Government Matters | Corporate, Finance and Investments

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The SEC's New Clawback Rules Will Change Internal Investigations

Public companies are swiftly adopting policies regarding "erroneously awarded compensation" by December 1, 2023, to comply with listing standards required by the new SEC Rule 10D-1. These policies will require companies to recover, or "claw back," incentive-based compensation previously received by current and former Section 16 officers if that compensation was erroneously awarded based on misreported financial information that the company is subsequently required to restate. The SEC rule and the listing standards are complex, but the impact is clear: public company executives whose compensation includes incentive pay based on one or more financial reporting measures will be at risk of having to pay back compensation if the company is required to prepare an accounting restatement, even if the error was immaterial and no misconduct occurred.

Meanwhile, it has long been the case that if a company becomes aware of a possibility that its prior financial reports contained an error, the company must determine whether an error occurred, determine whether misconduct was involved, and reach conclusions about whether a restatement must occur as well as how to prevent similar errors in the future. This usually requires an internal investigation to gather the relevant facts and reach conclusions on which the company and its auditors can rely.

Historically, the internal investigation would have been conducted under the supervision of either the company's legal department or the company's audit committee, depending on the circumstances. For example, allegations of possible misconduct involving senior officers might have suggested an independent audit committee investigation was needed, while circumstances involving an immaterial error in a prior period might have been handled by company personnel and reported to the audit committee.

With the "erroneously awarded compensation" policies and rules in effect, this calculus may change. If executive officers received incentive-based

compensation based on a financial reporting measure that subsequently must be restated, clawbacks may be required no matter how small the original errors were, no matter whether misconduct led to the errors and no matter whether the executives in question had any role in the errors. It will be natural for executives to prefer not to return compensation to a company once they received it, so the executives naturally would prefer that no restatement occurred. The new requirement that actions taken pursuant to required clawback policies must be disclosed puts even more pressure on these executives because any return of compensation will become public. As a result, the new rules create a potential conflict of interest that must be examined at the outset of every internal investigation involving a potential accounting restatement.

Because all current and former Section 16 officers whose compensation might be impacted by an accounting restatement may have a conflict of interest, audit committees are probably going to be conducting a higher percentage of the internal investigations public companies must conduct. The information flow during an internal investigation also may be impacted: in an ongoing investigation, executives have a legitimate interest in learning information as quickly as possible because it might affect the business they oversee, and executives involved in the preparation of financial statements may be motivated to complete any required restatement as quickly as possible. But if an executive is at risk of having to pay back previously received compensation based on the outcome of an internal investigation, the better course of valor may be to exclude that executive from information flow during the investigation to prevent any possibility or appearance of tampering with documents or witnesses before conclusions are reached.

In short, audit committees may be conducting more internal investigations and executives may not get information during the investigations. These circumstances will be frustrating to everyone, and experienced outside counsel will be essential to navigating them. Outside counsel advising companies and their audit committees should thoroughly understand the potential errors being investigated and how they might have impacted incentive-based compensation that could be subject to clawback in order to assess potential conflicts of interest of current and former executives. And companies can no longer take comfort that “little r” restatements (correcting an immaterial error from a prior period that would result in a material misstatement if the error were corrected, or left uncorrected, in the current period) have no significant impact. The impact on financial statements may not be significant, but if clawbacks are required, that can be very significant to current and former executives.

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