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SEC Continues Its Focus on Executive Compensation

December 3, 2021

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In its latest move to press for stronger regulation of executive compensation, on November 29, 2021, the U.S. Securities and Exchange Commission announced staff accounting guidance on share-based executive compensation awards while the company is in possession of "positive" material non-public information ("MNPI"). Specifically, in releasing ***Staff Accounting Bulletin No. 120***, the SEC announced that it expects companies, when valuing the share-based awards, to take into consideration the anticipated stock volatility once the MNPI becomes public. In other words, the SEC expects companies to take into account the likely stock price change once the positive MNPI is released when valuing awards to its executives. The guidance is primarily focused on "spring-loaded" awards, which are share-based compensation awards, such as stock option grants, made to executives shortly before the company announces information likely to move the stock price, like earnings that beat expectations or a significant transaction.

While the staff indicated that an anticipated stock bump is one of several data points, including historical pricing, that should be taken into account in valuing the award, it is clear that the staff expects that any anticipated stock value rise to be included in the valuation analysis. In announcing SAB 120, the SEC staff stated that it "believes that as companies measure compensation actually paid to executives, they must consider the impact that the material nonpublic information will have upon release. In other words, companies should not grant spring-loaded awards under any mistaken belief that they do not have to reflect any of the additional value conveyed to the recipients from the anticipated announcement of material information when recognizing compensation cost for the awards." It does not appear, however, that the SEC's position would impact fair market value determinations regarding stock option grants for federal tax purposes. Section 409A of the Internal Revenue Code requires, among other things, that a stock option be granted with an exercise price no less than fair market value (determined in accordance with Section 409A and Department of Treasury regulations) on the grant date in order to avoid penalty taxes on deferred compensation.

SAB 120 is part of a new, concerted focus by the Commission on executive compensation issues. Over the last year, the SEC has brought six enforcement proceedings involving undisclosed executive compensation. For instance, during 2021, the SEC has brought actions against reporting companies for:

- failure to value and disclose trips taken by company's CEO that were not "integrally and directly related to the CEO's job duties" on an aircraft jointly owned by the issuer and a company owned by the CEO;[1]
- failure to evaluate and disclose compensation to the company's former CEO for (i) the CEO's use of corporate aircraft for personal travel; (ii) the CEO's use of a corporate credit card for personal expenses without prompt repayment; and (iii) the CEO causing the company to use his son's business for landscaping services;[2] and
- failure to disclose certain perquisites and stock pledges concerning the company's co-founder and former CEO, including personal expenses, such as trips not directly related to the former CEO's duties, and stock pledges in real estate transactions in violation of company policies and agreements.[3]

In addition, the Commission is working to ***revive a rule*** to broaden clawback of executive incentive-based compensation. In 2015, the Commission proposed a rule in compliance with the 2010 Dodd-Frank Act, to mandate that national exchanges require listed companies to have processes to clawback executive compensation in the event of "material noncompliance" with federal securities laws. With the change in administrations in 2016, the proposed rule was never finalized. But, last month, the Commission reopened the comment period and all indications are that it will implement the expanded clawback rule. While Sarbanes-Oxley gave the SEC the limited power to recoup one-year's incentive-based compensation from CEOs and CFOs whose misconduct results in a restatement of financial statements, the proposed rule would broaden the scope of compensation clawbacks to three years, expand from whom compensation can be clawed back, and expand the events triggering a clawback.

The SEC has made the disclosure of executive compensation a regulatory and enforcement priority and it is almost certain that the Commission will be even more aggressive in pursuing cases, not only for traditional claims involving undisclosed "perks," but for undervaluing non-cash compensation.

With year-end compensation evaluations approaching and Form 10-Ks not far behind, companies should review the terms of their equity incentive plans and valuation processes. Issuers should take steps now to incorporate SAB 120 into the process of valuing share-based compensation. At the same time, companies need evaluate whether compensation plans should be revised to avoid running afoul of plan terms if they increase the grant-date fair value of a stock option for accounting purposes. Also, companies should examine whether accounting and disclosure controls are sufficient to address non-cash executive "perks." The SEC will be looking to bring more enforcement actions for undisclosed executive compensation. Among other benefits, ensuring that there are sufficient processes to identify and address all forms of non-cash compensation can help avoid the costs and fallout from an SEC investigation and enforcement action.

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1. ***https://www.sec.gov/litigation/admin/2021/34-92560.pdf***

2. ***https://www.sec.gov/litigation/admin/2021/34-91196.pdf***

3. ***https://www.sec.gov/litigation/admin/2021/33-11008.pdf***