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Article

New Regulatory Realities for Executives

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Executives operate in an aggressive regulatory environment. The Dodd-Frank Wall Street Reform and Consumer Protection Act mandates that companies recoup executive compensation in the event of a material financial restatement, and it encourages whistleblowers with monetary rewards.

Executives face increased risk that they will be personally liable for financial misstatements of their companies. The Securities and Exchange Commission is empowered to pursue them for misdeeds they may not have personally committed. As a result, they must vigilantly monitor their company's business practices to protect their own wallets.

This summer the SEC filed three related cases against Diebold, Inc., a manufacturer of ATMs and electronic voting machines, and certain of its senior executives. In two of these cases, the SEC alleged that Diebold and its executives engaged in fraudulent accounting policies to inflate earnings in order to meet analysts' expectations.

What is unique is that the SEC focused on business practices which on their face appear innocuous, but could be viewed as evidence of undue pressures that led to earnings manipulation. Specifically, the SEC alleged that Diebold's management conducted "monthly business reviews" and often received daily "flash reports," in which current company financial performance and internal projections were compared with analysts' forecasts.

The forecasts were often referred to by management as "required" or "necessary" earnings. When projected earnings were less than analysts' expectations, the senior executives would create "opportunity lists," identifying ways to achieve the analysts' desired results. The SEC recognized that some of the opportunities identified were "legitimate business opportunities," but it alleged that others constituted fraudulent transactions designed to improperly inflate financial performance.

In the third case, the SEC filed suit against Walden O'Dell, the former CEO of Diebold, seeking disgorgement of bonuses and other incentive-based and equity-based compensation. Section 304 of the Sarbanes-Oxley Act states that if a public company restates its financial statements due to material noncompliance "as a result of misconduct, with any financial reporting requirement under the securities laws," the CEO's and CFO's bonuses and incentive-based and equity-based compensation received during the 12 months after the misstated statements, along with any profits realized from the sale of the issuer's securities during that period, are subject to clawback.

The SEC did not allege that O'Dell engaged in any improper conduct. Instead, it sought reimbursement because he was at the helm of Diebold when the alleged fraud occurred. O'Dell agreed to a consent judgment and paid back $470,016 in cash bonuses, 30,000 shares of Diebold stock, and options for 85,000 shares of Diebold stock. As a result, the issue of whether Section 304 requires an executive to have participated in the misconduct that caused the misstatement was not addressed.

In a similar case handed down days after the Diebold release, a U.S. District Court concluded that Section 304 does not require the CEO or the CFO to have participated in the wrongdoing that caused the financial misstatement. In *SEC v. Maynard L. Jenkins*, the SEC demanded that Jenkins, the former Chairman and CEO of CSK Auto Corporation, return over $4 million in bonus, incentive-based and equity-based compensation and stock sale profits. Jenkins attempted to get the suit dismissed on the grounds that he did not participate in, or have knowledge of, the fraudulent conduct that resulted in the financial irregularities. The court denied the motion. This case is still ongoing.

Tougher Than Sox

The Dodd-Frank Act requires publicly traded companies to implement clawback policies that are significantly more onerous than the requirements under Sarbanes-Oxley. Under Dodd-Frank all current and former executive officers, not just the CEO and CFO, will have clawback exposure. The law requires companies to recoup any incentive-based compensation paid during the three-year period before the required financial restatement, if it was in excess of what would have been received under the restatements.

Unlike the Sarbanes-Oxley clawback provisions, which apply only to restatements that result from “misconduct,” the Dodd-Frank Act’s requirements apply whenever there is material noncompliance with the financial reporting requirements.

Under the whistleblower provisions of Dodd-Frank, employees can receive up to 30 percent of certain monetary sanctions the SEC receives if they provide “original information” (information not known from any other source). Because an employee can share in the bounty only if he or she is the first to tell the SEC, there is an incentive to go directly to the SEC, not the company.

The Dodd-Frank Act represents a departure from the philosophy of Sarbanes-Oxley, which encouraged companies to self-police through mechanisms such as whistleblower hotlines and to remediate problems internally. Studies consistently show that fraud is more likely to be uncovered by employees than any other source, so this shift in focus increases the prospect that the first time an executive may learn of unethical conduct will be in connection with a subpoena from the SEC.

Steps to Consider

Corporate executives should reexamine their culture and policies to ensure that they are effective in discouraging and detecting unethical behavior. Steps they should consider include the following:

- Set the proper tone at the top. Make sure ethical business practices permeate every aspect of the organization. To monitor earnings against analyst expectations and take steps to increase revenue in the last weeks of a quarter are not in and of themselves fraudulent, but the Diebold cases demonstrate the perils of such practices.

- Don’t label earnings estimates as “required” or “necessary.” Create an atmosphere where business realities, not analyst expectations, are what employees are focused on. The board should be involved in setting the overall tone of compliance.

- Devote proper resources to compliance. One of the most critical aspects of compliance is the company’s internal audit department. Executives should make sure it is appropriately staffed, and that it is respected. Internal audits may be the best defense against onerous clawback policies.

  Encourage internal reporting of suspected misconduct. To counter the lure of monetary rewards from the SEC, companies should carefully examine their policies for reporting concerns directly to the company. Rewards might be considered. Concerns raised by employees should be taken seriously. Appropriate follow-up action should be taken and documented.

  Early detection of problems before they result in material misstatements may be the only way executives can protect themselves from potential liability in the event of financial restatements.

- Reevaluate compensation policies. Make sure they don’t create an incentive for unethical behavior. Short-term incentives should not be too heavily weighted in the calculation. Economic targets should be based on companywide performance, rather than a particular business unit, so as to limit the ability of one employee or group of employees to secure a bonus by improper action. ■