of misstatements of their company's financials, and facilitates the imposition of judicial bars against officers and directors who have violated the securities laws."); S. Rep. No. 111-176, at 136 ("The Committee believes it is unfair to shareholders for corporations to allow executives to retain compensation that they were awarded erroneously.").

[56] 15 U.S.C. § 7243(a) (2012); Pub. L. No. 111-203, § 954, 124 Stat. 1376 (2010).

[57] *Compare* 15 U.S.C. § 7243 (establishing the SEC as the only entity tasked with enforcing the clawback), *with* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 954, 124 Stat. 1376, 1904 (2010) [hereinafter Dodd–Frank Act] (directing each national exchange-listed company to create its own clawback policy).

[58] *Id.*

[59] Dodd–Frank Act § 954.

[60] *Id.*

[61] Baker et al., *supra* note 13.

only triggered if the material noncompliance with reporting requirements came about "as a result of misconduct," while section 954 mandates a clawback whether or not misconduct was the root of the original misstatement.[62] Section 304 disgorges "any bonus or incentive-based or equity-based compensation," while section 954 only applies to portions of the incentive-based pay in excess of what the officers would have been paid under the accounting restatement.[63] Section 954 does not apply to stock-sale proceeds.[64] The two clawback programs also contain very different look-back periods. Section 954's recovery period is the three years that precede the date on which the issuer was required to prepare the restatement.[65] Section 304 has a shorter look-back period, only "cover[ing] compensation received in the year following the issuance of a misstated financial statement."[66] Finally, when Congress drafted section 954, it specifically directed the SEC to issue regulations that would ensure its implementation.[67] Section 304 contains no such language, and the SEC has not issued any direct regulations to help interpret the ambiguous statute.

In July of 2015, the SEC proposed new regulations interpreting and implementing section 954. While these proposed rules focus on section 954, a majority of the language shared between section 304 and section 954 suggests that some of this interpretive language could be relevant to subsequent interpretations of section 304. Indeed, when discussing the proposed regulations the SEC makes numerous references to section 304,[68] but also cautions that one specific definition should not be applied to a section 304 claim,[69] perhaps implying that other definitions should not suffer the same limitation. The following sections will address how the SEC's proposed rules interpreting section 954 may or may not be helpful in resolving some of the ambiguities in section 304.

IV. SECTION 304 AMBIGUITY: WHEN IS THE ISSUER REQUIRED TO ISSUE A RESTATEMENT?

Section 304 applies when the issuer "is required to prepare an accounting

[62] Mark A. Chen et al., *The Costs and Benefits of Clawback Provisions in CEO Compensation*, 4 REV. CORP. FIN. STUD. 108, 114 (2015).

[63] *Id.*

[64] Fried & Shilon, *supra* note 23, at 749.

[65] Terrance Gallogly, *Enforcing the Clawback Provision: Preventing the Evasion of Liability Under Section 954 of the Dodd–Frank Act*, 42 SETON HALL L. REV. 1229, 1243 (2012).

[66] *Id.*

[67] Dodd–Frank Act, Pub. L. No. 111–203, § 954, 124 Stat. 1376, 1904 (2010).

[68] Listing Standards, *supra* note 13, at 7, 63, 66, 109, 167, 168.

[69] *See id.* at 40 n.115 ("The proposed definition [of incentive-based compensation] would be applicable only to recovery of incentive-based compensation under proposed rule 10D-1, and would not apply to the recovery of incentive-based compensation pursuant to SOX Section 304.").

restatement."[70] Likewise, under section 954, the clawback provision applies if the issuer "is required to prepare an accounting restatement . . . ."[71] Unfortunately, neither section 304 nor section 954 specifies when a listed issuer is required to prepare an accounting restatement prompting recovery provisions.[72] As explained below, three separate courts were tasked with determining when an issuer is required to prepare an accounting restatement so as to trigger a section 304 clawback. These decisions led to varying results.

The Ninth Circuit Court of Appeals was the first to address this question when it reviewed a district court decision dismissing a derivative lawsuit based on claims of intentional misconduct that led to allegedly misleading financial statements. In *Teachers' Retirement System of Louisiana v. Hunter*,[73] a group of shareholders brought a section 304 claim alongside claims under section 10(b) of the Exchange Act and Rule 10b-5.[74] The Ninth Circuit found inadequate allegations of misconduct and insufficient proof of misleading financial statements to affirm the section 10(b) and Rule 10b-5 claims.[75] The court then addressed the shareholders' claim for section 304 damages. Even though the company had never filed a restatement, the shareholder group claimed that numerous violations of generally accepted accounting principles (GAAP) in the financial statements required the company to issue restatements.[76] The circuit court specifically avoided ruling on whether a restatement must be filed in order to pursue a section 304 claim.[77] Instead, the court found insufficient evidence to prove that the company actually presented erroneous information in its financial reports, and it found that "the complaint d[id] not adequately allege that any restatement is required."[78] Though far from definitive, the Ninth Circuit's ruling suggested that a section 304 claim might be able to proceed, absent a restatement, so long as the plaintiff could prove that a restatement was "required."[79] Compare *Hunter*, where the shareholder plaintiffs failed to adequately allege

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[70] 15 U.S.C. § 7243(a) (2012).

[71] Dodd–Frank Act § 954.

[72] As described by the Government Accounting Office, "[a] financial statement restatement occurs when a company, either voluntarily or prompted by auditors or regulators, revises public financial information that was previously reported." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-03-138, *Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges* 1 n.1 (2002), http://www.gao.gov/assets/240/236067.pdf.

[73] 477 F.3d 162, 168 (4th Cir. 2007).

[74] *Id.* at 168–69.

[75] *Id.* at 183–84.

[76] *Id.* at 188–89.

[77] *Id.* at 189. The court also specifically avoided ruling on whether a private right of action was available under section 304. *Id.*

[78] *Id.*

[79] *Id.*

that a restatement was required,[80] with a more direct situation where the SEC argued that a section 304 claim could be viable without the issuance an accounting restatement.[81]

In *SEC v. Shanahan*,[82] the SEC brought a section 304 action against Michael Shanahan—the CEO of Engineered Support Systems, Inc.—alleging multiple fraud and insider trading violations related to Shanahan's personal involvement in backdating stock options and the related concealment of material amounts of compensation paid to the company's top executives.[83] Despite the fact that the company never issued a restatement, the SEC attempted to use section 304 to disgorge incentive compensation payments and stock sale profits received by Shanahan after the company issued the erroneous financial statements.[84] When Shanahan filed a motion to dismiss the section 304 claim on the basis that the company had never filed a restatement,[85] the SEC countered by arguing that section 304 does not explicitly require a restatement.[86] Pointing to the specific language that disgorgement is appropriate if the 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,"[87] the SEC argued that Engineered Support was required to file a restatement because its 2002 financial statement contained material errors that required restatement under GAAP.[88]

The SEC's interpretation of the term "required" did not persuade the district court judge. After noting that the issue was one of first impression within its circuit,[89] the court issued a terse decision granting the Motion to Dismiss because 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."[90] In this non-precedential ruling,[91] the district court set forth a two-step test.[92] First, the

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[80] *Id.*

[81] 624 F. Supp. 2d 1072 (E.D. Mo. 2008).

[82] *Id.*

[83] *Id.* at 1075–76.

[84] *Id.*

[85] *Id.* at 1077–78.

[86] *Id.* at 1078.

[87] *Id.* at 1077 (citing 15 U.S.C. § 7243(a) (2012)).

[88] *Shanahan*, 624 F. Supp. 2d at 1078.

[89] *Id.*

[90] *Id.*

[91] Because this Federal district court decision is not binding on other courts, there is no controlling precedent on this issue. ROBIN WELLFORD SLOCUM, LEGAL REASONING, WRITING, & PERSUASIVE ENFORCEMENT 18 (2002) ("Federal district court decisions are not binding on other courts.").

issuer must be compelled or required to file a restatement; second, the issuer must actually file the restatement.[93] Within the first step, the court implied that there are two types of restatements: those that are required or compelled and those that are voluntary.[94] If the restatement was filed voluntarily, then the CEO or CFO would not be subject to the section 304 clawback. The court never differentiated between a voluntary or a compelled restatement and provided no guidance as to how the SEC could prove that the issuer was ordered or compelled to file a restatement. Instead, the court abruptly dismissed the claim for failure to prove the second step of its own analysis—that the company had issued a restatement.[95] The court provided no basis for its decision beyond vague citations to the Senate Report discussing section 304 and one treatise containing a commentator's conclusory statement that an issuer must restate its financial statements before triggering section 304.[96]

In 2014, the SEC once again filed a section 304 claim against the CEO and both the current and former CFOs of a company that had never filed a restatement.[97] While this action did not ultimately result in a reported decision,[98] it reinforces the SEC's view that the term "required" serves as an exception to any actual restatement requirement in section 304.

The SEC's proposed rules implementing the exact same language in the section 954 clawback mirror this interpretation. Although some public commentators recommended that the SEC issue regulations interpreting the phrase to mean that the trigger is the date the issuer files the accounting restatement,[99] the SEC flatly rejected this recommendation and specifically found that the section 954 clawback obligation "is not dependent on if or when the restated financial statements are filed."[100] Instead, the date an issuer is required to file a restatement is the earlier of either (1) the date the board of directors or a committee of the board of directors reasonably concludes, or should have concluded, that the

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[92] *Shanahan*, 624 F. Supp. 2d at 1078.

[93] *Id.*

[94] *See id.* ("It is the opinion of this Court that 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.").

[95] *Id.*

[96] The citation to the Senate Report merely noted in a parenthetical citation that "legislative history indicates Congress contemplated the statute's applicability only in terms of 'accounting restatements that result from material non-compliance,' rather than cases where there should have been an accounting restatement because of material non-compliance." *Id.* (citing S. REP. NO.107-205, at 53 (2002)).

[97] Complaint at 7, *SEC v. AgFeed Indus., Inc.*, *et al.*, No. 3:14-cv-00663 (Sept. 23, 2014).

[98] Final Judgment as to Defendant AgFeed Industries, Inc., *SEC v. AgFeed Indus., Inc.*, *et al.*, No. 3:14-cv-00663 (Oct. 6, 2014).

[99] Listing Standards, *supra* note 13, at 28.

[100] *Id.* at 31.

issuer's previously issued financial statement contained a material error, or (2) the "date a court, regulator or other legally authorized body directs the issuer to restate its previously issued financial statements to correct a material error."[101] The SEC explained that it rejected the filing of the restatement as a trigger and opted for the aforementioned two-factor approach because of its concern about "leaving the determination solely to the discretion of the issuer."[102]

The proposed regulations and existing case law demonstrate that the SEC interprets the term "required" to serve as an exception to any actual restatement requirement for both section 954 and section 304 clawbacks. This interpretation is in direct conflict with the *Shanahan* holding, but as noted above, the *Shanahan* case holds no precedential value. Because the Ninth Circuit avoided directly ruling on this issue and the SEC bolstered its original position with new regulations, this issue remains unresolved. But the SEC's bold language interpreting the term "required" to include situations where the board of directors "should" have concluded that the previously filed financial statements contained a material error sends a clear message that the SEC will not avoid pursuing clawbacks merely because the board of directors decided not to file a restatement. Because GAAP clearly requires the restatement of financial statements after material misstatements,[103] the SEC's position is consistent with this mandate. Future litigation in this area is likely.

V. SECTION 304 AMBIGUITY: DEFINING "MATERIAL NONCOMPLIANCE"

Both section 304 and 954 are triggered if the issuer is "required to prepare an accounting restatement" due to "material non-compliance . . . with any financial reporting requirement under the securities laws."[104] Section 304 litigation provides no guidance on what constitutes "material noncompliance" because, to date, no court has directly ruled on a CEO or CFO's claim that changes in restated financials were so minor that they did not trigger the clawback.[105] However, the issue is not moot.

In the proposed rules clarifying section 954, the SEC interprets the phrase "material noncompliance" to mean that the question is whether the error was

[101] *Id.* at 30.

[102] *Id.* at 31.

[103] *Financial Restatements: Understanding Differences and Significance*, ERNST & YOUNG (May 2015), http://www.ey.com/Publication/vwLUAssets/EY-financial-restatements-understanding-differences-and-significance/$FILE/EY-financial-restatements-understanding-differences-and-significance-cover.pdf (noting that these types of restatements are commonly referred to as "Big R" restatements).

[104] Listing Standards, *supra* note 13, at 22–24.

[105] *Id.* at 24.

material to previously issued financial statements.[106] The SEC goes on to separately discuss the terms "material" and "error."[107] Citing GAAP,[108] the SEC notes that an error in previously issued financial statements is "[a]n error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared."[109] The SEC then cites the International Financial Reporting Standards (IFRS), noting that prior period errors are:

> "omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that: (a) was available when financial statements for those periods were authorized [sic] for issue; and (b) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud."[110]

Rather than stating its own definition of the term "material," the SEC cites to the Supreme Court's use of the term in two cases that are unrelated to clawbacks.[111] A review of the two cases reveals a definition, but no bright-line test for materiality. In the first case, *TSC Industries, Inc. v. Northway*,[112] shareholders at TSC were asked to approve a proposal to liquidate TSC's assets in exchange for shares of stock in a different company.[113] A group of shareholders sued TSC, claiming the proxy statement accompanying the proposal was incomplete and materially misleading in violation of section 14(a) of the Securities Exchange Act of 1934.[114] The court of appeals found that the claimed omissions of fact were material as a matter of law because material facts included "all facts which a reasonable shareholder might consider important."[115] On review, the Supreme Court rejected the "might consider important" standard, noting that it

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[106] *Id.*

[107] *Id.* at 24–25, 24 n.66. The SEC also specified that the term financial statements includes "the statement of financial position (balance sheet), income statement, statement of comprehensive income, statement of cash flows, statement of owners' equity, and accompanying footnotes." *Id.* at 24 n.67.

[108] *Id.* at 24 n.66.

[109] *Id.*

[110] *Id.*

[111] *Id.* at 25 n.70.

[112] TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 440 (1976).

[113] *Id.* at 440–41.

[114] *Id.* at 441.

[115] *Id.* at 445.

set "too low a threshold"[116] for the imposition of liability because it was "too suggestive of mere possibility, however unlikely" it was that the omitted material would lead a reasonable investor to change his vote.[117] Likewise, the Court rejected a more stringent definition that would "require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote."[118] Instead, the Court chose a middle-ground definition of materiality, whereby information could be deemed material upon "a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."[119] The court restated this test, noting that there "must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[120] In the second case cited by the SEC, the Supreme Court explicitly reaffirmed this standard for materiality in the section 10(b) and Rule 10b-5 context.[121]

In the proposed regulations, the SEC refuses to describe any type or characteristic of an error that would be considered material because "materiality is a determination that must be analyzed in the context of particular facts and circumstances."[122] Instead, the SEC provides a specific list of changes that do not constitute error corrections and would not trigger the clawback.[123] These include:

> Retrospective application of a change in accounting principle; Retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization; Retrospective reclassification due to a discontinued operation; Retrospective application of a change in reporting entity, such as from a reorganization of entities under common control; Retrospective adjustment to provisional amounts in connection with a prior business combination; and Retrospective revision for stock splits.[124]

On face value, these examples appear useful, but in application they provide little insight. Each example describes changes in financial circumstances that occur subsequent to the issuance of the original, but not restated, financial statement. Their retrospective restatement occurs merely to enhance their com-

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[116] *Id.*

[117] *Id.* at 449 (citing Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302 (2d Cir. 1973)).

[118] *Id.*

[119] *Id.*

[120] *Id.* (citation omitted).

[121] Basic v. Levinson, 485 U.S. 224, 232 (1988).

[122] Listing Standards, *supra* note 13, at 25.

[123] *Id.* at 25–26.

[124] *Id.* (citations omitted).

parability with subsequent financial statements.

Even though the examples provided in the proposed regulations are not very helpful, the direct citation to a test for "material non-compliance" is useful. Because of these regulations, we now know that there is material non-compliance sufficient to trigger a section 304 claim if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[125] Finally, the SEC provides one additional clarification. The regulations suggest, without further discussion, that a series of immaterial error corrections, whether or not they resulted in filing amendments to previously filed financial statements, could constitute material error when viewed in the aggregate.[126] Arguably, this comment will broaden the Supreme Court's aforementioned test when it is applied within the context of section 304.

VI. SECTION 304 AMBIGUITY: WHEN IS INCENTIVE-BASED COMPENSATION DEEMED "RECEIVED"?

Section 304 states that the CEO or CFO is to reimburse:

> any bonus or other incentive-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 reporting requirement; and . . . any profits realized from the sale of the securities of the issuer during that 12-month period.[127]

A key tenet of this statute is that the funds subject to disgorgement must have been received during the twelve months following the faulty financial statement. It is not clear whether the term "received" applies to when the bonus or incentive-based compensation was earned, granted, vested, or paid to the CEO or CFO. There is no doubt that a cash bonus resultant from the information in an erroneous financial statement and paid to a CEO or CFO during the twelve-month window following the erroneous financial statement would be subject to the clawback.[128] However, other financial arrangements are less clear. For example, it is unclear whether a cash bonus granted during the twelve-month period following the issuance of the erroneous financial document, but not paid until a timeframe outside the twelve-month period, would be subject to

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[125] 426 U.S. at 449.

[126] Listing Standards, *supra* note 13, at 25.

[127] 15 U.S.C. § 7243(a)(1)–(a)(2) (2012).

[128] An example of such a disgorgement occurred in SEC v. Jasper, 883 F. Supp. 2d 915, 932–33 (N.D. Cal. 2010), where the district court entered judgment disgorging the CFO of cash bonuses of $207,466, $646,447, and $465,212 that were received during the fourth quarters of the years in which an erroneous financial document was made available to the public.

disgorgement.[129] It is also unclear whether a stock option granted during the twelve-month period, but subject to vesting requirements that delay possible execution until after the twelve-month period, would be subject to disgorgement.[130] To date, these questions remain unanswered and exist as a potential loophole to escape the clawback. As explained below, the proposed rules interpreting the term "received" in section 954 may provide limited guidance in this area.

Section 954 details a significantly different clawback period. While section 304's recovery period pertains to any incentive-based compensation received during the twelve months after the erroneous financial document was issued,[131] section 954's recovery period pertains to the three years that precede the date on which the issuer was required to prepare the restatement.[132] Both statutes utilize the term "received," and both statutes leave that term open to interpretation, but the length and computation of the recovery periods are different.[133] The SEC's proposed rules purposely use the term "received" within section 954, not to refer to a specific date on the calendar, but instead to refer to a fiscal period.[134] In fact, the SEC flatly rejects any interpretation that would view the "3-year period preceding" as a strict thirty-six-month period of time.[135] Instead, it views the three-year look-back period as a range of fiscal years, so as to be consistent with the general practice of issuers making compensation decisions on a fiscal year basis.[136] It then explains this usage through a series of examples, clarifying that the incentive-based compensation "would be deemed received for purposes of triggering the recovery policy . . . in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs after the end of that period."[137] The SEC goes on to point out that the terms of the award would determine the date of receipt.[138] For example, "[i]f the grant of an award is based, either wholly or in part, on satisfaction of a financial reporting measure, the award would be deemed received in the fiscal period when that measure was sat-

[129] JAMES F. REDA, STEWART REIFLER & MICHAEL L. STEVENS, THE COMPENSATION COMMITTEE HANDBOOK 196–97 (John Wiley & Sons, Inc., 4th ed. 2014).

[130] *Id.*

[131] 15 U.S.C. § 7243(a)(1) (2012).

[132] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[133] *See generally* 15 U.S.C. § 7243(a)(1) (2012); Pub. L. No. 111-203, 124 Stat. 1376.

[134] Listing Standards, *supra* note 13, at 51.

[135] *See id.*

[136] *Id.*

[137] *Id.* at 53–54 (footnote omitted).

[138] *Id.* at 54.

isfied."[139] Likewise:

> If an equity award vests upon satisfaction of a financial reporting measure, the award would be deemed received in the fiscal period when it vests. Similarly, a cash award earned upon satisfaction of a financial reporting measure would be deemed received in the fiscal period when that measure is satisfied.[140]

Does section 954's reliance on the use of a fiscal period, rather than a date, lessen its potential usefulness for section 304? It would normally take some time before a financial statement's material misstatement was discovered and confirmed.[141] As a result, section 954's recovery period of three years prior to when the issuer is required to restate is certainly more practical in capturing ill-gotten gains because it allows more time for such rewards to manifest themselves.[142] However, even in the limited twelve-month period defined in section 304, language explaining that a section 954 recovery should not be limited by a service-vesting condition helps bolster any claim that bonus or incentive-based compensation should be received when it is awarded, rather than when it is ultimately vested.[143] This lends credence to the date of grant within the twelve-month period under section 304 as "receipt" of an award, even though it may be vested and/or received later.[144] On the other hand, section 954's requirement that the incentive-based compensation be tied directly to the satisfaction of a financial reporting measure, and the absence of any such requirement in section 304, limits the usefulness of any comparison of the word "received" between the two clawbacks.[145] Until the issue is presented to a court for final ruling, we are left to speculate as to what types of compensation referrals may or may not qualify for disgorgement.

VII. SIGNIFICANT QUESTIONS LEFT UNANSWERED IN SECTION 304

The proposed rules interpreting section 954 provide no guidance for several other questions surrounding potential applications of the section 304 clawback. The questions involve situations that are unique to a section 304 clawback, such as the level of culpability needed for "misconduct," and how to calculate the clawback of "profits realized from the sale of securities" after the

[139] *Id.*
[140] *Id.*
[141] *See id.* at 115.
[142] *See id.* at 51.
[143] *See id.* at 52.
[144] *See id.* at 54.
[145] *See id.*

erroneous document was made publicly available.[146]

A. Misconduct

Section 304 is only triggered when the restatement arises from misconduct leading to material noncompliance with financial reporting requirements.[147] Unfortunately, Congress did not define the term "misconduct,"[148] and no court has attempted to define its boundaries[149] beyond stating, in dictum, that "the pay back remedy could be applied if any misconduct, however slight, leads to an accounting restatement."[150] The initial bill that eventually led to section 304 directed the SEC to "identify the scienter requirement that should be used in order to determine to impose the requirement to disgorge,"[151] but this language was removed in the final version. Now, there is no explicit scienter requirement. Without question, misconduct would certainly include conscious actions involving a mental state embracing "intent to deceive, manipulate, or defraud."[152] However, because there is no specific scienter requirement in section 304, it is conceivable that mere carelessness or negligence could constitute misconduct.[153] One legal commentator noted that "[a]t some level, every restatement not caused by a change in accounting rules can be deemed to be a result of misconduct."[154]

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[146] *See id.* at 48, 110.

[147] 15 U.S.C. § 7243 (2012).

[148] Bryer, *supra* note 40, at 18.

[149] The SEC has never tested the boundaries of what constitutes misconduct, instead focusing its energy on situations involving deceitful violations of standard accounting practices. Nader H. Salehi & Elizabeth A. Marino, *Section 304 of SOX: New Tool for Disgorgement?*, N.Y. L.J. (May 22, 2008), http://www.newyorklawjournal.com/id=1202421553868/167304-of-SarbanesOxley-Act-New-Tool-for-Disgorgement?slreturn=20160924091421.

[150] *In re* iBasis, Inc. Derivative Litig., 532 F. Supp. 2d 214, 224 (D. Mass. 2007). At most, one court referenced a lower boundary, noting "[t]he plain language of the statute indicates that the purpose of the Act is to punish 'misconduct,' not the mere decision to restate financial reports." *In re* AFC Enter., Inc. Derivative Litig., 224 F.R.D. 515, 521 (N.D. Ga. 2004); *see also* Bryer, *supra* note 40, at 18.

[151] H.R. 3763 § 12(b)(3) (2002).

[152] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

[153] This would not be out of step with other violations under the Securities and Exchange Act. For example, the U.S. Supreme Court specifically found that the SEC need not prove scienter to establish a person's liability under sections 17(a)(2) and (3), which prohibit a person in the offer or sale of securities from obtaining money or property by material misrepresentation or omission. Aaron v. SEC, 446 U.S. 680, 697 (1980) ("It is our view, in sum, that the language of § 17 (a) requires scienter under § 17 (a)(1), but not under § 17(a)(2) or § 17(a)(3) [of the Securities Exchange Act of 1934]."); S.E.C. v. Universal Express, Inc., 475 F. Supp. 2d 412, 423 (S.D.N.Y. 2007) ("Scienter need not be proven, however to establish a violation of Sections 17(a)(2) and (3), 15 U.S.C. § 77q(a) (2012), which respectively prohibit a person in the offer or sale of securities from obtaining money or property by material misrepresentation or omission and from engaging in any act that operates as a fraud or deceit upon the purchaser.").

[154] Kelsh, *supra* note 4, at 1009.

Industry specific characterizations of misconduct in the accounting profession include descriptions such "as acts carried out in the performance of a management accountant's professional occupation that fall below the standard expected of a reasonably competent management accountant" with specific listed examples of "inadequate record keeping" and "incompetence."[155]

At least one former SEC employee has indicated that there have been internal SEC discussions about whether mere negligence is enough to trigger a section 304 disgorgement.[156] This former employee also predicts that the "next horizon" for section 304 cases would "be negligence-based cases without regard to fraud."[157] However, there is strong argument that the section 954 clawback is more appropriate for errors based on mere negligence.[158] Section 954 does not require proof of misconduct; it requires only a disgorgement of incentive-based pay that is in excess of what the officers would have been paid under the accounting restatement.[159]

B. Calculating Profit for Stock Sales

Section 304's disgorgement provision applies to more than just bonuses and other traditional forms of incentive-based compensation.[160] It also applies to "any profits realized from the sale of securities of the issuer" during the twelve-month period "following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement."[161] This provision leads to more unanswered questions.

First, is the disgorgement limited to securities initially acquired as a result of service to the issuer, or does it apply to all securities of the issuer, regardless of when or how they were acquired by the CEO or CFO? It seems logical to argue that the disgorgement should only apply to securities obtained while working for the company. However, on its face, the broad language of the statute—"any profits realized from the sale of securities of the issuer during that 12-month period"[162]—implies that all CEO or CFO profits from the sale of securities of the issuer during the twelve-month period are susceptible to disgorge-

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[155] *What is Misconduct?*, CHARTERED INSTITUTE OF MANAGEMENT ACCOUNTANTS, http://www.cimaglobal.com/ Professional -ethics/Conduct/Misconduct/ (last visited Oct. 31, 2015).

[156] David McCann, *More Clawbacks Likely In Store*, CFO (May 23, 2013), http://ww2.cfo.com/compensation/2013/05/more-clawbacks-likely-in-store.

[157] *Id.* (citation omitted).

[158] *See id.*

[159] *Id.*

[160] 15 U.S.C. § 7243(a)(1) (2012).

[161] *Id.* § 7243(a)(1).

[162] *Id.*

ment, regardless of when or how the securities were acquired.[163] Also, the surrounding sections in SOX make it clear that Congress knew how to limit this sanction in other circumstances.[164] For example, in section 306(a), Congress specifically limited the prohibition on selling securities during a pension plan blackout period to only those securities acquired by the director or executive officer in connection with his or her service as a director or executive officer.[165] Section 304 does not contain such a limitation, and instead uses the definitively broad term "any." Given the straightforward language of the statute, there is a strong chance that any security sold during the twelve-month period following the erroneous filing would be subject to disgorgement, regardless of whether the CEO or CFO purchased the stock on her own or the company awarded it to her.[166]

The second pertinent question regards the calculation of profits subject to the clawback. If one needs to calculate the "profits realized from the sale of securities of the issuer,"[167] one must compare the sale price to a prior purchase price. Because section 304 does not specify a time limit for the initial purchase of a security, the potential profit disgorgement could capture profits that accrued long before the erroneous filing. A literal interpretation of section 304 suggests that the entire profit "realized from the sale of securities of the issuer" during that twelve-month period would be subject to disgorgement, even if the CEO or CFO purchased the stock years before working for the issuer.

Because section 954 provides no insight on these issues, CEOs and CFOs are left to ponder whether a court would interpret these sections broadly.

VIII. CONCLUSION

In recent years, Congress enacted two major laws directed toward fraudulent financial practices and reporting: Sarbanes–Oxley (2002) and Dodd–Frank (2010). Both laws contain clawback provisions designed to recover ill-gotten gains from corporate executives when a restatement of financial statements is

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[163] *See id.*

[164] *See id.*

[165] 15 U.S.C. § 7244 (2012).

[166] *See id.* § 7243(a)(1) (2012). Because most section 304 cases end with a dismissal or settlement, there are no clear rulings on this issue. *See* SEC Form 4: Statement of Changes in Beneficial Ownership, SEC 1475(11-11) (Nov. 10, 2003), https://www.sec.gov/about/forms/form4data.pdf. In one instance a case progressed all the way to a jury trial and court ordered disgorgement. *Id.* In that case the only security sales subjected to disgorgement were stock options exercised during the twelve-month period following the erroneous filing. *Id.* The court did not describe how it arrived at the $550,514 disgorgement for securities sales. *Id.* However, a review of SEC filings reveals that the executive exercised his option to purchase 15,000 shares of company stock at the option price of $14.0625 and sold them at $50.7634 on the same day, for a profit of $550,514. *Id.*

[167] 15 U.S.C. § 7243(a)(2) (2012).

required due to material noncompliance in the original issuance. When Sarbanes–Oxley was enacted, Congress did not direct the SEC to write rules to explicate and clarify the applications of the law's provisions. With the later enactment of Dodd–Frank, Congress did direct the SEC to write such rules. Ambiguities in the application of section 304 in Sarbanes–Oxley are identified and explained in this paper. Some have been the subject of litigation; some have not. This paper's central purpose is to define to what extent the rules proposed by the SEC, relevant to section 954 of Dodd–Frank, are applicable to and helpful in addressing the ambiguities in section 304 of Sarbanes–Oxley.

The SEC's proposed rules clearly define when restatement of financial statements is "required." Restatement is not dependent on actual restatement. Rather, it depends on when the board reasonably concludes or should have concluded that issued financial statements contained material error or when a legally authorized body directs restatement, whichever happens earlier.[168] Interpreting the term "required" to include situations when the board should have recognized required restatement makes it clear that the SEC will not avoid pursuing a clawback because the board did not file a restatement. The proposed rules may also help define what is meant by "material noncompliance." The discussion of what constitutes an error in reporting and materiality, as defined by prior United States Supreme Court rulings, should be helpful in section 304 actions. Finally, there may be some guidance provided in determining when compensation subject to clawback is considered "received." Sections 304 and 954 define very different time periods as parameters for finding ill-gotten gains. However, this may not preclude definition of the necessary elements for actual or constructive receipt.

This paper demonstrates that there are more differences between sections 304 and 954 than similarities. However, the three most important similarities do provide guidance regarding three of the most important parts of section 304. It is also clear that the route to clarity in the application of section 304 will only be charted through the courts.

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[168] Listing Standards, *supra* note 13, at 30.