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Re: Comments on Listing Standards for Recovery of Erroneously Awarded Compensation; File number S7-12-15

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Ms. Countryman:

We are submitting this letter in response to the request from the Securities and Exchange Commission (the "**Commission**") for additional public comments on the proposed rule entitled "Listing Standards for Recovery of Erroneously Awarded Compensation." On October 21, 2021, the Commission reopened the comment period for its proposal to implement the provisions of Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("**Dodd-Frank**") through a release published in the Federal Register (Release No. 33-10998) (the "**2021 Reopening Release**"). The proposed rules would direct the national securities exchanges and national securities associations to establish listing standards that would require each issuer to develop and implement a policy providing for the recovery, under certain circumstances, of incentive-based compensation based on financial information required to be reported under the securities laws that is received by current or former executive officers, and require disclosure of the policy (the "**Proposed Rules**"). The Proposed Rules were set forth in a release published in the Federal Register on July 14, 2015 (Release No. 34-75342) (the "**2015 Release**").

We appreciate the additional opportunity to comment on the Proposed Rules provided by the Commission, and we respectfully request that the Commission consider the following concerns and recommendations for several changes and clarifications to the version of the Proposed Rules that will ultimately be adopted (such rule, the "**Final Rule**").

1. **"An accounting restatement due to material noncompliance" should not include restatements that correct errors that are not material to previously issued financial statements.**

The 2021 Reopening Release asks: "*Should the scope of the Proposed Rules include (1) restatements that correct errors that are material to previously issued financial statements and (2) restatements that correct errors that are not material to previously issued financial statements, but would result in a material misstatement if (a) the errors were left uncorrected in the current report or (b) the error correction was recognized in the current period?*"

During the financial reporting process, issuers may identify errors in a prior reported financial statement that may or may not be material to that financial statement. The issuer, in consultation with an independent auditor, uses quantitative and qualitative factors to determine the materiality. For material corrections, restated and reissued financial statements are filed with the SEC pursuant to Item 4.02 of the

current report on Form 8-K. These corrected financial statements are sometimes informally referred to as "Big R" restatements or reissuances.

When the error is immaterial to prior financial statements, but if corrected in the current period, would materially misstate the current period financial statements, the issuer may make the correction in the current year's financial statements by adjusting the prior period information and disclosing the error. This is sometimes referred to as a "little r" restatement or revision restatement. Form 8-K is generally not used to report "little r" restatements.

Section 954 of Dodd-Frank adds Section 10D to the Exchange Act to require exchange-listed issuers to apply a compensation recovery policy when required to "prepare an accounting restatement due to the material noncompliance of the [respective] issuer with any financial reporting requirement under the securities laws."

In the 2015 Release, the Commission proposed definitions for "accounting statement" and "material noncompliance" that focused on correcting material errors solely in previously issued financial statements.

In the 2021 Reopening Release, the Commission questions whether clawback policies should also be triggered by a current report that needs an adjustment to prevent a material misstatement arising from immaterial errors in previously issued financial statements. If the revised clawback trigger is adopted as proposed, the Commission asks how the definition for "accounting statement" and "material noncompliance" should be modified or whether they should just be eliminated (issuers would instead rely on existing guidance, literature and definitions).

Immaterial errors should not trigger clawback policies. The materiality standard set forth in the 2015 Release facilitates the purpose of the clawback rule in being triggered on the basis of meaningful errors. Congress's incorporation of a materiality standard in Section 954 further supports making the distinction. A new materiality standard for disclosure of financial restatements should not be created solely for Rule 10D purposes.

We believe that executive compensation recovery policies should apply only when a restatement is required to correct errors that are material to previously issued financial statements and requires disclosure by Item 4.02(a) of Form 8-K, as that is an understood requirement by issuers, accounting firms and investors. The term "accounting restatement due to material non-compliance" in the Final Rule should be limited accordingly. We believe adopting this bright-line approach would promote consistency, clarity and predictability for implementation of the recoupment policies, while limiting unnecessary additional costs due to the uncertainty of a standard that is unclear and unknown.

2. **Bright-line triggering event for the three-year lookback period.**

For purposes of triggering the three-year lookback period, the Proposed Rules would establish the date on which an issuer is required to prepare an accounting restatement as the earlier of (a) the date the issuer's board of directors, a committee of the board of directors, or the officer or officers of the issuer authorized to take such action if board action is not required, concludes, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error, or (b) the date a court, regulator or other legally authorized body directs the issuer to restate its previously issued financial statements to correct a material error.

The 2021 Reopening Release asks: "*Should we remove the 'reasonably should have concluded' standard in light of concerns that the standard adds uncertainty to the determination?*"

We recommend removing the "reasonably should have concluded" standard from the Final Rule to avoid unnecessary uncertainty for issuers. Such a standard requires companies to conduct a hindsight form of review, which is difficult for companies to administer confidently and consistently. A clear, bright-line rule will allow for consistent application of the Final Rule. We believe that the date the Form 8-K is required to be filed is the most appropriate triggering event for the three-year lookback period. Using the date of the Form 8-K will (i) provide issuers with a clear understanding of when the obligation to recover compensation is triggered, (ii) allow for consistent application of the Final Rule across issuers and (iii) leverage the existing and familiar regulatory framework for disclosing errors to financial statements.

The Release also notes that, for errors that are not material to the previously issued financial statements, but where the issuer concludes that a restatement is required, "*evidence of the conclusion that a restatement is required is generally included in the issuer's documentation of its materiality analysis of the error.*"

As discussed above, we do not believe that such additional restatements should require the recovery of incentive-based compensation under the Final Rule. Therefore, we believe that the only triggering event should be the date that requires a filing of a Form 8-K for a restatement that corrects errors that are material to previously issued financial statements.

3. No additional check box on Form 10-K cover.

The 2021 Reopening Release considers: "*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 clawback analysis during the fiscal year*" and asks: "*Would one or both checkboxes and the related information be useful to investors?*"

We do not believe that additional checkboxes on the cover page of a Form 10-K would provide useful information to investors. The cover page of the Form 10-K should be reserved for information that is most helpful in understanding an issuer, its securities and the disclosure that will be provided in the annual report (e.g., the type of filer the issuer is, whether the issuer is current in its reporting, outstanding securities, etc.). We do not believe that the cover page of the Form 10-K is an appropriate place to highlight error corrections or the analysis of whether to apply a compensation clawback.

Investors would likely not gain any useful information through the checkboxes. We do not believe that the inclusion of a new checkbox would be consistent with the Commission's modernization and simplification efforts nor consistent with the Commission's overall mission. As part of the Commission's FAST Act modifications to Form 10-K, the Commission determined that the checkbox disclosing delinquent filings by insiders was no longer useful "as a tool to facilitate the staff's processing and review of the form [Form 10-K]." [1] We similarly do not believe that the inclusion of a new checkbox to indicate error corrections or the triggering of a clawback analysis would prove a useful tool to the Commission's processing and review of Form 10-K nor to the investor community's review of Form 10-K.

Because we do not see any additional benefits to investors, we would recommend against the inclusion of checkboxes on the cover page of the Form 10-K.

[1] *See* *FAST Act Modernization and Simplification of Regulation S-K*, SEC Release No. 33-10618; 34-85381 (March 20, 2019).

4. **Costs incurred by issuers in implementing clawback policies.**

The 2021 Reopening Release asks: "*How might these costs and/or benefits change in implementing a policy pursuant to a Commission rulemaking and the new potential interpretation of "an accounting restatement due to material noncompliance?*"

We appreciate the Commission's invitation for additional cost-benefit analysis. The type of mandatory clawback contemplated by the Proposed Rules will already impose a variety of costs. We would encourage the Commission to consider the below costs in implementing a reliable clawback policy that could potentially offset the incentive benefits.

- *Issuer-compliance cost*. Issuers will incur a variety of compliance costs if given responsibility for implementing a reliable excess-pay clawback. These would include costs of (i) formulating the clawback policy, (ii) revising executive pay arrangements to take into account of the clawback policy, (iii) modifying the policy over time in response to changing circumstances, (iv) determining whether a clawback is required and calculating the recoverable amount, (v) seeking recovery, including the costs of potential litigation by executives and/or shareholders and (vi) any required reporting costs.

- *Shift in incentive compensation structure.* Executive-burden costs may lead to changes in the structure of compensation arrangements, which could potentially destroy more economic value by not aligning executives' incentives with those of the company and its shareholders. These costs may result in a situation where the salary component of executive compensation becomes more and more important to executives as the portion of compensation that is not subject to the unknown potential of a clawback at present. Companies might decrease their use of accounting-based incentive compensation by increasing base salary, or increase their use of incentive compensation that are not accounting-based. Adding to that risk is the potential to move away from incentives based on financial performance metrics to incentives that are time-vested, or to increase executive compensation to risk-adjust for a possible clawback. This consequence is undesirable because, if based on well-chosen and accurate financial metrics, accounting-based incentive compensation serves a valuable role in aligning executives' incentives with those of the company and its shareholders. Moreover, decreasing the portion of accounting-based incentive compensation is at odds with other forces on companies, including the voting policies of proxy advisory firms and institutional investors.

- *Decreased executive morale and satisfaction.* The Proposed Rules would reach a large class of executive officers on a no-fault basis, without regard to their responsibility or lack thereof for the financial statement in question and irrespective of whether fraud occurred. Having portions of their compensation subject to change for matters outside their control will make financial planning challenging. This could cause otherwise talented executive officers to shy away from working with a public company.

For all of the reasons stated above, we recommend that more cost-benefit analysis should be conducted before finalizing the Proposed Rules.

5. **Definition of the "recoverable amount."**

The Commission proposed to define the recoverable amount as ''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.''

The 2021 Reopening Release asks: "*Would investors benefit from disclosure of how issuers calculated the recoverable amount, including their analysis of the amount of the executive's compensation that is recoverable under the rule, and/ or the amount that is not subject to recovery? For incentive-based compensation based on stock price or total shareholder return, would investors benefit from disclosure regarding the determination and methodology that an issuer used to estimate the effect of stock price or total shareholder return? What are the costs associated with such disclosure?*"

We continue to recommend that incentive-based compensation subject to recovery expressly exclude compensation paid based upon stock price performance or total shareholder return ("**TSR**"). As discussed in our 2015 comment letter, it would be very difficult for issuers to accurately and precisely calculate the isolated impact of a financial restatement on stock price. It is not possible to accurately measure the effect of a restatement on a company's stock price simply by measuring the market price of the company's stock both before and after financial statements were restated, because by the time the restatement actually occurs, the market price may already have absorbed the impact. In addition, attempting to calculate the appropriate amount to recover will require extensive economic analysis by executives and may well be challenged by executives and shareholders. If compensation based on stock price and TSR continues to be included, we at least recommend that issuers be permitted to take into account the potential cost of expert advisors and defending potential challenges in determining whether or not it would be impracticable to recover the compensation.

We believe that issuers should not be required to disclose their methodology for calculating the recoverable amount. Preparing such disclosure would be burdensome to issuers and require significant financial and personnel resources to develop and maintain additional documentation and hire outside advisors. Furthermore, because methodologies used to calculate the recoverable amount vary widely across issuers, the disclosure would not serve the purpose of providing meaningful, comparable information to investors.

Because of the complex analysis involved, litigation risks associated with the proposed disclosure and other confounding factors, we believe that issuers should not be asked to explicitly disclose how they calculated the recoverable amount.

6. Inline XBRL tagging.

The Proposed Rules would require that new compensation recovery disclosures be block-text tagged using XBRL. In addition, the Commission is considering requiring that specific data points within the new compensation recovery disclosure be separately detail tagged using Inline XBRL instead of, or in addition to, the proposed block-text tagging.

The Release asks: "*Would Inline XBRL detail tagging of some or all of the compensation recovery disclosures be valuable to investors? If so, which disclosures should we require issuers to detail tag and why? Is there an alternative technology to XBRL that we should consider? Should we enable more flexibility by adopting other tagging technologies?*"

While we recognize that inline XBRL could increase the ability of investors to compare information across filers, we would recommend that the Final Rule not require that specific data points within the new clawback disclosure be separately detail tagged using Inline XBRL. Given that the format and structure of disclosure about compensation recovery vary widely across different issuers, the specific metrics disclosed through inline XBRL tagging might not be comparable across issuers. In addition, such metrics can be

easily distorted by one-off events, rendering the comparisons useless or even misleading and resulting in only limited benefits to investors while unnecessarily burdening the issuers.

We believe that the initial compliance costs, the quality and the extent of use of XBRL data by investors would not justify the cost of creating XBRL data in company filings. Therefore, we recommend not to require compensation recovery disclosure be separately detail tagged using inline XBRL. If the Final Rule requires mandatory inline XBRL tagging, we recommend that issuers be given latitude with a phase-in period to ease the transition and be allowed additional time to comply with this new disclosure requirement.

7. Additional considerations.

In addition to commenting on the specific questions raised by the Commission in the Release, we would also like to reiterate the recommendations provided in our 2015 comment letter. We respectfully request that the Commission revisit and reconsider these recommendations to the Final Rule for the benefit of investors, issuers and other market participants before implementing the Final Rule.

- *Coverage of certain categories of issuers.* We believe that foreign private issuers and debt-only issuers should be exempted from the Final Rule.
    - Exempting foreign private issuers would be consistent with the Commission's desire to exempt foreign private issuers from onerous disclosure requirements not required by the issuer's home country law and to generally permit foreign private issuers to follow their home country practice on executive compensation matters.
    - Debt-only issuers are similarly exempted from many executive compensation disclosure rules and do not present the same risks to investors that the Proposed Rules are intended to address.
- *Board discretion regarding the recovery of incentive-based compensation.* We recommend that an issuer's board of directors have discretion to forgo recovery if it determines in good faith that recovery of excess incentive-based compensation is not in the best interest of stockholders. Especially if foreign private issuers are exempted from the Final Rule or given the choice to follow home country practices, a domestic issuer's board of directors should similarly be given discretion to decide whether to claw back incentive-based compensation so as not to be put on a different playing field than its foreign counterparts.
- *Exception for circumstances where recovery would violate home country or local law.* We do not believe that recovery should be required if recovery would violate the issuer's home country law or the law of the jurisdiction where the executive is located. Furthermore, we recommend against requiring a legal opinion as to the illegality of recover because such opinions can be costly and are often difficult to obtain in jurisdictions where the law is developing or uncertain.
- *Three-year look back period for executive officers—recovery on a pro rata basis.* We recommend that an issuer should only be required to recover incentive-based compensation from any person with respect to a pro rata portion of his or her incentive-based compensation attributable to the time the individual served as an executive officer.
- *Recovery of incentive-based compensation on a pre-tax basis.* In order to avoid an inequitable over-collection, we recommend that incentive-based compensation be recovered on an after-tax basis rather than on a pre-tax basis.

- *Use of deferred payment plans to recover excess incentive-based compensation*. We recommend that boards have the discretion to provide executive officers with the option of a deferred payment plan, which could reduce unexpected economic hardship, increase the likelihood of collection and minimize the risk or cost of litigation.

We appreciate the opportunity to participate in this process, and would be pleased to discuss our comments or any questions the Commission or its staff might have, which may be directed to Ning Chiu, Joseph A. Hall or Kyoko Takahashi Lin of this firm at [redacted].

Very truly yours,

DAVIS POLK & WARDWELL LLP