September 14, 2015

Center On Executive Compensation

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

RE: Comments on Proposed Rule Implementing Section 954 Dodd-Frank Wall Street Reform and Consumer Protection Act – File Number S7-12-15

Dear Mr. Fields:

The Center On Executive Compensation ("Center") is pleased to submit this set of comments to the U.S. Securities and Exchange Commission ("Commission") providing its perspective on the Commission's implementation of Section 954 of the Dodd-Frank Act, the listing standards for recovery of erroneously awarded compensation. Section 954 requires the SEC to promulgate a rule mandating an exchange listing standard directing companies to adopt a clawback policy whereby companies, upon a material financial restatement, must recover from certain current and former executives any excess compensation which would not have been awarded under the restated financials during the three years preceding the restatement. This letter provides the Center's perspective on the implementation of Section 954 including the following key takeaways:

- In the context of the discretion to exercise a clawback, the Commission's overly narrow definition of "impracticable" hinders the ability of a registrant to act in a manner which is consistent with the fiduciary duties of the registrant's board of directors who serve as representatives of the shareholders.
- The cancelling of compensation should be considered an acceptable manner of clawback recovery which "effectuates the purpose" of the regulation.
- In lieu of the "reasonably should have concluded" standard, the Commission should adopt a good faith standard for the determination of the "clawback date".
- The Commission should adopt a good faith standard for the determination of the impact of a material restatement on past stock price and Total Shareholder Return (TSR) metrics.

The Center is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 360 large companies, and the Center's more than 115 subscribing companies are HR Policy members that represent a broad cross-section of industries.

I. A Properly Structured Clawback Requirement Reinforces Pay for Performance and Benefits Shareholders.

The Commission's approach to the implementation of the Dodd-Frank clawback requirement should be considered in concert with the fiduciary duties of a registrant's Board of Directors. Pursuant to these duties, which extend to all areas of board oversight, a board must act in good faith and with reasonable care to make decisions which are in the best interest of the corporation and its shareholders. These fiduciary duties weigh in favor of granting the Board discretion in key areas of the final rule to ensure the clawback requirement is implemented in a manner which both fulfills congressional intent and protects shareholder interests.

The Center supports the Commission's efforts to implement the Dodd-Frank clawback requirement and has long believed that a properly designed clawback policy is a reasonable part of an effective pay for performance program. A properly designed clawback allows a registrant's board of directors to evaluate the totality of the circumstances surrounding a clawback to ensure, based on reasoned judgment, experience, and expertise, that the action taken provides the optimal outcome and benefit to the corporation and its shareholders. The path to arriving at the optimal outcome of a clawback, however, will inherently vary on a case-by-case basis due to the wide variety of factors giving rise to a clawback. These factors include the specific accounting circumstances giving rise to the restatement, the executives involved, the potential for bad actors, and the mechanics of the various incentive compensation plans utilized by the registrant which are potentially subject to the clawback. The only way to account for these factors is to provide sufficient discretion to allow the registrant's board to consider them and subsequently take an appropriate and informed course of action.

Overall, the Center believes that many aspects of the proposed rule are structured in a manner that recognizes the unique nature of individual registrants as well as the potential complexity of identifying a material restatement and the challenges inherent in executing a clawback. However, the Center urges the Commission to implement certain enhancements to the proposed rule that will strengthen the ability of registrants to comply with the stated goals of the proposal while better serving the interests of shareholders:

- <u>Expand Discretion in Clawback Exercise, Recovery, and Amount</u>: It is impractical to prescribe a method of executing a clawback that adequately anticipates all the facts and circumstances that could exist when a clawback may be required. Thus, the Center recommends the Commission (1) expand the proposed rule's definition of "impracticable" to permit a more complete evaluation of the costs and circumstances of clawback; (2) consider the cancellation of outstanding compensation as a valid method of clawback recovery; and (3) allow the Board to determine the amount of recovery in certain limited circumstances.

- Combine Effective Disclosure With the Exercise of Discretion: The counter-balance to the exercise of discretion is to require a registrant to disclose the extent to which discretion was applied and the circumstances and rationale behind the decision. The Center supports clear disclosure where discretion is exercised.
- Ensure Clarity in Determining When a Clawback is Necessary: Although the framework for identifying whether a clawback is necessary appears workable on its face, the Commission should adopt a good faith standard for determining the date of a clawback in lieu of the "reasonably should have concluded" standard utilized in the proposed rule.
- Ensure Clawback Execution Reflects How Registrants Award Compensation: Several technical adjustments to the proposed rule will further reinforce the generally workable framework the proposed rule has created with respect to how a registrant is required to approach the execution of a clawback.

The Center's comments begin with a discussion of why additional discretion with regard to clawback execution is necessary to allow a registrant's board to fulfill its fiduciary duties to act in the best interest of the corporation and its shareholders while also achieving the goals of the clawback mandate. This is followed by a discussion of how disclosure, particularly when combined with the necessary additional discretion, provides investors with an effective monitoring and informational mechanism. Finally, there are two discussions of the mechanics of the proposed rule itself. These provide suggestions and enhancements to ensure the process of identifying and executing the clawback requirement occurs in a predictable and consistent fashion that also minimizes the potential for second guessing.

II. The SEC Should Provide Registrants With Sufficient and Necessary Discretion in Exercising a Clawback to Ensure Shareholders Benefit.

As an important component of an effective pay for performance program, the clawback requirement should be implemented in a manner which provides an appropriate level of discretion to ensure a registrant can always act in a manner that promotes shareholder value. The alternative to providing a registrant with sufficient discretion is potentially to force a registrant to carry out a clawback in a manner that is at odds with the board's fiduciary duties and could result in shareholder harm. In such situations, it is logical to assume shareholders would choose to provide a registrant's board with the discretion necessary to execute a clawback in a manner that ensures a net benefit to them, including preventing the registrant from incurring unnecessary costs.

For a registrant, the exercise of a clawback amounts to a continuous balancing act between incurring costs to accomplish recovery and the potential benefits of recovery. At some point in the recovery process, the costs of a clawback will render any further action to effectuate clawback recovery detrimental to the registrant and its shareholders. In the final rule, the Commission should provide a registrant's board with the necessary discretion to make determinations regarding the costs and benefits of exercising a clawback.

A. The Proposed Rule's Definition of "Impracticable" Inhibits the Ability of a Registrant to Act in A Manner Which Results in Shareholder Benefit.

As proposed, the Commission provides that registrants are not required to pursue a clawback where recovery is "impracticable". The term "impracticable" is defined in two bright-line tests. The first test allows registrants not to exercise a clawback where it is demonstrated that the direct payments made to a third party to assist in enforcing the clawback would exceed the cost of the recovery amount. The second test allows foreign registrants to avoid exercising a clawback where doing so would violate home country law. Each test is subject to certain conditions.

When viewed as components of discretion, each test is necessary to ensure registrants can act in a manner which benefits shareholders and is paired with a correlating disclosure obligation. Unfortunately, these approaches, while valuable, are incomplete and do not sufficiently accommodate the wide variety of registrants, the uniqueness of company pay programs, the individual circumstances that are considered in awarding compensation, and the fact-specific circumstances that may trigger a clawback. This creates a serious risk that registrants may be forced to seek a prescribed and mechanical course of action that may depart from the informed decision-making process which would have otherwise been pursued by the board of directors. Not only does this have the potential to impose significant costs to the detriment of a corporation and its shareholders, but it may even have the effect of compelling a registrant's board to violate its fiduciary duties. Such action would clearly contradict the goals of the clawback regulation and Section 954.

As explained and illustrated below, the Center therefore recommends the Commission expand the definition of what is considered "impracticable" in a manner that permits a registrant's board to exercise the necessary discretion to determine, based on experience and expertise, the optimal course of action that best benefits shareholders. When paired with effective disclosure, a proper construction of the term "impracticable" best accomplishes the underlying intent of the clawback requirement.

1. The Definition of "Impracticable" Should Include Other Direct and Indirect Costs.

As noted above, the proposed rule provides two separate approaches regarding the exercise of discretion in deciding whether or not to pursue a clawback against an individual executive. The first approach recognizes the irrationality of requiring a registrant to exercise a clawback in instances where the registrant would incur direct costs attributable to a third party exceeding the recoverable amount and provides discretion to decline to pursue a clawback in such situations. Accordingly, upon such a determination and after a "reasonable attempt" at recovery is made, a registrant may conclude recovery is "impracticable" and decline to pursue the clawback. Unfortunately, the overly narrow focus on *third-party direct* costs will result in registrants being forced to incur potentially significant and wholly unnecessary costs to the detriment of the shareholders and in contravention of the purposes of the clawbacks regulation.

In a final clawbacks rule, the Commission should expand the definition of "impracticable" to allow a registrant to take into consideration costs beyond those attributed to engaging a third party. These costs would include the direct costs of the registrant's internal activities associated with the clawback exercise, such as the staff and management time associated with the exercise of the clawback. Additionally, indirect costs have the potential to be substantial and should also be considered by a registrant's board. Potential indirect costs include opportunity costs resulting from internal staff, management, and board resources which would have to be diverted to execute a clawback. In making a determination as to whether or not a clawback is "impracticable", allowing a registrant's board to take these costs into consideration is absolutely necessary to ensuring that action can be taken which ultimately results in a shareholder benefit.[1]

The proposed rule includes a requirement that, prior to a determination that a clawback is "impracticable," a registrant must make a "reasonable attempt" at recovery. The proposed rule does not provide any insight as to what constitutes a "reasonable attempt." However, based on the general tone of the proposal, we assume that the determination is contextual in nature, based on the individual facts and circumstances of the clawback and the covered executives. Even if this is a correct interpretation, this requirement could impose potentially significant costs on a registrant. With this in mind, we believe that it would be preferable to permit a registrant's board to make a preliminary determination as to the potential success of the "reasonable attempt." An initial determination would consist of an evaluation of the totality of the circumstances surrounding the clawback. Once all the facts have been vetted, the registrant's board would use its considerable expertise and judgment to determine how best to approach a clawback in a manner which maximizes the benefits to shareholders.

2. **To Effectively Prevent Conflicts With Foreign Law, the Definition of "Impracticable" Should Focus on the Location of the Executive, Not the Registrant.**

The proposal's second rule permitting the use of discretion allows foreign registrants to conclude the exercise of a clawback is "impracticable" when such exercise would result in the violation of home country law. The Commission's recognition of a need for discretion in such scenarios contemplates the difficult situations facing a foreign registrant in which complying with the clawback would result in violation of the law in its home jurisdiction. This is a valuable provision, but the Commission can make the

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[1] The Center is not advocating that indirect costs would automatically render a clawback impracticable. We are only stating that a registrant's board should be permitted to consider indirect costs as part of the totality of the circumstances evaluation of the clawback in determining whether recovery is "impracticable". Subsequent disclosure of any factors considered in the determination would be required to be disclosed.

exclusion even more practical by shifting the focus from the location of the registrant to the location of the executive.

In a final rule, the Commission should permit a registrant to conclude the exercise of a clawback is "impracticable" if recoupment is required against an executive located in a jurisdiction where doing so would conflict with the laws of that jurisdiction.[2] Such discretionary authority follows the sound logic of the proposed rule which focuses on permitting registrants to avoid situations where they are faced with having to comply with mutually exclusive laws of different jurisdictions. Furthermore, given both the global scope of many U.S. and foreign-listed registrants and the broad nature of the Commission's proposed definition of "executive officers," it is likely that a registrant may have covered executives located abroad, potentially in countries where pursuing a clawback would be illegal. As a result, shifting the focus to the location of the executive is essential to ensuring a registrant can act in a manner that benefits shareholders while also avoiding conflicting foreign laws.

The proposed rule's requirements allow a registrant to exercise discretion based on a conflict with foreign country law, but only if the registrant secures a legal opinion by home country counsel as to the illegality of executing the clawback. We understand the Commission's concern that a registrant, without securing and disclosing an opinion of home country counsel, could act deceptively in order to avoid having to exercise a clawback by falsely claiming compliance would conflict with foreign laws. However, in many foreign jurisdictions the legality of the exercise of a clawback pursuant to the proposed requirement is likely to be a case of first impression. This would require full litigation of the claim, even if it appears prior to litigation, based on a reasonable assessment, that recouping the compensation will still likely be illegal in the end.[3] As a

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[2] Denmark - Under the Danish Share Option Act and the Salaried Employees Act, a company must compensate any terminated employees for any unvested options they receive on the termination of the employment. Therefore, a general clawback provision may well be unenforceable in certain cases under the Danish Stock Options Act. France (and in all likelihood several other EU countries) – The enforceability of any clawback will depend on the employment contract of the individual and it may not be possible to enforce clawback unless the individual agrees to a change in the terms of his employment contract. A number of companies have found this to be a practical problem as employees are reluctant to change their contracts to include clawback. Japan – A Tokyo District Court found that an employee who has been terminated and therefore could not achieve the five-year employment condition required to "earn" their equity award should be entitled to the award in any event as termination was out of his control and a company decision. In addition a clawback may in fact be considered illegal under Article 16 of the Labor Standards Law of Japan which prohibits an employer from making a contract which fixes in advance either a sum payable to the employer for breach of contract or an amount of indemnity for damages.

[3] In a number of countries, including those listed in the above footnote, the true enforceability of clawback is still untested but the enforceability of a post-vesting clawback is strongly in question. For example, in Spain, under the 2014 Spanish Supreme Court *Helicor* ruling, bonus payments that were withheld from a terminated employee due to the failure of the company to achieve specific performance criteria for the payment were ordered to be paid. The Court considered, despite the discretionary nature of the payments as well as the failure achieve targets, that sufficient discretion went into the awards that they could not be withheld.

result, securing the required legal opinion may be difficult, if not impossible, without first attempting to enforce the clawback and litigating any claim that results. This is likely to result in substantial costs to the registrant and its shareholders. In a final clawback rule, therefore, the Commission should provide that a legal opinion by foreign country counsel which has a reasonable basis to conclude that clawback recovery would violate the laws of that foreign country satisfies the legal opinion requirements of the final rule.

B. The Act of Cancelling Granted and Unvested Compensation Should Constitute an Approved Means of Clawback Recovery.

The Center commends the Commission for the proposed rule's recognition that the means of clawback recovery may vary by registrant or by type of compensation arrangement and for providing registrants with the discretion to determine how best to accomplish recovery. The Center will limit its comments to focus on the proposed rule's condition that the manner of recovery selected by a registrant must "effectuate[] the purpose of the statute – to prevent executive officers from retaining compensation that they received and to which they were not entitled under the issuer's restated results."[4] We ask that the Commission recognize that a registrant's action of cancelling granted or unvested compensation be considered a manner of clawback recovery which "effectuates the purpose of the statute."

A large proportion of executive pay is awarded on a long-term basis, with vesting periods of three or more years. As a result, executives typically have significant portions of unvested pay outstanding in any given year.[5] Even after an executive has left the company, he or she may have compensation outstanding if the company's policies are such that certain equity grants continue to vest post-termination (this is often true in the case of a retired executive or an executive who is terminated as a result of a change-in-control). If it is determined that a clawback of compensation for a particular executive is necessary, the cancellation of an unvested or outstanding incentive award would have the same effect as recouping cash incentives already paid.

The case for the ability to cancel future and unvested awards is particularly compelling in light of how it can impact the costs of clawback recovery and even, under certain scenarios, potentially eliminate the need for a company to exercise discretion to decline to pursue a clawback due to direct costs exceeding the amount of the recoupment. For example, a registrant which must pursue recovery from a former or retired executive faces a higher risk of incurring significant costs. However, if that individual still has outstanding compensation which was yet to fully vest or which would be earned in the future, a registrant could simply cancel that compensation and accomplish the clawback recovery at minimal cost to shareholders while also fulfilling the goal of Section 954.

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[4] Listing Standards for Recovery of Erroneously Awarded Compensation, 80 FR 41,144, 41,163 (July 14, 2015) (to be codified at 17 CFR 229, 240, and 249)

[5] Fred Cook 2014 Top 250 Report, Page 11, may be found at http://www.fwcook.com/alert_letters/The_2014_Top_250_Report_Long-Term_Incentive_Grant_Practices_for_Executives.pdf

We are conscious of the Commission's concern that the cancelling of contingent compensation that may not be received (*e.g.*, unvested restricted stock) could have the effect of circumventing the underlying purpose of the clawback requirement. There are, however, approaches for limiting this potential result. For instance, registrants could cancel awards that are scheduled to vest within a close time period to when the clawback would be executed, thereby providing registrants with a more certain and cost-effective mechanism for clawback recovery.

As an example, suppose a registrant discovered during March that a clawback was necessary and subsequently in September determines the excess amount. At the same time, the registrant is aware that the CEO has an unvested restricted stock award which, barring an unforeseen departure, stands to fully vest on December 31st of that year. In this scenario, the restricted stock award is essentially considered fully vested and could be canceled by the registrant as a cost-effective means of clawback recovery. If the CEO were to depart before the December 31st vesting date, the registrant would be required to pursue alternative recovery methods.

Alternatively, suppose the CEO stood to earn an award based on a performance period which ends on December 31st of that year. The value and certification of this award would typically take place in February of the following year, providing a registrant with an opportunity to reduce the amount of the award by the value of the clawback amount. It is important to consider what could happen in these scenarios if a registrant were not allowed to cancel unvested or unpaid compensation: the CEO could refuse to pay the clawback amount to the registrant while the registrant is forced to deliver compensation to the CEO (on December 31st or in February) and then sue the CEO or take other recovery approaches to get the money back.

As part of the final rule, the Commission should consider the mechanics of the clawback and the impact on the timing of executing recoupment. Notably, the process of determining the individuals and the incentive compensation subject to the clawback as well as the amount to be recovered from each individual is likely to take some time. Thus, the ability to cancel unvested compensation that is near the vesting date would cover all current executives as well as those that were involuntarily terminated. A registrant would, however, likely be required to pursue alternative recovery methods against executives who departed voluntarily during the time period between the clawback date and the recovery date because upon voluntary departure a former executive is likely to have forfeited outstanding compensation.

C. Additional Discretion Is Necessary to Accommodate for the Requirement that Registrants Recover Amounts on a Pre-Tax Basis.

In determining the amount of compensation which must be recovered pursuant to a clawback, the proposed rule requires that recovery be determined using pre-tax amounts. However, without the ability to cancel granted and unvested compensation as a manner of clawback recovery, a subject executive will already have paid potentially significant amounts in taxes on any compensation subject to the clawback.[6] As a result, requiring registrants to clawback pre-tax amounts could result in a significant monetary gap between the recovery amount and the amount originally realized by the executive. For example, suppose pursuant to a clawback an executive owes $100 to the registrant. When the $100 was paid to the executive originally, he or she paid a 39% federal tax rate and a 4% state rate, taking home a net award of $57.

Forcing immediate recovery of the full $100 from an executive who never actually realized over 40% of the originally payment amount has the potential to impose significant financial hardship on the executive. Affording a registrant's board discretion with regard to the amount subject to the clawback could allow a registrant to avoid negative consequences in a manner which best benefits shareholders. Additionally, providing discretion in this manner best accomplishes the purpose of the statute – to prevent executive officers from retaining compensation that they received and to which they were not entitled under the issuer's restated results – by ensuring the clawback recovery amount mirrors what an executive actually earned.

If the Commission chooses not to provide board discretion in circumstances where pre-tax recovery creates a monetary gap between the recovery amount and the amount an executive actually took home, a final rule should expressly state that a registrant providing an executive with assistance in amending tax filings which are required as a result of the clawback does not violate the final rule. Further, the final rule should provide that postponing clawback recovery until a time where an executive has completed the necessary amended tax filings to reflect income in light of the clawback constitutes "reasonably prompt[]" recovery in compliance with the final rule.

D. In Pursuing Recovery, Registrants Should Approach Clawback Recovery for the Cumulative Clawback Amount Taking into Account Potential Under and Over Payments.

In addition to considering the forfeiture of granted and unvested equity as a valid manner of clawback recovery, the Center recommends the Commission also provide that registrants may accomplish clawback recovery by considering recovery amounts in total over the three-year look back period, balancing any under-payments with any potential over-payments which may result from a material restatement. In the proposed rule's request for comment, the Commission provides a scenario in which a restatement causes a registrant to shift revenue recognition from one year to another. Under such a scenario, a registrant with incentive compensation based on revenue will likely see the incentive compensation based on revenue be adversely affected by the shift in one year, while in a previous or subsequent year it will have a positive impact. Rather than requiring an executive subject to the clawback to provide a check to the registrant for the overpayment in the first year while at the same time compelling a registrant to provide a check to make up the underpayment, it obviously would be much more cost-effective and sensible to permit the registrant to consider all overpayments and

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[6] In 2014, the marginal income tax rate for individuals making over $406,750 was 39.6%. Potential state income tax rates would increase the amount of taxes paid. See http://www.irs.gov/pub/irs-pdf/i1040tt.pdf.

underpayments during the clawback period. At that point, a registrant could effectuate recovery by considering net total, and then require any remaining over or under payment to be settled by the responsible party.

As is the case with the exercise of discretion regarding whether or not to pursue a clawback, the Commission could require registrants to briefly disclose the manner of clawback recovery so as to properly inform shareholders of the registrant's actions.

E. Registrants Should Be Permitted Discretionary Authority to Write Off Unlikely Clawback Recovery Amounts.

The proposed rule allows registrants to decline to pursue a clawback if the costs of such pursuit would be greater than the amount of the clawback itself. However, in some cases, a registrant may find that it is in the best interest of the shareholders to pursue a clawback, but only up to a certain dollar amount before costs of recoupment rise sharply or the clawback becomes impractical. In such situations, particularly in light of the proposal's requirement that it disclose uncollected amounts, registrants should have the ability to decline to pursue the clawback further and to subsequently "write off" the unrecoverable amounts, akin to the treatment of bad assets or debt on the balance sheet.

For example, suppose a former executive subject to the clawback has fallen under extreme financial hardship and only has access to 60% of the funds required to be recovered pursuant to a clawback. Recovering up to that 60% would be a cost-effective proposition for the registrant. Anything beyond that 60% would not be recoverable without incurring significant costs.[7]

In such a situation, registrants should be able to exercise discretion to pursue a clawback for a certain amount but decline to pursue the full amount if the costs of doing so are judged to outweigh the amount to be clawed back. The exercise of discretion in such a scenario is clearly preferable either to failing to recoup any of the amount in question or pursuing a small remainder of the amount at a cost that outweighs the benefit. Subsequent to the disclosure of the board's rationale, a final rule should permit the unrecoverable amounts to be written off so that they are not required to be disclosed on a continuous basis as outstanding.

III. Pairing Effective Disclosure With the Exercise of Necessary Discretion Maximizes the Benefits the Clawback Requirement Provides Shareholders and Registrants.

In light of the necessity of providing registrants with the ability to exercise discretion in the manner detailed above, the Center recommends the Commission require a registrant which chooses to utilize such discretion to provide additional disclosure detailing the rationale behind the decision. Such disclosure effectively complements and enhances the use of discretion as advocated by the Center. Furthermore, an

[7] While we don't anticipate this specific fact pattern occurring frequently, the example does, however, provide a scenario detailing one of the potentially innumerable practical issues which could face registrants.

effective disclosure requirement furthers the fiduciary duties of a registrant's board of directors by providing investors with an appropriate mechanism with which to evaluate the reasonableness of the board's actions.

The fundamental principle and logic behind the federal securities law disclosure regime endorses the full and open disclosure of material information to allow investors to make knowing and informed investment and voting decisions. The proposed rule already utilizes the disclosure regime to this end as demonstrated, for example, by the requirement that companies disclose unpaid clawback amounts in the proxy as a mechanism to put pressure on registrants and executives to accomplish full repayment.

Akin to how the disclosure in the proposed rule operates, a registrant exercising additional discretion as recommended by the Center would be required to describe the rationale behind the decision. The resulting disclosure could consist of, for example, an explanation as to why a registrant chose not to pursue recovery against an individual, why a registrant chose to recover an amount less than the total recoverable amount, or that pursuing recovery against an individual could result in a violation of the laws of another country.

IV. The Process by Which a Registrant Determines If a Clawback Is Necessary Should Be Clear and Workable While Minimizing the Potential for Second Guessing.

As proposed, the Commission has constructed a three-step framework by which registrants determine whether or not a clawback is necessary and for determining the scope of the retroactive application of the clawback. We believe the framework is, in general, workable, particularly the manner in which the three-year retroactive look-back period is determined. There are, however, areas where the Commission must provide additional clarification in order to ensure that the three-step process is clear and workable while minimizing the potential that a registrant's decision-making is later subject to second guessing.

A. Requiring a Clawback Upon a Material Financial Restatement Provides a Workable Framework for Registrants.

Pursuant to the proposed rule, the first step for determining whether or not a clawback is necessary is the identification of a material error in a previously issued financial statement which triggers the obligation to prepare a restatement. Accordingly, a registrant is required to initiate an investigation of whether a clawback will be necessary upon a material financial restatement.

We believe the Commission's decision to require a clawback assessment upon the identification of a material error to a previously issued financial statement provides a sensible and workable standard for a clawback trigger which also best reflects the intent of the drafters of Section 954. As is detailed in the proposed rule, Congress's use of the phrase "material noncompliance…with financial reporting requirements" indicates an expressed desire for a heightened standard for triggering a clawback and provides a clear effort to differentiate from other known standards such as GAAP restatements or financial revisions. Additionally, because materiality is analyzed and determined in the context of a particular set of facts and circumstances, the standard recognizes the infeasibility of a one-size-fits-all approach. Furthermore, as denoted in the proposed rule, materiality as a standard has received significant judicial and regulatory attention and, as a result, should be conceptually familiar to registrants.

B. Further Clarification Is Needed With Regard to Establishing the Date When a Material Financial Restatement Is Required.

According to the proposed rule, the second step for determining the necessity for a clawback requires a registrant to identify the "date the issuer is required to prepare an accounting restatement." The proposal provides two approaches with regard to how a registrant is to establish the date of a financial restatement. Specifically, for the purpose of the clawback requirement, the "date the issuer is required to prepare an accounting restatement" is the earlier of:

1. 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
2. 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 proposed rule recognizes the potential that several different dates could easily be viewed as the "date the issuer is required to prepare an accounting restatement" and works to create a framework which minimizes the potential for manipulation. We agree with the Commission's concerns. However, in the process of working to prevent the manipulation of the determination date, the proposed rule creates the potential for significant confusion by including a "reasonably should have concluded" standard.

The importance of providing a predictable process for determining the clawback date cannot be understated. The date functions as the *key determination* for clawback exercise as it establishes the three-year look-back period and as a result, the executives and incentive compensation subject to the clawback. Subsequent second guessing as to the date has the potential to fundamentally transform the entire scope of a clawback. The consequences of this type of change would result in significant costs and burdens, particularly if a registrant has already executed the clawback in part or in full.

In light of the need for greater certainty in determining the clawback date, the Commission's use of a "reasonably should have concluded" standard as part of the clawback date determination standard is extremely problematic. The law is replete with standards based on reasonableness, and all of them provide fertile and frequently-used grounds for litigation and second-guessing based on hindsight. As described above, the potential consequences for second-guessing in the context of a clawback are significant because often the circumstances are far from clear. The Center therefore recommends that the Commission replace the "reasonably should have concluded" approach utilized in the proposed rule with one which instead relies on a registrant's board having exercised good faith in making the date determination. An approach based on a good faith standard would significantly minimize the potential for second-guessing while also addressing the Commission's concerns that a registrant may manipulate its determination date to avoid having certain compensation included in the clawback.

Additionally, the Center requests that with regard to the second method of determining the date – the date of a court or regulatory order – that the Commission not consider the date as being established until a court order is final, non-appealable, and the registrant has exhausted all its options for relief. This will prevent situations where a registrant may be forced to engage in a clawback only to have the restatement on which the clawback was based overturned at a later date.

If the Commission chooses not to adopt our recommendation to replace the "reasonably should have concluded" standard with one which is based on good faith, the Center recommends the Commission provide additional, non-dispositive examples of when a registrant "reasonably should have known" a clawback was needed. The Commission provides only a single example in the proposed rule of a scenario, though not dispositive, which could trigger the "reasonably should have concluded" standard.[8] While this example is helpful to a certain extent, the Center is concerned that the use of a reasonableness standard, without further clarification of what constitutes reasonableness, will negatively impact board decision-making. This is of particular importance in light of the very high potential for second guessing and subsequent litigation with regard to a registrant's determination of the date.

Registrants, therefore, should be on notice regarding the circumstances the Commission believes registrants "should have known" a restatement was necessary. To this end, we urge the Commission to provide other non-dispositive examples a registrant should consider as potentially being indicative of meeting the "reasonably should have known" standard. By providing more examples, the Commission enhances the framework employed in the proposed rule while minimizing the likelihood that a registrant's decision-making is later subject to regulatory second guessing. This will also assist the exchanges as they look to develop their listing standards.

C. Basing the Three-Year Look-Back Period on the Date a Material Restatement Is Required Allows Registrants to Maximize the Potential for Recovery.

The third and final step to establishing the framework of a clawback under the proposed rule involves determining the three-year look-back period during which all incentive compensation received is potentially subject to the clawback recovery policy. Consistent with the statute, as proposed, the look-back period will encompass the three fiscal years preceding the fiscal year during which a registrant determined a material restatement is necessary. The proposed rule provides an example where a calendar year company concludes a restatement is necessary in November of 2018 and the

[8] Listing Standards for Recovery of Erroneously Awarded Compensation, 80 FR 41,144, 41,176 (July 14, 2015) (to be codified at 17 CFR 229, 240, and 249)

three-year look-back period would then apply to incentive compensation received in 2017, 2016, and 2015.

We commend the Commission for structuring the three-year look-back period as proposed. Not only is the proposal consistent with the language of Section 954, but it will also maximize the potential for registrants to execute clawbacks while minimizing the potential for confusion.

The chances for a successful clawback recovery are significantly higher for executives currently employed at a registrant. In contrast, it is more difficult to recover compensation from former employees because in many cases the executives are no longer tied to the registrant, making recovery slower and more expensive for shareholders. The chance of a successful recovery becomes even more remote the longer the period between the end of an executive's employment at the registrant and the registrant's attempted exercise of a clawback.

By structuring the look-back period to require registrants to pursue recovery for excess compensation received during the three fiscal years preceding the clawback date, however, the proposed rule facilitates recovery by ensuring the look-back period encompasses a time frame where the highest proportion of executives subject to the clawback are still employed at the registrant. Furthermore, because long-term executive compensation comprises a majority of total compensation for senior executives and is typically awarded in the form of equity over a period of three years, the proposed rule's framework for creating the look-back period makes it very likely that the company will be readily able to execute the clawback through cancellation of an unvested award or direct recoupment.

V. The Process of Exercising a Clawback Should Be Structured to Recognize and Reflect the Manner in Which Registrants Award Compensation.

In designing a registrant's executive pay program, a registrant's board of directors has the discretion to structure the program in a manner which it believes best promotes shareholder value. This is accomplished through a combination of performance-based awards linked to the achievement of predetermined measures of company financial performance and time-based awards which are typically designed to enhance executive retention in recognition that continuity in leadership is vital for long-term shareholder growth. The pay for performance aspect of a registrant's pay package encompasses the bulk of an executive's potential compensation and is at risk, being contingent on the achievement of company financial performance. Clawbacks, which work in conjunction with a registrant's pay for performance program to ensure compensation is only received upon the attainment of actual financial results, should be executed in a manner which reflects the structure and manner in which a registrant awards compensation.

A. Limiting Clawbacks to Section 16 Officers Provides a Pre-Existing and Familiar Definition.

In the proposed rule, the Commission chose to define the population of executives potentially subject to a clawback by mirroring the definition of a Section 16 executive officer. This framework provides registrants with a familiar and workable definition which will allow them to identify the appropriate individuals who will be subject to a potential clawback. By mirroring the definition of Section 16 officers, the proposed rule's definition of executive officers generally encompasses those individuals whose compensation is tied to financial metrics which, if restated, may result in the individual having been awarded excess compensation as defined by the proposed rule. Furthermore, the proposed definition of "executive officer" encompasses the individuals at a registrant charged with oversight of policies and procedures that impact filed financial statements. Expanding the pool of executives potentially subject to a clawback definition beyond Section 16 executive officers would lead to a result beyond Congress's intended purpose when it stated the clawback would "apply to executive officers."

However, the proposed rule should limit the application of a clawback to compensation received only during the fiscal years during which an individual actually served as a Section 16 officer. Currently, the recoupment applies to compensation received during the three-year period preceding the restatement, even if the individual was an executive officer for just one of the three years. According to the proposed rule, the Commission chose to include Section 16 officers on the basis that including "all executive officers would more effectively realize the statutory goal of Section 10D because officers with policy making functions and important roles in the preparation of financial statements set the tone for and manage the issuer."[9] Following this logic, however, the application of a clawback to only fiscal years in which an individual was serving as a Section 16 officer and received incentive-based compensation as defined by the rule best works to fulfill the intent of the Congress to apply the clawback to only "executive officers."

B. Limiting Clawbacks to Compensation Tied to the Achievement of Financial Reporting Measures Is Consistent With Equity Incentive Plan Designs.

In the proposed rule, the Commission determined that only compensation which is tied to the achievement of a financial reporting measure is subject to a clawback. We commend the SEC for recognizing in the proposed rule that registrant incentive plans utilize a wide variety of performance-vested and time-vested compensation structures in order to link compensation to performance and maximize executive retention. The Center believes that this is both consistent with the language of Section 954 and consistent with the way equity compensation is considered within companies. Incentive compensation that is awarded, granted or vested based on financial reporting measures should be subject to a clawback in the event of a material restatement, to the extent that pay was awarded erroneously based on misreported financial metrics.

By contrast, vehicles such as time-vested options and restricted stock should not be subject to a clawback as they are not directly tied to the accomplishment of specific financial objectives. Although the value of time-vested options and restricted stock is

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[9] Listing Standards for Recovery of Erroneously Awarded Compensation, 80 FR 41,144, 41,153 (July 14, 2015) (to be codified at 17 CFR 229, 240, and 249)

tied to stock price, neither type of award is granted contingent upon the achievement of particular stock price or financial goals. Therefore, a financial restatement should not result in the recoupment of these grants because they are not incentive compensation as defined by the statute. It is worth noting that performance-based pay constitutes nearly 60% of the total executive pay package,[10] meaning that the majority of executive pay will typically be subject to a clawback in the event of a material restatement.

C. As Proposed, the Process for Determining the Amount Subject to Clawback Is Problematic and Can Result in Inconsistencies.

As proposed, registrants are required to calculate the amount of compensation subject to the clawback by determining the amount of the award which was granted in excess of what would have been awarded under restated financials. This framework is appropriate for compensation based on reported financial measures such as revenue or return on equity.

For compensation based on Total Shareholder Return (TSR) or stock price, however, the calculation is much less clear. The proposed rule provides that companies are required to make a good faith estimate as to how the restated financials would have impacted the applicable financial measure. Registrants are required to document and disclose how the estimate is calculated. The Center recognizes the need for a clawback rule to include pay based on TSR and other stock price metrics given the prevalence of such metrics in incentive plans. That said, the process of determining how a material financial restatement would have impacted those metrics is far from an exact science. As a result, in a final rule, the Commission should expressly provide that any estimate of the impact of a restatement on TSR or stock price made in good faith by a registrant is considered *per se* reasonable in satisfaction of the clawback requirements. This deference is necessary in light of the multiplicity of potential calculation methods and the high risk that a registrant's calculations could subsequently be challenged on the basis that the board did not pursue an alternative method of estimating the impact of the restatement.

D. The Proposed Rule's Definition of When Compensation is "Received" Provides a Workable Framework in the Context of Executive Pay Design.

Pursuant to the proposed rule, incentive compensation is deemed "received" and thereby potentially subject to a clawback in the fiscal year during which an award's financial objective(s) is achieved. The resulting framework is workable for registrants and provides a predictable mechanism for identifying the appropriate incentive compensation in the event of a clawback. The framework also has the potential to make clawback recovery significantly easier for companies. This is a result of the potential that there will be a time gap between the date an award's financial objective is achieved and the date an executive obtains control over the award. During this period,

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[10] Including annual incentive and performance shares. Both would be subject to clawback to the extent the performance objectives are based on financials Equilar 2014 Proxy Season Trends Webinar, http://marketing.equilar.com/l/82992/2015-06-30/gvd5

a registrant maintains control over the still outstanding award, providing an opportunity, in the event of a clawback, for the registrant to effectuate recovery by simply cancelling the necessary portion of the outstanding award.

VI. Conclusion

The Center appreciates this opportunity to provide additional comments on the implementation and rulemaking related to Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. If you have any questions about the Center's comments, please do not hesitate to contact me at [redacted].

Sincerely,

Timothy J. Bartl
President

cc: Securities and Exchange Commission:
Hon. Mary Jo White, Chair
Hon. Luis A. Aguilar, Commissioner
Hon. Daniel Gallagher, Commissioner
Hon. Michael S. Piwowar, Commissioner
Hon. Kara M. Stein, Commissioner