

November 22, 2021

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549
RIN 3235-AK99
File Number S7-12-15

Re: Reopening of Comment Period for Notice of Proposed Rulemaking for the Listing Standards for Recovery of Erroneously Awarded Compensation

Dear Madam:

McGuireWoods, LLP and Brownstein Hyatt Farber Schreck, LLP hereby submit this letter in response to the request for public comments by the Securities and Exchange Commission (the “**Commission**”) to the Reopening of Comment Period for the Notice of Proposed Rulemaking for the Listing Standards for Recovery of Erroneously Awarded Compensation (the “**Proposed Rules**”) for Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “**Dodd-Frank Act**”), which was published in the Federal Register on July 14, 2015.¹ Section 954 of the Dodd-Frank Act added Section 10D to the Securities Exchange Act of 1934 (the “**Exchange Act**”). Our comments specifically address the impact of the Proposed Rules on incentive-based compensation arrangements provided by large and diversified financial institutions to their employees.

- I. Current Market Practices Indicate that Issuers’ Policies for Recovering Erroneously Awarded Compensation are Effectively Deterring Misconduct.**
- A. Recovery policies are widely implemented among public companies and are regarded as a corporate governance best practice.**

Publicly-traded companies have been required to have mandatory policies in place for recovering erroneously awarded compensation since the Sarbanes-Oxley Act was enacted in 2002. The recovery policies set forth in the Sarbanes-Oxley Act impose a relatively narrow recovery requirement that applies only to the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) and is triggered only if a restatement of financial results occurs as a result of misconduct.²

¹ 80 Fed. Reg. 41,144 (July 14, 2015).

² 15 U.S.C § 7243

Exchange Act Section 10D includes a more expansive recovery requirement for erroneously awarded compensation that applies to all executive officers (not just the CEO and CFO) and is triggered by restatements of financial results, regardless of whether or not they were caused by misconduct. Although the recovery provisions have not yet taken effect,³ many publicly-traded companies have voluntarily adopted these more expansive recovery policies in response to pressures from proxy advisory firms or investors or out of a belief that such policies are part of good corporate governance.

Since the enactment of Exchange Act Section 10D, there has been a notable trend in these voluntarily-adopted compensation recovery policies to broaden them to apply in more circumstances and cover additional types of compensation and conduct. In addition, proxy advisory services and institutional investors have, in recent years, adopted policies that favor recovery policies with specific designs. A 2018 Equilar report on executive compensation and governance outlook found that 92% of the S&P 500 companies disclosed the existence of a recovery policy in 2017.⁴ Thus, it is clear that such policies to recover erroneously awarded compensation are widely implemented among public companies because they are regarded as a corporate governance best practice.

B. The final rule should better reflect current best practices in the marketplace.

It has been more than eleven years since Section 954 of the Dodd-Frank Act was signed into law by President Barack Obama on July 21, 2010 and more than six years since the Proposed Rules for Exchange Act Section 10D were published in the Federal Register on July 14, 2015. As noted above, the vast majority of publicly-traded companies have responded to market demands and crafted expansive recovery policies that reflect such demands. The Commission should be mindful of the time and expense that will be needed in order to change these policies. Corporate boards and board committees will need as much time as possible to comply with any changes to the rule.

In addition, the Commission should be mindful of the success that publicly-traded companies have had in developing effective recovery policies that deters misconduct and rewards transparency, accuracy, and oversight. Recent cases overwhelmingly demonstrate this success. In 2020, McDonald's Corporation joined a growing list of companies that have taken action to forfeit unpaid compensation or demand repayment of compensation previously paid to a former CEO, including equity awards or proceeds from the sale of equity awards, pursuant to company recovery policies.⁵ Similarly, in *Hertz Corp. v. Frissora*, Hertz sought to recover approximately \$56 million in incentive compensation paid to the former CEO and General Counsel in connection with the recovery policy put in place by the company.⁶

³ Proposed Rules were issued in 2015 and have not yet been finalized.

⁴ See Corporate Governance Outlook 2018 (December 2017), https://www.hoganlovells.com/~/_media/hoganlovells/pdf/select-2017/equilar-corporate_governance_outlook_dec_2017.pdf.

⁵ *McDonald's Corporation v. Stephen J. Esterbrook*, WL 5246130 (Del. Ch. 2020).

⁶ *The Hertz Corp. v. Frissora*, 2:19-cv-08927 (D.N.J 2021).

C. The final rule should take into account the impact that implementing the Proposed Rules will have on current recovery policies.

Because the vast majority of publicly-traded companies have already adopted recovery policies, implementing a rigid final rule that does not take into account the policies that companies have implemented, will penalize these companies by forcing them to revise or replace existing policies and replace them with new ones. This will be an expensive and time consuming exercise.

In addition, new and inflexible rules will create confusion with respect to outstanding awards that are already granted and are subject to current recovery policies. Thus, the Commission should take into account the impact of implementing new policies will have on existing policies.

II. Final Rule Should Only Require Recovery of Erroneously Awarded Compensation if an Accounting Restatement is Required to Correct an Error that is “Material” to Previously Issued Financial Statements.

A. The final rule should provide a consistent application of the term “material” for purposes of determining when a recovery is necessary.

We support the Commission’s Proposed Rules tying the recovery of erroneously awarded compensation to an accounting “restatement to correct an error that is material to previously issued financial statements.” Exchange Act Section 10D(b)(2) applies to “accounting restatements due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws...” While this language focuses on the materiality of the noncompliance itself, as opposed to the impact on the financial statements, we agree with the Commission’s statement in the Proposing Release of the Proposed Rules that “an error that is material to previously issued financial statements constitutes ‘material noncompliance’ by the issuer with a financial reporting requirement under the securities laws.” It does not make sense to tie recovery to the materiality of the noncompliance with the accounting rule itself because (i) it would be impossible for an issuer to determine whether noncompliance is material other than by reference to the impact on the financial statements, and (ii) congressional intent of Section 954 of the Dodd-Frank Act appears to focus on recovery of compensation tied to financial results as opposed to tying to compliance with financial reporting requirements.⁷

We believe the final rule should define the term “material” so that it is clear when a restatement is necessary. We recognize that materiality in the securities law context is largely left undefined with reference to judicial or regulatory interpretation and guidance, requiring an analysis of applicable facts and circumstances. However, materiality in the context of Section 954 of the Dodd-Frank Act is different and warrants a different approach to assure a higher level of certainty for issuers and recipients of incentive compensation. Recovery of excess compensation may have a significant impact on issuers and recipients of incentive awards and may also impact those who did not have any role in the noncompliance causing the recovery (unless the final rule limits the executive officers subject to recovery to those involved with the preparation of financial statements). For example, recovery may impact: (i) federal and state income tax filings and elections, (ii) reporting under Section 13 and Section 16 of the Exchange Act, (iii) federal and state

⁷ See generally Senate Committee Report 111-176.

tax withholding requirements, and (iv) financial statements and disclosures made in filings with the Commission.

Defining the term “material” would, among other things, (i) promote consistent application among issuers, (ii) remove the temptation for issuers to conclude that noncompliance is immaterial by making the decision more binary, (iii) reduce the pressure on issuers to err on the side of caution by recovering incentive compensation when the materiality determination is unclear to avoid regulatory or shareholder scrutiny, (iv) reduce the likelihood of shareholder lawsuits second guessing issuers’ judgment as to materiality when the materiality determination is unclear, and (v) assure that recovery from recipients of incentive compensation is warranted, thereby reducing the uncertainty of the impact on their personal lives.

B. The final rule should only define an accounting restatement as occurring when the issuer is required, by applicable accounting standards, to issue restated financial statements to correct one or more errors that are “material” to previously issued financial statements.

The final rule should define a “material” error as occurring when the issuer is required, by applicable accounting standards, to issue restated financial statements to correct one or more errors that are “material” to previously issued financial statements. We believe that the material error occurs when the independent auditor notifies the issuer of its reasonable belief that an issuer can no longer rely upon its previously stated financial statement. As other commentors have properly noted, an issuer’s independent auditors evaluate both an issuer’s quantitative and qualitative factors when making such determinations.⁸ By looking to the issuance of such a notice by the independent auditor to define when a material error has occurred, and a restatement is necessary, provides an objective standard that can be applied in a consistent manner.

C. A restatement is not material if it corrects immaterial errors in historical financial statements even if they would otherwise make the current financial statements misleading.

In the Proposing Release to the Proposed Rules, the Commission states that it is considering whether “an accounting restatement due to material noncompliance” should be interpreted to include all required restatements made to correct an error in previously issued financial statements. Financial Accounting Standards Board Accounting Standards Codification Topic 250 defines “error in previously issued financial statements” as an error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles, oversight, or misuse of facts that existed at the time the financial statements were prepared.

We believe the drafters of Section 954 of the Dodd Frank Act clearly intended that not all restatements should trigger recovery and, in particular, that immaterial restatements should be excluded from recovery. Therefore, we do not believe that the final rule should trigger recovery

⁸ See letter in response Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation (Release Nos. 33-10998; 34-93311; IC-34399; File No. S7-12-15) from PricewaterhouseCoopers LLP (September 14, 2015).

when a restatement corrects immaterial errors in historical financial statements even if the prior immaterial errors would otherwise make the current financial statements misleading. Doing so would be inconsistent with Section 954 of the Dodd-Frank Act, which requires material noncompliance with financial reporting requirements. Further, concluding otherwise would require issuers to repeatedly restate its financials for the most immaterial errors, which ultimately might drive issuers to avoid any and all corrections of errors. Thus, we urge the Commission not to adopt a rule that would treat all corrections of one or more errors as material.

D. Retrospective application of a change in accounting principles should not trigger the recovery of previously awarded compensation.

We agree with the Commission that certain changes to an issuer's financial statements do not represent the correction of an error, and therefore would not trigger application of the issuer's recovery policies. The Proposed Rules provide that, among other items, a change from one permissible accounting method to another does not constitute a correction of an error, and therefore, should not trigger recovery as these occurrences are not resulting from material noncompliance with financial reporting requirement under the securities laws. Only in instances where an issuer is going from an impermissible to a permissible method of accounting should it rise to the level of a correction of an error.

E. The final rule should not adopt GAAP definitions for purposes of determining when a material restatement has occurred.

We believe it is appropriate to define "restatement" without reference to any particular accounting framework. Exchange Act Section 10D expressly refers to material noncompliance with any financial reporting requirement under the securities laws without any reference to GAAP or any other accounting framework. We support this approach and believe that defining "restatement" with reference to GAAP is inappropriate because the GAAP definition of "restatement" is very broad and does not make a materiality distinction.

In addition, not all issuers use GAAP. If the Commission decides that the definition of the term "accounting restatement" should refer to U.S. GAAP, we believe the Commission would also need to address foreign private issuers that prepare their financial statements using International Financial Reporting Standards and other non-U.S. GAAP accounting frameworks.

F. The standard for determining when the look back period is triggered once a "material" error has occurred should be an objective standard.

As the Commission accurately noted, the Proposed Rules do not specify how the lookback period should be measured nor the events that "trigger" a restatement. The Proposed Rules seek to clarify this "trigger date" by requiring the lookback period to commence on the earlier of: (1) the date the board of directors concludes, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error; or (2) the date a court or regulator directs the issuers to restate its previous financial statement in order to correct a material error.

The Proposed Rules’ “should have concluded” is an ambiguous and overly broad standard that is inconsistent with Item 4.02(a) of Regulation S-K. Item 4.02(a) correctly provides disclosure when the issuer’s “board of directors, a committee of the board of directors or the officer or officers of the registrant authorized to take such action if board action is not required, concludes that any previously issued financial statements . . . should no longer be relied upon because of an error in such financial statements.”

Further, as noted earlier, the issuance of a notification from the issuer’s independent auditor informing the issuer of its reasonable belief that an issuer can no longer rely upon its previously stated financial statement should constitute a “trigger date.” In the event the issuer’s board of directors disagrees with its independent auditors, then the board of directors should be required to issue a statement that details its conclusion that such notification is incorrect.

In order to provide the desired certainty and objective standard for issuers, shareholders and exchanges, we believe the Proposed Rules should remove the “should have concluded” standard and require the three-year lookback period to commence on the earlier of: (1) the date an issuer’s independent auditor notifies the issuer that its previously issued financial statement contained a material error; (2) the date the board of directors concludes that the previously issued financial statement should no longer be relied upon; or (3) the date a court or regulator directs the issuers to restate its previous financial statement in order to correct a material error.

III. The Final Rule Should Adopt Clear, Objective Standards Regarding the Application of the Recovery Requirements.

A. The final rule should adopt the Proposed Rules regarding how to measure the three-year look back period.

We agree with the Commission that the three-year lookback period should be based on three fiscal years. Using three fiscal years, rather than three consecutive years preceding the date the issuer is required to prepare a restatement, is consistent with general practices of making compensation determinations and awards. This provides an objective standard that can be uniformly applied across issuers.

B. The Proposed Rules’ application to all Section 16 “executive officers” is overly broad and does not advance the purpose of Section 954 of the Dodd-Frank Act.

Exchange Act Section 10D requires national securities exchanges and associations to adopt listing standards that require issuers to adopt and comply with policies that provide for recovery of excess incentive-based compensation from “any current or former executive officer of the issuer who received incentive-based compensation.” However, the Proposing Release correctly acknowledges that “Section 10D [of the Exchange Act] does not define ‘executive officer’ for purposes of the recovery policy.”⁹

The Proposed Rules indicate that the Commission received several questions and suggestions regarding how to best resolve the ambiguity of the term “executive officer” and that

⁹ 80 Fed. Reg. 41,152 (July 14, 2015).

the Commission ultimately included a definition of ‘executive officer’ “that is modeled on the definition of ‘officer’ in Rule 16a-1(f).”¹⁰ Thus, the Proposed Rules suggest an executive officer would include an issuer’s president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy making functions for the issuer. Executive officers of the issuer’s parents or subsidiaries would be deemed executive officers of the issuer if they perform such policy making functions for the issuer.

We agree that Exchange Act Section 10D(b)(2) is ambiguous as to which individuals should be considered executive officers for purposes of applying the recovery policy rules. However, we recommend the Commission consider potential revisions to the term executive officer that will focus the application of the rules on individuals who are responsible for an issuer’s financial reporting and/or were actually involved in the error leading to an accounting restatement. However, should the Commission reject these limitations, we recommend the final rule use the definition for executive officer contained in Item 402 of Regulation S-K and refine its reporting rules to more closely align with existing executive compensation disclosure requirements.

1. ***The final rule should limit the application of mandatory recovery policies to executive officers who are responsible for certifying financial statements (CEO and CFO).***

The purpose of Exchange Act Section 10D is to require issuers to enact policies that enable the recovery of incentive-based compensation that exceeds the amount that would have been paid absent the issuer’s material noncompliance with financial reporting requirements under applicable securities laws. Absent material misstatements in financial reports, there would be no need for an issuer to pursue compensation recovery contemplated by Exchange Act Section 10D. While the text of Section 10D refers broadly to executive officers, in our view the focus on restatements due to material noncompliance with financial reporting should influence the implementation approach with respect to executive officers subject to recovery of compensation in the final rule.

Therefore, we believe that the final rule would better advance the goal incentivizing accurate financial reporting and eliminating the payment of incentive-based compensation based on erroneous financial statements by applying the recovery policy rules to the executive officers who actually certify the issuer’s financial reports, rather than a broader group of individuals within an organization, many of whom have nothing to do with the preparation of such financial statements. The Proposed Rules endorse this premise in that it provides in the Preamble that “we believe it is clearly appropriate for officers with an important role in financial reporting to be subject to the recovery policy.”¹¹ We agree with the Commission’s position articulated in the Preamble and believe limiting application of the final rule to an issuer’s CEO and CFO will focus these individuals on ensuring those statements are correct so as to avoid material misstatements that would trigger a recovery of their incentive-based compensation.¹²

¹⁰ 80 Fed. Reg. 41,153 (July 14, 2015).

¹¹ 80 Fed. Reg. 41,153 (July 14, 2015).

¹² 15 U.S.C § 7243.

As a result of this certification obligation and responsibility, an issuer's CEO and CFO are in charge of setting financial reporting policies of the issuer and, rightly, should be held accountable for lapses that lead to overpayments of incentive-based compensation. The same generally cannot be said for all executive officers of an issuer, for example the Chief Human Resources Officer (CHRO). Requiring recovery of the CEO's and CFO's incentive-based compensation inherently leads such individuals to take all appropriate steps to make sure an issuer's financial statements are correct and accurate. Recovering incentive-based compensation paid to an issuer's CHRO generally does far less to ensure the issuer's financial statements are accurate since the CHRO does not have a direct role in the preparation of such statements. While an issuer may have controls and procedures that involve an executive officer such as a CHRO, this officer would generally not be ultimately accountable for taking the steps to ensure that an issuer's financial statements are correct.

2. ***If the final rule does not limit recovery of erroneously awarded compensation to the CEO and CFO, it should only require compensation recovery policies to apply to executive officers who either certify financial statements or who were involved in the issue leading to the financial restatement.***

As described above, requiring issuers to adopt compensation recovery policies applicable to all executive officers does not further the goal of improving corporate governance and internal controls designed to prevent the payment of excess incentive-based compensation based on incorrect financial statements.¹³

If the final rule does not limit application of recovery actions to those who certify an issuer's financial statements, it should only be expanded to cover executive officers who are responsible for certification and those involved in the issue leading to the financial restatement. As discussed earlier, we believe limiting the final rule to an issuer's CEO and CFO provides sufficient incentives to adopt and implement policies that will discourage payment of excess incentive-based compensation; however, this alternative standard keeps with the premise that only executive officers who play a role in the issue resulting in the material noncompliance should bear the brunt of compensation recovery actions.

Otherwise, such recovery actions would be unnecessarily punitive with respect to executive officers who had no involvement in the actions leading to the financial restatement and for whom recovering incentive-based compensation would have no positive effect on improving corporate governance to reduce the risk of future material noncompliance with financial reporting requirements. Furthermore, subjecting executive officers of an issuer to an overly punitive recovery rule with respect to their compensation could negatively impact retention, succession planning and recruiting. Senior leaders who are not designated as Section 16 officers may have no desire to assume positions so designated, even though they may be the best talent for the position due to background and experience and the significant investment in the individual already made by the issuer.

¹³ See Senate Report reference in its discussion of Section 954 to the U.S. Financial Regulatory Reform: An Investor's Perspective, Investor's Working Group, July 2009, which included in its recommendations for improving corporate governance strengthening the federal recovery policy on executive pay.

Additionally, public companies may find themselves at a disadvantage when recruiting outside talent for executive officer positions, as the marketplace for executive talent is not limited to publicly-traded companies. In fact, with the rise of private equity and other alternative funding sources, the number of publicly-traded companies has generally decreased since the 1990s.¹⁴ Therefore, talented executives often have the choice of whether to lend skills and expertise to privately-held companies or to sign on with a publicly-traded company. If the Commission crafts the final rule in such a way that is overly punitive, it would be one more factor discouraging top talent to join publicly-traded companies and instead opt for private opportunities. For example, it is perfectly reasonable for an executive to decide that joining a portfolio company of a private equity fund is more attractive than taking a comparable public company position in which a no-fault compensation recovery rule essentially puts her incentive compensation earned during the three prior years at risk.

3. *The final rule should utilize the definition of executive officer found under Item 402 of Regulation S-K instead of the term officer under Rule 16a-1(f)*

If the Commission does not agree with either of the proposed modifications above with respect to defining executive officers whose compensation is subject to recovery, the final rules should utilize the Item 402 definition of executive officer, rather than the broader notion of an officer under Rule 16a-1(f), as this approach would more closely align the final rule with Exchange Act Section 10D.

Item 402 of Regulation S-K defines an executive officer as the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer.¹⁵ Executive officers of subsidiaries may be deemed executive officers of the issuer if they perform such policy making functions for the issuer.¹⁶

This definition is very similar to the Rule 16a-1(f) definition of officer; however, it notably does not include a reference to an issuer's principal accounting officer. We believe excluding the explicit reference to an issuer's principal accounting officer is appropriate as the individual who serves in this role typically does not have any policy-making function, is rarely a direct report to the CEO and is not customarily a part of an organization's executive management team. In the event an organization's principal accounting officer were to serve in such a high-level role, such individual would be included under the Item 402 definition as an officer performing a policy making function. Thus, issuers would not be able to inappropriately exclude principal accounting officers who truly serve a meaningful senior executive role within the organization; however, the final rule would not inadvertently cover individuals who are outside the issuer's senior executive orbit.

¹⁴ See Spencer Israel, *The Number of Companies Publicly Traded in the US Is Shrinking – Or Is It?*, MarketWatch (Oct. 30, 2020), <https://www.marketwatch.com/story/the-number-of-companies-publicly-traded-in-the-us-is-shrinking-or-is-it-2020-10-30>.

¹⁵ Item 402, Regulation S-K.

¹⁶ *Id.*

Moreover, we believe that the final rule would more closely align with the text of Exchange Act Section 10D by incorporating the Item 402 definition of executive officer. As described above, Exchange Act Section 10D specifically utilizes the term “executive officer” when describing the individuals subject to compensation recovery policies. Therefore, the Item 402 term “executive officer” directly matches the statutory text.

Conversely, the Proposed Rules’ incorporation of the Rule 16a-1(f) definition of “officer” appears to be an expansion of the statutory text of Exchange Act Section 10D. If Congress desired a broader application of the compensation recovery policies, it could have easily used the term officer instead of executive officer. The final rule should acknowledge the narrower scope of the statutory text by incorporating the Item 402 definition of executive officer.

4. *The final rule should either eliminate disclosure of individual recovery efforts or limit disclosures to executive officers whose compensation is already subject to public disclosure in an issuer’s filings.*

Item 402 of Regulation S-K sets forth well-developed disclosure rules applicable to current executive officers and former executive officers. In general, Item 402 requires disclosure of compensation paid to an issuer’s “named executive officers”, who are:

- i. All individuals serving as the issuer’s Principal Executive Officer (PEO) during the last fiscal year;
- ii. All individuals serving as the issuer’s Principal Financial Officer (PFO) during the last fiscal year;
- iii. The issuer’s three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year; and
- iv. Up to two additional individuals for whom disclosure would have been provided under the clause (iii) above but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year.¹⁷

Thus, Item 402 already describes the rules by which disclosure is required for current and former executive officers in an issuer’s filings.

a. *Exchange Act Section 10D does not require disclosure of actual compensation recovery actions*

Beginning with the text of Exchange Act Section 10D(b)(1), we note that the statute only requires the “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.” Thus, the statute only requires issuers to disclose its compensation recovery policies. The statute makes no indication that Congress contemplated issuers disclosing specific compensation recovery actions taken against current or former employees. Therefore, we believe the Proposed Rules suggestion that

¹⁷ Item 402(a)(3), Regulation S-K.

issuers disclose actual compensation recovery action is not supported by the Exchange Act Section 10D and should be removed from the final rule.

- b. *Any compensation recovery disclosure should be limited to those executive officers whose compensation is subject to disclosure under Item 402 of Regulation S-K*

In the event that the final rule retains a requirement that issuers disclose actual compensation recovery actions, we believe such disclosures should be limited to individuals whose compensation is currently subject to disclosure in the issuer's current proxy statement, consistent with existing proxy disclosure rules set forth under Item 402 of Regulation S-K.

As described above, Item 402 sets forth rules regarding executive officers for whom an issuer must make disclosures in its current proxy statement regarding executive compensation decisions. More specifically, Item 402(b) already requires issuers to "explain all material elements of the [issuer's] compensation of [its] named executive officers."¹⁸ As part of this discussion, Item 402 contemplates that such material information includes "policies and decisions regarding the adjustment or recovery of awards or payments if the [issuer's] relevant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment".¹⁹ Thus, Item 402 already requires issuers to disclose compensation recovery actions taken with respect to its named executive officers.

Given the lack of a statutory basis under Exchange Act Section 10D for requiring disclosure of specific compensation recovery actions and the existing disclosure obligations under Item 402 of Regulation S-K, we believe that the final rule should, at a minimum, limit such disclosures to the standards already articulated under Item 402.

- c. *If the final rule includes a broader recovery disclosure requirement, such disclosures should be generalized for non-NEOs*

In the absence of statutory authority and Item 402's existing disclosure obligations, we recommend the final rule limit additional disclosure of compensation recovery actions to non-personally identifiable information on an aggregated basis.

First it would appear odd if the final rule were to require disclosure of recovery actions applied to individuals who have never appeared in an issuer's proxy statement since investors would have no context or history with respect to such individual's prior compensation. Requiring such disclosure would likely distract investors from the focus of the proxy statement's compensation disclosures concerning named executive officers.

Second, any description of compensation recovery actions applied to individuals who are not current named executive officers should be made on an aggregated basis to avoid creating new personal compensation disclosure obligations for individuals not otherwise subject to Item 402. For example, an issuer might disclose that it pursued compensation recovery actions against ten

¹⁸ Item 402(b), Regulation S-K.

¹⁹ Item 402(b)(2)(viii), Regulation S-K.

current and former executive officers, none of whom are current named executive officers, with respect to material noncompliance with financial reporting standards and the total amount recovery amounts sought was approximately \$2,500,000. Such information could be useful to investors to know that the issuer decided to pursue compensation recovery actions. The specific individuals pursued and the individual amounts at issue is less helpful for investors and borders on compensation voyeurism.

Finally, a generalized approach to broader compensation recovery disclosures would also serve to reduce the risk that such disclosures would be impermissible under “home country” laws. For example, current EU privacy laws would generally prohibit issuers from revealing compensation information for individuals who are not otherwise covered by the Item 402 executive compensation reporting regime.²⁰ A generalized approach to recovery disclosures would further minimize the costs associated with such disclosures as issuers would not have to perform local, state and international legal research regarding the permissibility of disclosing compensation matters for individuals who are not current Named Executive Officers (NEOs) of the issuer.

- d. *Compensation recovery disclosure rules should avoid requirements to provide unnecessarily detailed mathematical descriptions*

In the same vein as our recommendations concerning generalized disclosures concerning compensation recovery efforts, we recommend the final rule avoid requiring issuers to provide detailed mathematical descriptions of the calculations involved in determining specific amounts subject to recovery, as this information is likely not particularly relevant to investors and would distract from the broader discussion of compensation recovery. We believe a general description of the way in which an issuer determined an amount subject to recovery is sufficient to ensure issuers are abiding by the requirements of Exchange Act Section 10D.

For example, an issuer should not be required to disclose all of the various assumptions and technical calculations involved in determining the amount of incentive-based compensation earned based on an issuer’s total shareholder return (“TSR”) performance is subject to recovery. Instead, a high-level overview of the factors considered by the issuer when performing the calculations and the end result of those calculations would be more helpful and understandable for investors.

5. *The final rule should not include a checkbox disclosure on Form 10-K.*

We do not believe that the action being considered by the Commission of “whether to add check boxes to the cover page of the Form 10-K that indicate separately (a) whether the previously issued financial statements included in the filing include an error correction, and (b) whether any such corrections are restatements that triggered a recovery analysis during the fiscal year”²¹ will provide greater transparency and disclosure regarding restatements to investors and therefore, will

²⁰ See generally Deutscher Corporate Governance Kodex [Corporate Code], <https://www.dcgk.de/en/code/foreword.html>; see also Jonathan Baird, Altheimer & Gary and Peter Stowasser, Schulte Techtsanwalte, Executive Compensation Disclosure Requirements: The German, UK and US Approaches (Sept. 23, 2020).

²¹ See 86 Fed. Reg. at 58,235.

not be useful to investors. In our view, disclosure requirements regarding restatements and recovery of compensation are sufficiently required by other rules such that this checkbox would provide little additional information of value to investors. We believe that the Commission itself recognized the relatively small incremental value of a checkbox alone without other substantive disclosures when it revised a former checkbox requirement of Form 10-K.

On March 20, 2019, the Commission adopted amendments designed to modernize and simplify numerous disclosure requirements of Regulation S-K and rules and forms under the Securities Act of 1933, as amended (Securities Act) and the Exchange Act.²² Pursuant to those amendments, among other revisions, the Commission eliminated the checkbox on the cover page of Form 10-K (and the related instruction in Item 10 of Form 10-K) whereby the registrant had been required to indicate that there is no disclosure of delinquent filers under Exchange Act Section 16 in the Form 10-K and, to the best of the registrant's knowledge, will not be included in a definitive proxy or information statement incorporated by reference. The Commission included this amendment as part of amendments to Item 405 of Regulation S-K and Exchange Act Section 16a-3(e). These amendments were adopted based on the Commission's belief that the amendment would "improve the Section 16 disclosure regime for the benefit of both registrants and investors by making the rules more straightforward, compliance less burdensome, and the disclosure itself more streamlined."²³ With specific reference to the removal of the checkbox, the Commission indicated that "[w]e believe the value of this cover page disclosure has outlived its usefulness as a tool to facilitate the staff's processing and review of the form."²⁴ In our view, the substantive disclosures required with respect to restatements and recovery of excess compensation provide an appropriate disclosure regime without the addition of this checkbox.

C. The final rule should further define what incentive compensation is subject to potential recovery.

We agree with the Commission's use of a principles-based approach to defining incentive-based compensation that may be subject to recovery under the final rule. As the Commission noted in its discussion accompanying the Proposed Rules, this enables the final rule to operate effectively as new forms of compensation and new measures of performance upon which compensation is based are developed.²⁵ In our view this approach is also important because it allows the application of the final rule to compensation arrangements that may vary significantly among issuers and are generally tailored to the strategy and characteristics of an issuer. However, we believe that certain concepts included in the principles-based approach of the Proposed Rules need to be further defined, and in some cases modified to retain consistency with the statutory intent and language of Section 954 of the Dodd-Frank Act, enable issuers to implement and comply with the final rule effectively, and mitigate various implementation issues that issuers may face based on the current provisions of the Proposed Rules.

²² See 84 Fed. Reg. 12,686 (April 2, 2019).

²³ *Id.*

²⁴ *Id.*

²⁵ 80 CFR 41,154-41,155.

1. *We agree that fixed salary, discretionary awards, non-financial metric based awards, and time-vested awards should not be subject to the type of compensation that may be recovered.*

In our view the Commission has appropriately captured the principle of incentive-based compensation to include any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure. We also believe that the Commission's guidance regarding the types of compensation that would be excluded from incentive-based compensation when applying the principles-based approach include:

- fixed salaries,
- bonuses paid solely at the discretion of the compensation committee or board, including discretionary bonuses paid from a "bonus pool" which is not determined wholly or in part on satisfying a financial reporting measure performance goal,
- non-equity incentive plan awards earned solely upon satisfying one or more strategic measures or operational measures, and
- equity awards for which the grant is not contingent upon achieving any financial reporting measure performance goal and vesting is contingent solely upon completion of a specified employment period and/or attaining one or more non-financial reporting measures.

We believe this application of the principles to be consistent with the statutory intent of Section 954 of the Dodd-Frank Act, as well as with the statutory language. Section 954 of the Dodd-Frank Act is focused on recovery of compensation because erroneous financial information was included in the issuer's financial statements and this error provided excess compensation to an executive. The text of Exchange Act Section 10D(b)(1) includes "financial information required to be reported under the securities laws" and the text of Exchange Act Section 10D(b)(2) includes "financial reporting requirement under the securities laws." Non-financial events such as discretionary bonuses, the passage of time, achieving a subjective standard such as leadership, or satisfying a purely strategic or operational metric such as completing an acquisition, implementing a technology upgrade, reducing an issuer's carbon footprint, or hiring diverse talent do not result in an erroneous financial reporting measure being included in an issuers financial statements. In our view there are no circumstances in which compensation that is received upon completion of a specified employment period or upon the attainment of any non-financial goal would be appropriate to subject to recovery.

2. *The final rule should limit incentive compensation to that based on "financial reporting measures" used in preparing issuer's financial statements.*

In our view the definition of financial reporting measures under the Proposed Rules is overreaching and beyond the intent of the Section 954 of the Dodd-Frank Act and needs to be limited. Under the Proposed Rules, financial reporting measures are defined as those that are:

- determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements,

- any measures derived wholly or in part from such financial information,
- stock price, and
- TSR.

We believe that financial reporting measures should include only those used in preparing an issuer's financial statements and should not include stock price or TSR. By limiting the definition of financial reporting measure in this manner, it will make identification of awards and the calculation of excess compensation subject to recovery purely mechanical and is consistent with the statutory language of Section 954 of the Dodd-Frank Act.

The identification and calculation of excess compensation based on a financial reporting measure used in preparing an issuer's financial statements will involve an objective and mechanical mathematical calculation. The issuer would recalculate the applicable financial reporting measure based on the proper application of an accounting principle. The amount of incentive compensation that would have been received based on the recalculated financial reporting measure will be compared to the amount of incentive compensation that was based on the financial reporting measure as calculated in the previously reported financial information.

For example, if a one year performance based award was determined based solely on earnings per share for a fiscal year and a restatement was required for that fiscal year, it would be clear that earnings per share is a financial reporting measure, the new value of earnings per share would be mechanically calculated based on the proper application of the accounting principle, and the excess incentive-based compensation would be the difference between the amount awarded based on the originally reported earnings per share and the amounts awarded based on the restated earnings per share. This calculation provides objectivity and transparency when identifying the financial reporting measure and determining the amount of compensation subject to recovery. Furthermore, utilizing a financial reporting measure based on application of an accounting principle used in the preparation of an issuer's financial statements would generally subject the recalculated value of the financial reporting measure to review by an issuer's independent auditor in connection with the restatement.

The language of Exchange Act Section 10D requires 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 Exchange Act Section 10D(b)(2) specifically requires an issuer to recover excess incentive-based compensation in connection with a "financial reporting requirement under the securities laws" that was "based on the erroneous data". In our view the statutory language is appropriately interpreted to support a definition of financial reporting measures that is limited to financial reporting measures used in preparing the issuer's financial statements that are accounting-based metrics. The Commission itself notes in its discussion of the Proposed Rules that "[a]lthough the phrase 'financial information required to be reported under the securities laws' might be interpreted as applying only to accounting-based metrics, we believe that it also includes performance measures such as stock price and TSR that are affected by accounting-related information and that are subject to our disclosure requirements."²⁶

²⁶ *Id.* at 41,155.

We do not agree with this conclusion and we do not find the Commission’s reference to an issuer’s requirement to disclose stock price information pursuant to Item 201 of Regulation S-K a convincing argument to support the broader interpretation of the statute. Nor do we agree with the Commission’s argument that Congress’ direction to include compensation that is based on financial information and to recover compensation based on the erroneous accounting data suggests that the Commission should include incentive compensation tied to measures such as stock price and total shareholder return to the extent that improper accounting affects such measures, and in turn results in excess compensation.

We believe the statutory intent of Section 954 of the Dodd-Frank Act is to recover the amount by which incentive-based compensation paid to an executive was in excess of what would have been paid based on financial reporting measures used in preparing the issuer’s financial statements for which an executive can be held directly accountable. Such financial reporting measures should not extend beyond accounting metrics calculated and determined by the issuer to prepare the financial statements. When discussing recovery, the Senate Committee on Banking, Housing and Urban Affairs stated that “This is money that the executive would not have received if the accounting was done properly.”²⁷

While the metrics of stock price and TSR are affected by an issuer’s financial information, they are measures that reflect many factors beyond the issuer’s preparation and reporting of financial information that are accounting-based metrics, the criterion set forth in Section 954 of the Dodd-Frank Act. For example, stock price and TSR can be impacted by macroeconomic factors and industry events that are beyond the control of the issuer, by other announcements of the issuer that do not relate to such financial information, and by the independent action of investors who make decisions based on various factors. Executives should not be subject to the recovery of compensation based on a measure for which they are not directly accountable.

We do not share the Commission’s concern that not including TSR as a financial reporting measure could incentivize issuers to alter their executive compensation arrangements in ways that would avoid application of the mandatory recovery policy and result in less efficient incentive alignment. Boards of Directors understand the general need to design compensation programs to align the interests of executive officers with those of the issuer’s shareholders to enhance shareholder value in furtherance of the long-term best interests of the corporation and its shareholders. Corporate governance best practices generally demand that executive compensation is designed to align the interests of executives and shareholders.²⁸ Compensation Committees develop compensation programs tailored to the strategy and characteristics of an issuer.

We do not believe that Compensation Committees composed of independent non-management directors with fiduciary duties would consider the potential ability to shield compensation from recovery when making compensation decisions for an issuer’s executive officers. Additionally, compensation programs are subject to the scrutiny of proxy advisory firms,

²⁷ See Report of the Senate Committee on Banking, Housing, and Urban Affairs, S.3217, Report No. 111-176 at 135 (April 30, 2010) (“Senate Report”).

²⁸ See *The Business Roundtable Principles of Corporate Governance*, p. 19 (2016). “Executive compensation should be designed to align the interests of senior management, the company and its shareholders and to foster the long-term value creation and success of the company.”

institutional investors, and all shareholders through an issuer's say-on-pay advisory vote. In our view excluding stock price and TSR from financial reporting measures would not have any significant impact on the approach to executive compensation program design by an issuer.

3. *We recommend that awards based on stock price or TSR should not be subject to recovery due to practical problems associated with determining the amount subject to recovery.*

Inherent in the Proposed Rules' vague description regarding valuation of excess compensation is the fact that awards based on stock price or TSR are not directly tied to financial information required to be reported under securities laws. Because these awards are not based on financial reporting measures that apply an accounting principle, a performance award that vests upon the attainment of a specified level of the issuer's stock price at the end of a performance period would require the issuer to determine how to calculate the effect of the accounting restatement on stock price at the conclusion of the applicable performance period in order to determine the value of excess compensation. Therefore, rather than a mechanical objective calculation like that involved in the determination of a restated accounting metric such as revenue or earnings per share based on an accepted methodology in an accounting principle, the issuer would need to develop a subjective method to determine the impact that an accounting restatement had on an issuer's stock price or TSR or spend resources to have a third party do so.

As noted above, stock price and TSR are impacted by many factors beyond the issuer's preparation and reporting of financial information. Therefore, in our view it will be extremely difficult to accurately determine the impact of an accounting restatement alone on stock price or TSR at the end of the performance period for awards subject to recovery. The Commission itself acknowledges that "...issuers may need to engage in complex analyses that require significant technical expertise and specialized knowledge, and may involve substantial exercise of judgment in order to determine the stock price impact of a material restatement. Due to the presence of confounding factors, it sometimes may be difficult to establish the relationship between an accounting error and the stock price."²⁹

We disagree with the Commission's assertion that it believes "being able to use reasonable estimates to assess the effect of the accounting restatement on these performance measures in determining the amount of erroneously awarded compensation should help to mitigate these potential difficulties."³⁰ The difficulties will still exist for an issuer when determining the appropriate reasonable estimate.

Permitting the use of reasonable estimates will only mitigate some of the issuer's risk in developing the method used in preparing the reasonable estimate or relying on a third party to do so. For example, issuers will be provided with the flexibility to determine the method used to estimate the "but for" stock price³¹ so an issuer will generally not be challenged or second guessed for their choice of reasonable method. However, an issuer will still be faced with the complexity

²⁹ 80 Fed. Reg. at 41,155.

³⁰ *Id.*

³¹ See 80 Fed. Reg. at 41,177 discussing "the stock price that would have been if financial statements originally had been presented as later restated."

of doing an event study if selected as the methodology utilized, or will be faced with the complexity of selecting and developing another method. In our view, the subjectivity, difficulty, and costs associated with the development of reasonable estimates on which to determine the impact of a restatement on stock price or TSR to calculate excess executive compensation subjects issuers to an undue burden, particularly when the effort is undertaken with respect to a metric that should not be included as a financial reporting measure at all, because neither stock price nor TSR is a financial reporting measure used in preparing financial statements.

In the event that the Commission decides to include awards based on stock price and / or TSR as incentive-based compensation for purposes of the final rule, we recommend providing issuers with a safe harbor methodology for determining the amount subject to recovery in the event of a restatement. Such a safe harbor methodology would not only provide issuers with the comfort that they have sought to recover the appropriate amount of excess compensation but also benefit investors as we would expect the safe harbor would be widely adopted and thus would promote a uniform approach to addressing recoveries among all issuers.

4. *The final rule should limit recovery amounts to after-tax amounts to avoid undue hardship for and an inequitable over-collection from executive officers.*

We disagree with the concept in the Proposed Rules that the recoverable amount of incentive-based compensation should be calculated on a pre-tax basis “to ensure that the company recovers the full amount of incentive-based compensation that was erroneously awarded.”³² In our view it would be inequitable to require an executive officer to return incentive-based compensation on a pre-tax basis after the executive has paid taxes on that compensation, resulting in an over-collection when recovering excess compensation from the executive. An executive should not be placed in a position where the executive has less money than before the incentive-based compensation was received by the executive.

We believe this is overreaching and more punitive in nature than the intent of Section 954 of the Dodd-Frank Act. Additionally, there is no clear way for an executive to mitigate this overcollection by an issue. For example, the tax consequences to the executive in the year of repayment are unclear and the executive may never be made whole with respect to the compensation recovered because of the limits with respect to how the executive may reflect the repayment as an itemized deduction and the uncertainty whether the “claim of right” doctrine in Section 1341 of the Internal Revenue Code will be available to the executive. Furthermore, the executive could face liquidity and other financial hardships in attempting to remit the gross amounts of excess compensation for a three-year lookback period. These hardships would likely incentivize an executive to more strongly resist any recovery action pursued by an issuer since the amount sought would far exceed the amount the executive actually received.

5. *The final rule should assist issuers with compliance of applicable recovery obligations by including guiding principles currently reflected in the Preamble in the body of the rule itself.*

³² 80 Fed. Reg. at 41,160.

The Proposed Rules include a helpful discussion regarding means by which issuers should determine the amount of excess compensation subject to recovery; however, the final rules could further assist issuers by expanding upon the original guidance to address certain fact-patterns.

The Proposed Rules require issuers to recover “the amount of incentive-based compensation received by the executive officer or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement.”³³ Generally, this process involves the issuer taking the following steps:

- Recalculating the applicable financial reporting measure and the amount of incentive-based compensation based thereon; and
- Determining whether the executive officer received excess compensation (after taking into account any discretion applied by the compensation committee) based on the amount received pursuant to the original calculations.³⁴

We generally agree with the approach outlined in the Proposed Rules and that it should be applied “in a principles-based manner” and share the Commission’s view “that applying the principles may not always be simple.”³⁵ There will inevitably be circumstances that cannot be anticipated by regulations and issuers should conduct recovery calculations and actions in a principles-based manner.

We also note that the Preamble to the Proposed Rules contains helpful guidance for issuers regarding the application of the principles-based approach described above. In particular, the Preamble describes the treatment of equity awards subject to recovery, as follows:³⁶

- **Equity Awards – Still Held:** If the shares, options or stock appreciation rights (SARs) are still held at the time of recovery, the recoverable amount equals the number received in excess of the number that should have been received applying the restated financial measures.
- **Exercised Options / SARs – Shares Held:** If options or SARs have been exercised, but underlying shares are still held at the time of recovery, the recoverable amount equals the number of shares underlying the excess options or SARs applying the restated financial measure.
- **Shares Sold:** If the shares have been sold prior to the recovery, the recoverable amount equals the sale proceeds with respect to the number of excess shares.
 - *Comment:* The Final Rule should clarify that the recoverable amount should be net applicable capital gains taxes since such amounts are not attributable to the executive officer’s performance of services for the issuer.
- **Reduction for Exercise Price Paid:** Any recoverable amount will be reduced to reflect an exercise price paid to obtain the underlying shares (e.g., options, SARs).

³³ 80 Fed. Reg. 41,159 (July 14, 2015).

³⁴ *Id.*

³⁵ *Id.* at 41,160.

³⁶ *Id.*

In working with our clients, we have found that these critical and helpful guiding principles may not be well recognized due to their placement in the Preamble. Therefore, we recommend the Final Rule include a discussion of these principles in the body of the rule to ensure issuers understand their recovery obligations. We have also found that issuers often find examples helpful and recommend the Final Rule add examples to illustrate the application of these principles.

6. *The final rule should prorate the amount subject to recovery in the event the individual did not serve as an executive officer for the entire three-year lookback period.*

We believe that the Proposed Rules would unjustly penalize an individual who did not serve as an executive officer for the entire lookback period. The Proposed Rules require recovery of excess incentive-based compensation received by an individual who served as an executive officer of the listed issuer at any time during any performance period within the three-year lookback period. The final rule should provide that an issuer is only required to recover a pro rata portion of the excess incentive-based compensation based on the time the individual served as an executive officer during the applicable performance period. Under the Proposed Rules, an individual could have incentive-based compensation subject to recovery that was granted while the individual was not an executive officer and for which the individual was not serving as an executive officer for a substantial portion of the performance period. In our view, this is not the intent of Section 954 of the Dodd-Frank Act.

For example, suppose that a senior manager who is not an executive officer participates in the issuer's performance award program and is granted a long-term incentive award in February of 2018 that will be determined based on financial reporting measures with a performance period from January 1, 2018 through December 31, 2020. The senior manager is promoted to an executive officer position effective January 1, 2020. Upon satisfaction of the performance condition, assume the award is received in December of 2020. Furthermore, in August of 2021 the issuer must restate its 2020 financial statements, with the three-year lookback period covering fiscal years 2018, 2019 and 2020. As a result, the award is subject to recovery of any excess amounts of incentive-based compensation. Applying the Proposed Rules, the individual's entire performance award for the performance period of January 1, 2018 to December 30, 2020 would be subject to recovery, even though the individual was not an executive officer when the performance award was granted and was only an executive officer for one-third of the performance period. In our view, the implementation of Section 954 of the Dodd-Frank Act should only subject one-third of the award to potential recovery, the period during which the individual was an executive officer. Taken to extreme, if the executive was appointed as an executive officer in the last week of the performance period within the lookback period, the result would be even more inequitable, subjecting the full award to potential recovery when the individual was an executive for 1 of 156 weeks of the performance period, or .6% of the performance period.

7. *The final rule should apply prospectively.*

We believe there are significant contractual issues raised for existing compensation arrangements if the final rule subjects awards that were granted prior to the effective date under

existing contractual arrangements with executive officers to potential recovery as required by the Proposed Rules. Applying a recovery policy to existing compensation arrangement may raise questions regarding enforceability particularly in states where public policy is focused on protecting employees. Furthermore, it may not be possible to apply recovery provisions retroactively to outstanding or previously paid awards.³⁷ Recovery of compensation without the consent of the covered executives and retroactive application may conflict with existing agreements. As a result of the potential contractual issues, existing agreements may require amendments and such amendments may not be enforceable under state laws because the executive is not receiving any reciprocal rights or benefits.

If the final rule does not apply prospectively, issuers would need to analyze these potential contractual issues and take any necessary actions to provide issuers with the best available contractual basis for enforcing a recovery of compensation with respect to existing agreements. This would place an undue burden on issuers. The objective of Section 954 of the Dodd-Frank Act can be achieved without imposing this undue burden on issuers. Furthermore, it is unclear whether such efforts by an issuer would result in a clear basis for recovery under existing agreements. This would place issuers who may need to apply the recovery policy in a difficult position. In our view, to mitigate the contractual issues and the undue burden placed on issuers when applying the recovery policy to existing compensation arrangements, the final rule should apply prospectively to awards that are granted after the effective date of the final rule and not to agreements and awards outstanding on the effective date.

Applying the final rule prospectively would allow new compensation arrangements to be drafted with the final rule in mind. Issuers would have the time to analyze the contractual issues raised by the recovery policy under the final rule and take appropriate steps to mitigate these issues in new agreements. For example, new incentive compensation awards could provide for forfeiture as needed to effect recovery of prior awards. To enhance enforceability, reference to recovery provisions could be placed in award agreements that are acknowledged and signed by the executive officer. In our view, the Commission should provide issuers with the ability to mitigate potential contractual issues in new agreements for prospective awards.

8. *The final rule should not permit recovery of amounts deferred under tax-qualified retirement plans as such actions violate ERISA anti-alienation rule.*³⁸

We are concerned that in applying the principles-based approach to determine incentive-based compensation that is subject to recovery, the Proposed Rules may be interpreted to apply to tax-qualified retirement plans. As a consequence of applying the Proposed Rules to tax-qualified retirement plans an issuer could violate the Employee Retirement Income Security Act of 1974

³⁷ For example, California Labor Code § 221 states that “It shall be unlawful for any employer to collect or receive from an employee any part of wages theretofore paid by said employer to said employee.” The New York Labor Code, in §193, contains a provision similar to that of California: “No employer shall make any charge against wages, or require an employee to make any payment by separate transaction unless such charge or payment is permitted as a deduction from wages under the provisions of subdivision one of this section.”

³⁸ National Association of Corporate Directors recommended creation of a NQDC Plan from which amounts would be available for recovery – essentially a portion of all “incentive compensation” would be automatically deferred during the three-year lookback period and presumably released at the conclusion.

(“ERISA”) and the Internal Revenue Code (the “Code”) and the plan, plan sponsor, and participants could also be negatively impacted, not just executive officers who are subject to the recovery policy in the Proposed Rules.

We understand that subjecting tax-qualified retirement plan amounts to recovery would likely violate the anti-forfeiture, anti-alienation, and anti-reversion rules of ERISA and the Code applicable to such plans. Treasury Regulations interpreting Code § 411(a), which is virtually the same as the parallel provision in ERISA § 203, provide that a plan provision requiring forfeiture of vested benefits if a former employee competes with the employer would violate the anti-forfeiture rules of Code § 411(a).³⁹ Courts have also reached similar conclusions. Both ERISA and the Code provide that any vested amounts held in tax qualified retirement plans may not be forfeited, with very limited exceptions, which we do not believe would not apply in these circumstances.⁴⁰

Furthermore, subjecting a tax-qualified retirement plan to a repayment obligation would violate the provisions of ERISA and the Code that prohibit the alienation of a retirement plan benefit. In *Guidry v. Sheet Metal Workers*, for example, the Supreme Court considered whether a constructive trust could be imposed under labor law on the retirement plan benefit of a union official guilty of embezzling funds.⁴¹ The Court found that this would violate ERISA’s anti-alienation rule and refused to let the remedial provisions of a labor statute take precedence over ERISA, saying that that “[w]here there is no clear intention otherwise, a specific statute will not be controlled or nullified by a general one”⁴² Thus, courts may find that ERISA’s anti-alienation rule would override a Commission regulation under the Exchange Act alienating tax-qualified retirement plan benefits.

ERISA and the Code also prohibit amounts held in a tax-qualified retirement plan from reverting to the employer, with limited exceptions not applicable here. Repayment of benefits from a plan to the employer could be viewed as an impermissible reversion.⁴³

D. The final rule should provide boards of directors significant discretion with respect to compensation recovery decisions and processes.

We acknowledge that Exchange Act Section 10D states that “the issuer will recover” incentive-based compensation and agree with the Proposed Rules that the statute “does not address whether there are circumstances in which an issuer’s board of directors may exercise discretion not to recover.”⁴⁴ We generally support the Proposed Rule’s approach to providing issuers with flexibility in determining whether and how to pursue recovery actions; however, there are several areas in which the final rule could improve on the discretion described under the Proposed Rules.

³⁹ Treas. Reg. § 1.411(a)-4(c), Example 1.

⁴⁰ ERISA §203; Code §411(a).

⁴¹ 493 U.S. 365, 369–71 (1990).

⁴² *Id.* at 375–76, 376 (quoting *Morton v. Mancari*, 417 U.S. 535, 550–51 (1974) (alteration in original)).

⁴³ ERISA § 403(c); Code § 401(a)(2); IRS Rev. Rul. 1991-4, 1991-1 C.B. 57 (Jan. 22, 1991) (permitting repayment of plan assets to the employer in only very limited circumstances (e.g., a contribution made due to a mistake of fact or law)).

⁴⁴ 80 Fed. Reg. 41,161 (July 14, 2015).

1. *A more holistic evaluation as to compensation recovery actions would benefit shareholders and make the final rule more workable in practice for issuers.*

The Proposed Rules acknowledge that issuers may consider “whether the direct costs of enforcing recovery would exceed the recoverable amounts”; however, it takes a narrow and impracticable view of such determination.⁴⁵ The final rule would better serve shareholders by providing issuers with broad discretion as to the factors it considers when making such an assessment.

Specifically, the final rule should reflect the reality that the following issues are reasonable factors for boards to consider when assessing whether or not to pursue a compensation recovery action:

- **Amount at Issue:** Boards should be able to determine that costs associated with de minimis recovery actions are likely to far outweigh the amount at issue and decline to take action under such circumstances without having to first engage in compensation recovery actions.
 - For example, it hardly seems worthwhile for a board to have to “make a reasonable attempt to recover”⁴⁶ an excess incentive compensation amount of \$100. Even spending time discussing such a matter is not in the shareholders’ best interests, no less the fact that the value of any amount of time spent pursuing such amount would far exceed the recovery.
- **Involvement of Executive Officer:** If an executive officer was not involved in the activity leading to material noncompliance with financial reporting obligations, it is reasonable to conclude that the likelihood of recovery against such person may be severely limited and thus the costs associated with such recovery action are likely to outweigh the amount actually recovered.
 - For example, and as noted earlier, a company may reasonably determine that it has a low likelihood of enforcing a no-fault compensation recovery action against an executive who was not involved in the issue leading to a restatement due to state law considerations designed to protect employee wages. Therefore, the company may reasonably determine that the costs associated pursuing such a recovery action are not in shareholders’ best interests.
- **All Costs Associated with Recovery:** The Proposed Rules suggest boards only consider “direct” costs; however, this narrow view ignores other costs associated with pursuing a compensation recovery action that when aggregated with direct costs would outweigh the recovered amounts.
 - For example, the Proposed Rules contemplate boards must obtain an opinion of local counsel prior to concluding an issuer is prevented by home country law from

⁴⁵ 80 Fed. Reg. 41, 162 (July 14, 2015).

⁴⁶ *Id.*

pursuing a recovery action.⁴⁷ The costs associated with obtaining such an opinion should be counted when deciding whether to pursue recovery.

- Moreover, the Proposed Rules also suggest that issuers may obtain expert opinions regarding the amount subject to recovery in an incentive-based award was payable upon the issuer's TSR or stock price performance.⁴⁸ Such expert opinion costs should likewise be relevant factors boards should consider before embarking on a recovery action.
- **Reputational Risk:** Issuers should be able to take into account reputation risk and damage it may incur by pursuing recovery actions against current or former executives.
 - For example, the issuer should be able to consider whether an executive is likely to leave the issuer's employment as a result of a recovery action. The issuer, rightly, should not be required to jeopardize its ability to retain executive officer talent due to the application of a compensation recovery action, especially when it comes to executive officers who may not have been involved in the matter leading to the accounting restatement.
 - Similarly, the issuer should be able to consider the potential effect of pursuing recovery efforts on its ability to recruit new executive talent.
- **Litigation Risk:** Issuers should be allowed to consider whether pursuing a recovery would expose the company to employment or other litigation risk.
 - For example, the issuer should rightly evaluate whether an executive or former executive may have employment law or other counterclaims that the executive has not pursued to date, but that the executive may raise if the company were to commence a recovery action against that executive. In the event the issuer determines that the potential litigation / counterclaim risk (which includes reputation risk), exceeds the amount of potential recovery, shareholders would benefit from the company declining to pursue such action.

2. *The home-country exception should be modified to avoid forcing issuers to violate applicable laws.*

The Proposed Rules correctly understand that certain compensation recovery actions may be illegal under home country laws. However, the Proposed Rules limit the application of this helpful carve out to home country laws in effect on July 14, 2015, the date on which the Proposed Rules was published in the Federal Register.⁴⁹

We acknowledge the Commission's concern about home countries passing laws that would have the effect of preventing compensation recovery actions following the release of the Proposed Rules; however, the Commission's approach to such laws puts issuers in a potentially unwinnable situation. For example, if the European Union were to pass a law barring all recovery, would the

⁴⁷ *Id.*

⁴⁸ 80 Fed. Reg. 41,155 (July 14, 2015).

⁴⁹ 80 Fed. Reg. 41,162 (July 14, 2015).

Commission truly not excuse an issuer for not pursuing a compensation recovery action against an executive officer who lives in France? Such an approach leaves the issuer with the dilemma of either violating US law or EU law and surely is not the desired intent of the Proposed Rules. Thus, the final rule should extend the home-country exception to include home country laws that are currently in effect.

3. *Flexible settlement and repayment terms would help issuers enforce recovery policies and aid in recovery of erroneously awarded compensation.*

The final rule should recognize that the actual collection of compensation that is erroneously awarded is difficult and provide issuers with flexibility to engage in settlement agreements with covered executive officers that promote economically efficient compensation recovery. Specifically, the final rule should provide that boards may enter into good-faith settlement agreements with executive officers with respect to amounts subject to recovery claims, rather than having to litigate potential disputes between the parties. In doing so, issuers and executive officers may resolve matters more quickly and will likely incur far fewer costs associated with the collection of amounts subject to recovery.

In addition, the final rule should endorse the fact that executive officers may not be financially able to repay an entire amount subject to recovery immediately and this fact may lead the executive officer to resist any attempt to recover the compensation at issue. However, providing issuers the ability to structure compensation repayment programs with executive officers would benefit issuers and covered executive officer design practical repayment structures.

E. *The Final Rule Should Remove the Requirement that XBRL Tagging Occur in the Event of a Material Restatement.*

The Proposed Rules require recovery disclosures to be block-text tagged using the eXtensible Business Reporting Language (XBRL). The Commission believes this will be useful to investors. Although the frequency of use by investors is debated, we agree that high-quality and reliable data tagging is generally beneficial to investors, but only to the extent that such data is comparable.

Several 2018 comment letters regarding InLine XBRL tagging noted, “[s]ince the [Commission] began requiring the use of XBRL in 2009, XBRL-tagged information has been fraught with errors and comparability challenges.”⁵⁰ The Commission itself has admitted that “a high rate of custom tagging inhibits comparability of data,” thus, mounting to these comparability challenges. Yet, the average custom tag rate for filers increased year over year in 2020.⁵¹

Given that disclosure is only required in the event of a material restatement, the recovery process will vary significantly among issuers, depending on the structure and form of its individual

⁵⁰ See letter in response to the Inline XBRL Filing of Tagged Data (Release No. 33-10323, 34-80133; File No. S7-03-17) from Ernst & Yong LLP (May 16, 2017).

⁵¹ U.S. GAAP – XBRL Custom Tags Trend, U.S. Securities and Exchange Commission (June 29, 2021) (https://www.sec.gov/structureddata/gaap_trends_2020).

compensation programs. Thus, issuers will inevitably create custom tags, as the standard taxonomy will not provide an appropriate element to tag the recovery disclosure. With this inevitable increase in custom tags, we believe requiring XBRL tagging of recovery disclosures will create additional comparability issues and be unhelpful to investors.

However, if the Commission decides to retain the XBRL tagging requirement, we agree that Inline XBRL should be accepted for disclosures. As the Commission noted in 2018, Inline XBRL only requires preparation of one Inline XBRL document that is both human-readable and machine-readable.⁵² Inline XBRL removes the unnecessary step of generating an HTML document, then tagging a copy of the data to create a separate XBRL exhibit. This eliminates the filing of a separate exhibit.

IV. The Commission should Re-propose the Rules.

The Commission should repropose the rules for Section 10D of the Exchange Act. To do otherwise, will be overly burdensome for issuers. Section 954 of the Dodd-Frank Act was signed into law more than eleven years ago and it has been more six years since the Proposed Rules were published in the Federal Register. The vast majority of publicly traded companies have implemented detailed recovery policies based on the demands of proxy advisory firms, investors, and corporate best practices. Issuing final rules more than six years after the proposed rules were issued is unfair and likely to be difficult and costly for issuers to comply. Issuers will need a significant amount of time and resources to make changes to their existing recovery policies once the rules are finalized. The Commission should re-propose the rules so that issuers can fully comply with the final rules.

The Administrative Procedures Act (APA) states that a final rule is not necessarily invalid simply by reason of the fact that the rule finally adopted differs from the original proposal. An agency is not required to publish in advance every precise proposal which it may ultimately adopt as a rule. The rationale of the APA's notice-and-comment requirements rests on the expectation that the final rules will be somewhat different and improved from the rules originally proposed by the agency. An agency can make even substantial changes from the proposed version. However, when an agency adopts final rules that differ from the proposed rules, and the changes are so major that the original notice does not adequately frame the subjects for discussion, the agency may be required to give notice a second time (by issuing new proposed regulations).⁵³ It is arguable that making changes to a proposed rule more than six years after its issuance constitutes a major change in of itself. Thus, it is only fair that the rules be re-proposed.

Closing

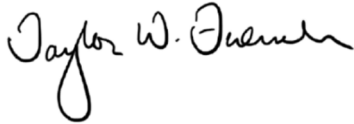
We would like to thank you for the opportunity to provide you with our comments.

We welcome the opportunity to further discuss the concerns and recommendations set forth in this letter and hope that we can be a resource to the Commission as you review and consider all of the

⁵² Inline XBRL Filing of Tagged Data, Release No. 33-10514 (June 28, 2018) [83 FR (Aug. 16, 2018)].

⁵³ *Connecticut Light and Power Co. v. Nuclear Regulatory Commission*, 673 F.2d 525 (D.C. Cir. 1982).

comments. If you have any questions, please do not hesitate to contact Taylor Wedge French at (704) 373-8037 or Rosemary Becchi at (202) 359-4270.



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