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Via E-Mail

November 22, 2021

The Honorable Gary Gensler
Chair
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: File Number S7-12-15: Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation

Dear Chair Gensler:

CFA Institute appreciates that the Securities and Exchange Commission's ("SEC" or "Commission") has issued its *Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation* (the "Reopened Release") to consider certain developments since the Commission's initial proposal was published in July 2015 (the "Initial Proposal"). We welcome the opportunity to supplement our prior response given that many years have passed since the comment period closed on that proposal in September 2015. As we stated in September 2015, and we continue to believe today, implementation of Section 954 of the Dodd-Frank Act will allow investors to better understand a company's compensation policies regarding the recovery of erroneously granted compensation.

CFA Institute is a global, not-for-profit professional association of more than 178,000 members, as well as 157 member societies around the world. Our members include investment analysts, portfolio managers, advisers and other investment professionals. We have a long history of promoting fair and transparent global capital markets and advocating for strong investor protections. An integral part of our efforts toward meeting those goals is ensuring that corporate financial reporting and disclosures – and the related independent audits – provided to investors and other end users are reliable and of high quality.

Summary of Our Letter

Investors rely heavily on the accuracy, transparency, and reliability of the financial information they receive from public companies to allocate capital and make voting decisions. The Commission has long recognized that the importance of timely and accurate financial reporting cannot be overstated. For example, in December 2019, a unanimous Commission publicly stated,

> ***High quality, reliable financial statements form the bedrock of our U.S. capital markets.***[1]

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[1] See SEC Chairman Jay Clayton, SEC Commissioner Robert J. Jackson, Jr., SEC Commissioner Hester M. Peirce, SEC Commissioner Elad L. Roisman, SEC Commissioner Allison Herren Lee, Statement on Appointment of New Chair and Five New Members of the Financial Accounting Foundation Board of Trustees, and Appointment of Next Chair of the Financial Accounting Standards Board (December 19, 2019), available at: https://www.sec.gov/news/public-statement/statement-commission-2019-12-19-fasb-gasb-trustees.

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When a loss of investor confidence in financial reporting cascaded through the U.S. capital markets in the wake of the Enron and WorldCom era corporate scandals, Congress passed the Sarbanes-Oxley Act of 2002 ("SOX") in an effort to restore investor trust. SOX contained the first statutory provision for CEOs and CFOs to return incentive compensation when that compensation was attained because of inaccurate or misstated financial results. In 2010, Congress expanded the provisions (Section 954) as a part of the Dodd-Frank Act, at the request of CFA Institute and others, after the issuance of an investor-focused task force recommendation to expand the provisions to all of the executive officers of a company.

Over the years, the Commission has taken action to implement the SOX and Dodd-Frank statutory mandates, ordered CEOs and CFOs to pay back incentive compensation that was based on misstated financial statements as a result of misconduct, and issued guidance to aid reporting companies. Federal courts have also weighed in on the Commission's application of the SOX clawback rules. However, Section 954 of the Dodd-Frank Act remains unenforceable as the Commission has not yet adopted a final rule despite issuing a proposal in the 2015 Initial Proposal.

Since the passage of the 2010 Dodd Frank legislation, some companies have implemented practices to recover erroneously awarded compensation. As detailed more fully below, the discovery of material accounting errors and the subsequent correction of such errors may occur in different ways. The manner of these corrections has impacted the implementation of these compensation recovery practices. When material errors are discovered in a company's issued financial statements, the accounting standards (worldwide) require restatement of the financial statements. Financial statements including material accounting errors must be restated such that current and historical periods are presented free from material misstatement. The SEC staff has similarly stated that material errors must be restated. Over the years, however, a practice has emerged with certain restatements being categorized as more severe or significant than others. This has led to confusion that some accounting restatements are more important than others or that certain restatements trigger clawback while others do not.

The categorization or labeling of restatements – as "Big R" or "Little r" restatements – has caused some to question the authenticity and veracity of corporate reports -- an anathema to investors. It appears that this confusion is a result of the mechanism (i.e., the SEC form or filing) that companies use to report the correction. We do not believe that the form of the restatements should override the substance of the restatement. Similarly, we do not believe that a safe harbor for executive compensation clawback exists merely dictated by the form of restatement rather than its substance.

Accounting for Accounting Errors

GAAP and IFRS Definitions of Accounting Errors & Treatment of Such Errors

Accounting errors can result from mathematical mistakes, mistakes in the application of generally accepted accounting principles, or the oversight or misuse of facts known or available to the company at the time the financial statements were prepared. Accounting errors can occur in recognition, measurement, presentation, or disclosure. For companies to consistently report on accounting errors, both US and international accounting standard setters (i.e., the Financial Accounting Standards Board (FASB) for US generally accepted accounting principles (US GAAP) and the International Accounting Standards Board (IASB) for International Financial Reporting Standards (IFRS)) have provided companies with guidance regarding correction of an error when one has been discovered after the financial statements have been issued. Since 1971, US GAAP (i.e., APB Opinion No. 20) has provided authoritative guidance to listed companies for corrections of accounting errors in previously issued financial statements.

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In 2005, the FASB updated its guidance in FASB ASC Topic 250[2] noting:

> *The correction of an error in previously issued financial statements is not an accounting change. However, the reporting of an error correction involves adjustments to previously issued financial statements similar to those generally applicable to reporting an accounting change retrospectively. Therefore, the reporting of a correction of an error by restating previously issued financial statements is also addressed by this Subtopic. (ASC Topic 250-10-05-5).*

Similarly, IFRS provides guidance (i.e., IAS 8) requiring prior period errors to be corrected by retrospective restatement. Accordingly, under both accounting standards, material errors are corrected by reflecting the correction in a retrospective manner. Hence, this retrospective method has become known as a "restatement."

After the discovery of an accounting error, the company and its auditors must evaluate the nature, circumstances, and materiality of previous misstatements and make decisions about how the error will be corrected. The assessment of materiality includes both quantitative and qualitative factors, and accordingly, requires a high degree of judgment. The assessment becomes increasingly complex when analyzing multiple errors, offsetting errors, aggregating and netting errors, and determining intentionality. As one Federal District Judge[3] noted:

> *Surely investors would consider the involvement of [executive] officers of a company in complex and wide-ranging schemes to inflate the company's income to be material even if the scheme had not yielded substantial results*. (emphasis added)

Moreover, the analysis of the quantitative impact of errors may not be a straight-forward as the assessment can be evaluated by the so-called "rollover method" or the so-called "iron-curtain method."

Investors Need Disclosure Regarding Nature of Error and its Materiality

As CFA Institute stated in its September 2015 comment letter, because of the inherent estimates, judgements, and complexity involved, companies should disclose their evaluations, the process and assumptions used to determine whether the error(s) in question were material or immaterial, and why it decided the matter in this way. Such disclosure should be thorough enough for investors to understand the material facts of the case, understand the reasoning behind such a decision, and make appropriate decisions about the board's actions.

Reissuance Restatements ("Big R") vs. Revision Restatements ("Little r")

SOX Impact of Restatements on Executive Compensation

As noted in the summary above, in July 2002, Congress passed, and President Bush signed, the Sarbanes-Oxley Act of 2002 which included a provision (i.e., Section 304) for the recovery of both CEO and CFO awarded compensation when financial statements are later to be found materially inaccurate or erroneous as a results of misconduct. SOX Section 304 states:

> *If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from*

[2] In issuing Statement No. 154, *Accounting Changes and Error Corrections*, which supersedes APB Opinion No. 10, the FASB did not change the way companies account and report for corrections of errors in previously issued financial statements.

[3] *SEC v. COLLINS AIKMAN CORP*, 524 F. Supp. 2d 477 (S.D.N.Y. 2007).

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> *the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.*

New SEC Commission Restatement Disclosure Requirements, Post SOX

In its implementation of SOX, the Commission, among other things, also expanded the number of items that would require formal notice to investors and others. Accordingly, in August 2004, the Commission began requiring listed companies to publicly announce if the company or its auditor concludes that "*any previously issued financial statements … should no longer be relied upon because of an error in such financial statements*." This requirement is contained in Item 4.02 of Form 8-K as noted below:

> *This new item requires a company to file a Form 8-K if and when its board of directors, a committee of the board of directors, or an authorized officer or officers if board action is not required, concludes that any of the company's previously issued financial statements covering one or more years or interim periods no longer should be relied upon because of an error in such financial statements as addressed in Accounting Principles Board Opinion No. 20 (APB Opinion No. 20).*

SEC Commission Restatement Disclosure Requirements:
Unintentionally Creates Two Classes of Restatements ("Big R" and "Little r") &
Reduces Executive Compensation Subject to Clawback

While the accounting standard setters and the Commission Staff have consistently maintained that the discovery of a material error requires restatement, the adoption of Item 4.02 of Form 8-K led to a diversity in the manner of correction in filings made with the SEC. As SEC Staff[4] noted in December 2008:

> *Said another way, if a restatement of previously issued financial statements is required, but such restatement would not result in the previous year financial statements changing materially, then the company can restate those financial statements the next time they are presented without amendment to the previous filings or the issuance of an Item 4-02 8-K.*

In applying the SEC Staff's guidance, companies and their auditors began referring to the correction of material errors by amendment and announcement via Form 8-K as "Reissuance Restatements" (or "Big R" restatements) and the correction of material errors through the company's next periodic annual or interim report as "Revision Restatements" (or "Little r" restatements). However, both methods of correcting material accounting errors constitute "restatements" whether: (1) through amendment of previously filed financial statements or (2) without the amendment of previously filed financial statements and provided in the current or future company filing.

Whether a restatement occurred by one method or another should not be determinative on whether, in fact, a restatement has occurred. Consequently, we believe the term "an accounting restatement due to material noncompliance,"[5] should encompass all restatements (those labeled "Big R" and restatements labeled "Little r").

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[4] Mark Mahar, *SEC Associate Chief Accountant,* remarked in a speech before the AICPA National Conferences on SEC and PCAOB Developments, on December 8, 2008:

> *Prior year financial statements should be corrected even though such revision was and continues to be immaterial to the prior year financial statements.*

See also SEC Staff Accounting Bulletin No. 108.

[5] See 2015 Initial Release, *Listing Standards for Recovery of Erroneously Awarded Compensation*, stating:

As the Commission notes in the Reopened Release, "Big R" restatements – meaning those reported in Item 4.02 of a Form 8-K – have decreased in both number and as a percentage of all restatements over the eight years since the Commission has required issuers to report non-reliance on Form 8-K (Item 4.02).

Academic Analysis of the Impact of "Big R" vs. "Little r" Restatements

An academic study[6] of restatements from 2000 to 2014, suggests that companies may have used this categorization with ill motives noting:

> *In recent years, many companies have not announced restatements in Form 8-K and have avoided amending previously issued financial statements for the periods affected. Companies have instead revised the affected numbers for the previous periods and showed them in subsequent quarterly or annual reports (known as "little r" restatements").*

In addition, the Wall Street Journal reported in December 2019 that another study found that nearly half of "Little r" restatements had at least one characteristic indicating they should have been "Big R" restatements. The study's author believed that the Commission's rules caused a perverse motivation – to avoid recouping compensation from executives. The study's author is cited in the WSJ article as saying: *Managers appear to be frequently using their discretion over how errors are corrected to avoid ["Big R"] restatements.* Further, the WSJ article notes that the study's author's analysis points to one potential motivation:

> *"Clawbacks" that allow companies to recoup compensation from executives in the event of a Big R restatement. Companies with such clawbacks were more than twice as likely as others to use revisions for potentially material errors.*

The lack of transparency in a company's materiality assessment and the reason for the method of correction may also be contributing factors.

SEC's Consideration of the Issue is Valid

The Commission has a valid concern about the perception that companies have been "opportunistic" in an attempt to avoid the triggering of clawback requirements. Whether real or perceived, the mere perception of "gaming" undermines investor confidence and the credibility of financial reporting. By encompassing all accounting restatements in clawback provisions regardless of the form used to file the restatement, the SEC may serve to mitigate this perception of misaligned motivations.

Investors Believe Recovery of Erroneously Awarded Compensation from All Executive Officers Is Most Appropriate

During the Summer of 2008, the CFA Institute Centre for Financial Market Integrity and the Council of Institutional Investors (CII) began exploring the idea of commissioning a study on financial regulatory reform. Both organizations were concerned that investor views were missing in the ongoing national debate about overhauling the U.S. system of financial regulation.

Proposed Rule 10D–1 would require exchanges to adopt listing standards that would require a listed issuer (including a small entity) to develop and implement a policy providing that, in the event that the issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement, the issuer will recover from any of its current or former executive officers who received incentive-based compensation during the preceding three-year period based on the erroneous data, any such compensation in excess of what would have been paid under the accounting restatement.

[6] Christine E. L. Tan and Susan M. Young, *An Analysis of 'Little r' Restatements,* Accounting Horizons, September 2017.

The result was the launch in February 2009 of an independent non-partisan panel, the Investors' Working Group (IWG), formed to provide an investor's perspective on improvement of the regulation of U.S. markets. One of the consensus views adopted by the IWG related to the strengthening of provisions on unearned compensation ("clawback") to scope in addition to the CEO and CFO. As the IWG noted:

> *Clawback policies discourage executives from taking questionable actions that temporarily lift share prices but ultimately result in financial restatements. Senior executives should be required to return unearned bonus and incentive payments that were awarded as a result of fraudulent activity, incorrectly stated financial results or some other cause. The Sarbanes-Oxley Act of 2002 required boards to go after unearned CEO income, but the Act's language is too narrow. It applies only in cases where misconduct is proven—which occurs rarely because most cases result in settlements where charges are neither admitted nor denied—and only covers CEO and CFO compensation. Many courts, moreover, have refused to allow this provision to be enforced via private rights of action.*[7]

The IWG's recommendation is reflected in legislative history as a basis for Section 954 of the Dodd-Frank Act:

> *The Committee believes it is unfair to shareholders for corporations to allow executives to retain compensation that they were awarded erroneously. This proposal will clarify that all issuers must have a policy in place to recover compensation based on inaccurate accounting so that shareholders do not have to embark on costly legal expenses to recoup their losses or so that executives must return monies that should belong to the shareholders. The Investor's Working Group wrote ''federal clawback provisions on unearned executive pay should be strengthened.''*[8]

Consequently, we believe that a Commission rule or an interpretation that only certain restatements will trigger clawbacks, while other restatements will enjoy a safe harbor for executives, would undermine the purpose and intent of Section 954 of Dodd-Frank. The Commission would, in effect, be overriding the statute, and preventing application of the provision to an arbitrary category of restatements ("Little r" restatements). Additionally, such an approach could require Commission Staff to issue extensive guidance to categorize exactly which accounting errors constitute "clawback errors" and which constitute "non-clawback errors".

Timing of a Restatement & Impact on Clawback

As our September 2015 comment letter stated, *"[A] great deal of time can pass between the time an error is detected in the financial statements and the time a court or regulator requires a company to take action."* The discovery and correction of a myriad of accounting errors can be complex and may take some time.

In the Commission's Initial Proposal, the trigger for the lookback period would be the date the issuer's board, audit committee or authorized officer concludes, or "reasonably should have concluded," that the issuer's previously issued financial statements contain a material error. Because the time between discovery and the board concluding that a material error has occurred can be lengthy, there is currently ambiguity regarding the date the lookback is triggered in the view of some.

Some suggest removal of the "reasonably should have concluded" language would simplify the computational math ([Current Date] minus [Three Years]. We disagree. Our view is that removal of such

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[7] US Financial Regulatory Reform: The Investors' Perspective, A Report by the Investors' Working Group, July 2009, *available at* https://financialservices house.gov/uploadedfiles/072711smith.pdf

[8] Rep. S. Comm. on Banking, Hous. & Urb. Affairs, S. 3217, S. Rep. No. 111-176, at 136.

language would create greater ambiguity regarding the date a material error was discovered, the conclusion that a material error has occurred and the impact this would have on the clawback periods in question. This could diminish the company's credibility, confidence of investors in the timeliness and accuracy of the company's financial reporting and the actual clawback computation.

Retention of the language, "reasonably should have concluded," mitigates any concern that: (1) corporate internal investigations are longer than necessary, (2) there are unreasonable delays in concluding that a restatement is required, or (3) misalignment of executives' incentives improperly impacts the timeliness or accuracy of the financial reporting.

Disclosures

As we stated previously, we urge the Commission to enhance company disclosures upon discovery of a material error and the application of voluntary or mandatory clawback policies. This would mitigate the concerns in the preceding section. The Commission should consider whether companies should disclose the date the material error was discovered, the process and assumptions used to determine whether the error(s) in question were material or immaterial, their evaluations and why they decided the matter in the way they did, as well as the calculation of recovery amounts, if any.

We also support modernized disclosure on the cover of the annual or interim reports to indicate errors have been correct and tagging of related data to lower the cost to investors of analysis (using inline XBRL).

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Thank you for your consideration of our views and perspectives. If you have any questions or seek further elaboration of our views, please contact Robert P. Peak [redacted] or Sandra J. Peters at [redacted].

Sincerely,

/s/ Sandra J. Peters

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CC: Commissioner Hester Peirce
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