September 14, 2015

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Listing Standards for Recovery of Erroneously Awarded Compensation (File No. S7-12-15)

Dear Sir or Madam:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule ("Proposed Rule" or "Proposal"), which was published by the Securities and Exchange Commission ("SEC" or "Commission") in the Federal Register on July 14, 2015.[2]

The Proposal would implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act").[3] Under that provision, the Commission must adopt a rule directing the securities exchanges to establish issuer listing standards providing for the recovery of incentive-based compensation paid to executives in excess of what those executives should have received, as shown by an accounting restatement.

We believe that the Commission has developed a strong proposal that largely adheres to both the letter and the spirit of Section 954 of the Dodd-Frank Act. Nevertheless, the Commission can and should improve the Proposed Rule in several respects, as detailed below, to ensure that it fully realizes the Congressional objectives underlying Section 954.

1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the domestic and global capital and commodity markets. It advocates for transparency, oversight, and accountability in the financial markets.

2 Listing Standards for Recovery of Erroneously Awarded Compensation, 80 Fed. Reg. 41,144 (Jul. 14, 2015) (to be codified at 17 C.F.R. pts. 229, 240, 249, and 274).

3 Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, *codified at* 15 U.S.C. § 78j-4 (2010).

Above all, however, the Commission's top priority should be to resist the inevitable calls from industry opponents to weaken or dilute this generally well-crafted Proposal.

INTRODUCTION AND SUMMARY

Major contributors to the financial crisis were misaligned incentives generally and executive compensation policies in particular at many financial institutions that motivated corporate leaders to engage in high-risk activities for short term profit and lucrative bonuses. Citigroup CEO Chuck Prince's infamous quote captures much of what went so wrong in the suites of the too-big-to-fail banks on Wall Street:

> "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

These short-sighted policies, fueled by misguided competitiveness and greed rather than principles of sound corporate governance, came at the expense of the long term viability of those institutions, the entire financial system, and, ultimately, the U.S. economy. As a result, the financial crisis of 2008 will cost over $20 trillion in lost GDP, in addition to the long-lasting suffering still being experienced by millions of Americans who lost their jobs, savings, and homes.[4]

A specific problem in the realm of corporate governance was the tendency of some corporate executives to engage in accounting fraud or manipulation to justify inflated compensation awards. As one Congressional study of the crisis concluded:

> "Even before the current crises, many criticized such incentive plans for encouraging excessive focus on the short term at the expense of consideration of the risks involved. This short-term focus led to unsustainable stock buyback programs, accounting manipulations, risky trading and investment strategies, or other unsustainable business practices that merely yield short-term positive financial reports."[5]

To address these abuses, Congress enacted a collection of corporate governance and executive compensation reforms in Subtitle E of Title IX of the Dodd-Frank Act, including the following:

- Section 951, requiring shareholder advisory votes on executive compensation and golden parachutes (SEC rules final);

[4] *See generally* Better Markets, "The Cost of the Crisis" (July 2015), *available at* http://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

[5] Congressional Oversight Panel Special Report on Regulatory Reform, "Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability," (2009).

- Section 952, requiring new listing standards that impose enhanced independence requirements for members of issuers' compensation committees (SEC rules final);

- Section 953(a), requiring disclosure of executive compensation in relation to company performance (SEC rules proposed), and Section 953(b), requiring disclosure of the ratio between the CEO's total compensation and the median total compensation for all other company employees (SEC rules adopted); and

- Section 956, mandating the disclosure to regulators of all incentive-based compensation arrangements, and prohibiting incentive-based compensation arrangements that encourage inappropriate risks by providing executives or others with excessive compensation (SEC rules proposed).

Section 954 is part of this collection, and it was specifically designed to ensure that corporate executives are not allowed to retain incentive-based compensation that was awarded based upon materially inaccurate financial statements. Once implemented, it will help curb high risk activities, increase compliance with accounting standards, and promote fairness to shareholders by ensuring that they are not forced to pay executive compensation that was undeserved.[6] It is one of many important reforms that are necessary to help reduce excessive risk-taking by financial market participants, thereby decreasing the likelihood of another financial crisis.

COMMENTS

Although Section 954 is a relatively simple provision, it illustrates the complexities facing the SEC as it implements many of the reforms in the Dodd-Frank Act. The statutory mandate in Section 954 calls upon the SEC to address a wide variety of issues, ranging from the issuers and executives that should be covered, to the types of compensation that should be subject to claw back, to the degree of discretion that issuer boards should have as they implement the rule's provisions. In general, the SEC has established strong and appropriate requirements in the Proposal, often consulting the underlying objectives of Section 954 and adopting a provision that most effectively accomplishes those objectives.

Below, we review the major elements of the Proposal, focusing largely on its strengths, but also recommending some significant improvements that the Commission should incorporate in the final rule.

Issuers. The Proposed Rule will appropriately cover most types of issuers, including smaller reporting companies as well as emerging growth companies.

[6] *See* S. Rep. No. 111-176 (2010).

Securities. The Proposed Rule will also appropriately cover most types of listed securities, including debt and preferred securities, and exchanges will have no discretion to alter those determinations.

Materiality. Section 954 provides that an issuer must recover incentive-based compensation resulting from "material noncompliance" with financial reporting requirements. The SEC rightly rejected calls to define "materiality," and instead adopted a principles-based approach. The SEC correctly observed that "materiality" in this context must be analyzed under the "particular facts and circumstances" applicable in each case. Moreover, as the SEC also notes, the concept of "materiality" has received extensive judicial and regulatory treatment in a variety of situations. Issuers therefore will have ample guidance as they assess materiality under the rule. Accordingly, the SEC left the term intact without constricting it with a specific definition or description.

In response to a request for comment, we note that whenever an issuer decides that an accounting error or irregularity is ***not*** material, the rule should require the issuer to document its analysis supporting that conclusion, and provide that analysis to the Commission and the relevant exchange.

Date trigger. Section 954 provides that issuers must recover excess compensation paid during the 3-year period preceding the date on which the issuer "is required to prepare an accounting restatement." The SEC's implementation of this test is critical. If the issuer's executives are left with too much control or discretion over the decision to restate the financials, then the rule will be easily evaded.

Under the SEC's Proposal, an issuer would be deemed "required" to prepare an accounting restatement on the earlier of—

1. The date the issuer's board of directors or other relevant corporate authority concludes, ***or reasonably should have concluded***, that the issuer's previously issued financial statements contain a material error; or

2. The date a court, regulator, or other authority directs the issuer to restate its previously issued financial statements to correct a material error.

Adding the "reasonably should have concluded" test is critically important, as it will create a more objective standard that limits board discretion and the potential for evasion.

Executive officers. The SEC has appropriately and broadly defined the universe of corporate officers whose compensation would be subject to the rule. It encompasses the issuer's president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit or division, or ***any other officer or person who performs a policy-making function for the issuer***. It would also encompass executive officers of the issuer's parents or subsidiaries, if they perform such policy-making functions. Finally, the SEC appropriately determined that the rule should cover excess compensation received by an individual who served as an executive officer of the listed issuer ***at any time*** during the relevant performance period. These broadly formulated provisions will help thwart attempts to evade the rule through the use of misleading job titles.

To further strengthen the rule and better achieve the objectives underlying Section 954, the Commission should expressly include the principal legal officer, the chief compliance officer, and the chief information officer as covered executives.

Incentive-based compensation. Rather than list all types of covered compensation, the Proposed Rule appropriately adopts a principles-based approach. The Proposed Rule applies to "any compensation that is granted, earned, or vested based wholly or in part upon the attainment of any financial reporting measure." This broad and flexible approach is important for two reasons. First, it will accommodate new forms of compensation as they emerge. In addition, it will thwart attempts to evade the rule by designing novel types of compensation that do not fit within a specified category.

The Commission has also correctly interpreted Section 954 to cover compensation based on performance measures such as a company's stock price and total shareholder return. While these metrics might not be regarded as purely accounting-based measures, they nevertheless fall within the ambit of the statutory formulation, which broadly encompasses all compensation "based on financial information required to be reported under the securities laws." This conclusion finds support in other wording of Section 954, which provides for recovery of excessive compensation "based on" erroneous data. Such language indicates a Congressional intent to reach not only incentive-based compensation directly and expressly tied to financial accounting metrics, but also compensation indirectly "based" on such metrics. Furthermore, as a practical matter, stock price and total shareholder return are widely used in calculating executive compensation, so their exclusion would substantially undermine the attainment of the objectives underlying Section 954.

While the range of compensation included in the Rule is broad, it is still too narrow and will permit evasion if the final rule is not strengthened. For example, it would not include incentive-based compensation that is ostensibly subjective or based purely on board judgment, even where it is in reality keyed to financial performance measures. Ultimately determining the true character of any type of compensation can be exceedingly difficult if issuers are bent on manipulating such distinctions.

The remedy to this problem is two-fold. First, as others have recommended, the final rule should provide for pro rata recovery of all forms of incentive-based compensation paid during the look-back period, regardless of how it may be characterized. The subjective, non-financially related compensation should be recovered in the same proportion as the accounting-based incentive compensation is recovered. This approach in effect creates a reasonable and necessary presumption that all incentive-based compensation is based at least in whole or in part on financial performance measures.

Absent this approach, the final rule must at least include the type of anti-evasion clause suggested in the Release.[7] It should provide that regardless of label, all incentive-based compensation is subject to recovery under the rule if it is in fact based in whole or in part, and directly or indirectly, upon financial information metrics. While this falls short of a presumption, it would still require the recovery of any incentive-based compensation that could be shown to be accounting-based in light of all the facts and circumstances.

<u>Time when compensation is "received."</u> The Proposed Rule correctly provides that an executive will be deemed to have received incentive-based compensation during the financial reporting period in which the specific metric is achieved, even if the right to receive payment is subject to other conditions and actually occurs later in time.

However, under the Proposal, compensation received by an executive before the issuer's securities become listed would not be subject to recovery. The statute does not provide for this limitation; the Release offers no justification for it; and, it should be removed.

<u>Board discretion not to recover</u>. The Proposed Rule would create exceptions allowing issuers to forego recovery of incentive-based compensation in two situations: 1) where direct costs of enforcing recovery would exceed recoverable amounts, or 2) where recovery would violate home country law. The Release explains that pursuit of recovery may not be in the best interest of shareholders, where the likely recovery is small relative to the expense, or where an issuer is forced to choose between de-listing its securities and violating home country law.[8]

However, when Congress enacted Section 954, it chose not to create any type of de minimis exception or give the SEC specific authority to create exemptions from the basic mandate in Section 954. Therefore, the SEC's decision to invoke its general exemptive authority under the securities laws is an inappropriate approach.

In the Release, the SEC acknowledges that creating any exceptions could undermine the core purpose of Section 10D, which is to maximize the recovery of undeserved incentive-based compensation.[9] The Proposal therefore incorporates a number of important safeguards to minimize this effect. For example, in all cases, the issuer would have to make a reasonable attempt to recover, document that attempt, and provide that documentation to the exchange. In addition, it would have to explain any decision not to pursue recovery. With respect to conflict with home country law, the issuer would need to obtain an opinion of home country counsel that recovery would result in a home country violation; and the relevant home country law would have to have been adopted prior to the date the ***Proposal*** was published in the Federal Register. Further, in either case, any decision to forego recovery would have to be made by independent committee or majority of independent board members.

However, even with these safeguards, the exemptions are unwise. First, as noted above, they conflict with Congress's intent, as reflected in the unqualified nature of the

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[7] 80 Fed. Reg. at 41,157.
[8] *Id.* at 41,161-62.
[9] *Id.* at 41,163.

mandate in Section 954. In addition, they rest on a questionable rationale. The Release cites the best interests of shareholders as the basis for both of the exemptions.[10] However, while promoting fairness to shareholders is one objective of Section 954, the primary purpose of this reform is to discourage corporate leaders from pursuing excessively risky activities by removing compensation incentives that drive such behavior. The exceptions undermine this goal. In any case, promoting sound corporate governance policies is invariably good for shareholders in the long term.

The exemptions will also have negative practical effects. With the exemptions in place, those who have received the most in incentive-based compensation have the greatest motivation and ability to resist recovery and to convince an issuer that the reward will not be worth the effort. As a result, many issuers may abandon recovery efforts even though a significant amount of compensation is at stake and the recovery effort should persist. If, however, the final rule ensures that all executives face an inevitable and relentless recovery effort, it will tend to induce less litigation and resistance in the process, leading to better outcomes.[11]

Timing of recovery. The Proposed Rule would give boards discretion over how quickly issuers must complete the recovery of excess compensation. This is appropriate, to a degree, since the process will be subject to a variety of specific facts and circumstances, including the amount of compensation at issue, the available resources for the recovery effort, the nature of the compensation, and the financial circumstances of the executive.

However, the Proposed Rule must more effectively guard against attempts by executives to protract the recovery process, as well as possible collusion between boards and executives aimed at prolonging the process to the point that it becomes meaningless.

To address these concerns, the final rule should require issuers to explain or justify the chosen time frame, in light of all relevant factors, and provide that analysis to the Commission and the relevant exchange. In addition, the final rule should incorporate an explicit mandate that issuers must recover excess incentive-based compensation "reasonably promptly." The Release identifies "reasonably promptly" as an appropriate requirement, but it is not incorporated into the Proposed Rule itself and it should be "codified" in the final version.[12]

Disclosure requirements. The disclosure requirements in the Proposed Rule are appropriately designed to facilitate prompt delisting proceedings by exchanges when issuers fail to adopt, comply with, or make disclosure in accordance with, recovery policies. Furthermore, the Proposal correctly requires that disclosures be filed in accordance with the

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[10] 80 Fed. Reg. at 41,161-63.

[11] At a minimum, we urge the Commission to strengthen the exemptive conditions, especially with respect to the foreign law standard. For example, paying a law firm to issue the requisite opinion letter will be relatively easy. Therefore, the final rule should require that the letter be unqualified and issued by a nationally recognized law firm that has the demonstrable expertise and experience on the relevant legal issue. Moreover, because many countries have laws that are not enforced, the final rule should also stipulate that the foreign law underlying the exemption must be actually enforced in the home country, in a meaningful way and not as a mere technical violation.

[12] 80 Fed. Reg. at 41,163.

federal securities laws, to promote consistency and to subject the disclosure requirements to the SEC's compliance oversight.

The SEC has also correctly exercised its discretionary authority to require the disclosure of more detailed information about instances of accounting restatements and recovery efforts under Section 954. The array of information required is useful, but still incomplete. For example, it should also include an identification of each executive from whom recovery of excess compensation has been sought and the status of the recovery effort.

Issuer indemnification. The Proposed Rule correctly prohibits issuers from indemnifying executives for any recovery of compensation under Section 954. Clearly, and as explained in the Release,[13] such indemnification arrangements would conflict with the plain language of the statute, which provides that issuers will recover excess compensation "***from any current or former executive officer***." If indemnification were permitted, then there would in effect be no recovery from the officer, in contravention of the statutory mandate.

Based on this rationale, the final rule should also prohibit executives from obtaining third party insurance policies to fund potential recovery obligations. The Release indicates that such insurance coverage would be permissible,[14] yet it too would violate the core statutory mandate that excess compensation be recovered ***from*** the executive, not from anyone else—whether it be the issuer through indemnification or an insurance company through an insurance policy. And practically speaking, the rule will do much less to incentivize sound corporate governance and accounting practices if the obligation to surrender incentive-based compensation can simply be neutralized through insurance. This must be prohibited in the final rule; otherwise, the rule, and indeed the statutory provision, will never achieve their intended purposes.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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President & CEO

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[13] 80 Fed. Reg. at 41,169.
[14] *Id.*

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