SOCIETY
of Corporate Secretaries
& Governance Professionals

September 18, 2015

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

Re: Listing Standards for Recovery of Erroneously Awarded Compensation (Release Nos. 33-9861; 34-75342; File No. S7-12-15) ("Proposing Release")

Dear Mr. Fields,

The Society of Corporate Secretaries and Governance Professionals (the "Society") appreciates the opportunity to provide comments on the U.S. Securities and Exchange Commission's (the "Commission") proposed rule to implement the provisions of Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which added Section 10D to the Securities Exchange Act of 1934 (the "Exchange Act"). Section 10D requires the Commission to adopt rules directing the national securities exchanges to prohibit the listing of any security of an issuer that is not in compliance with Section 10D's requirements for disclosure of the issuer's policy on incentive-based compensation and the recovery of incentive-based compensation that is received in excess of what would have been received under an accounting restatement. Proposed Exchange Act Rule 10D-1 would implement the provisions of Section 10D (the "Proposed Rule").

The Society was founded in 1946 and is a professional membership association of more than 3,200 corporate secretaries, in-house counsel, and other governance professionals who serve approximately 1,600 entities, including 1,000 public companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and their committees and the executive management teams of their companies regarding corporate governance and disclosure. Our members generally are responsible for their companies' compliance with securities laws and regulations, corporate law, and stock exchange listing requirements.

Summary

In view of the number of topics and requests for comment addressed in this letter, we have ordered our comments in two categories: Primary Comments, indicating those topics of most concern to the Society, and Secondary Comments, indicating additional topics of interest to the Society.

Our Primary Comments are as follows:

1. The definition of "accounting restatement" should refer to generally accepted accounting principles or the applicable basis of accounting used to prepare financial statements.

2. Disclosure of materiality conclusions should not be required.

3. The proposed definition of when an issuer is "required to prepare an accounting restatement" should be revised and clarified in three important ways.

4. The Proposed Rule should cover only the issuer's principal executive officer, principal financial officer, principal accounting officer, and, in addition, any other executive officer that the board of directors or compensation committee determines to have had an important role in contributing to the events leading to a financial restatement.

5. The definition of "incentive-based compensation" should exclude equity awards that vest solely on the basis of continued employment or the passage of time, even if the value of such awards fluctuates with the value of the issuer's stock.

6. The Proposed Rule should not limit the discretion of the compensation committee, and the proposed definition of "impracticable" is too limited.

7. The Commission should provide additional guidance on what constitutes a "reasonable" attempt to recover excess compensation.

8. The Proposed Rule should include an exception for pre-existing employment agreements.

9. The Proposed Rule should not require recoupment if recoupment would violate state law.

10. The Proposed Rule should not apply retroactively.

Our Secondary Comments are as follows:

1. The Proposed Rule should not apply to issuers who are issuers of only nonconvertible listed debt.

2. The Proposed Rule should not require an issuer to recover compensation through the offset, reduction, or withholding of compensation if doing so would violate Sections 401(a) or 409A of the Internal Revenue Code or Section 206(d)(1) of the Employee

Retirement Income Security Act.

3. Issuers should be allowed to adjust the amount of compensation required to be recovered based upon a reasonable estimate of the offsetting impact.

4. A financial statement restatement by a peer group member should not trigger a recovery requirement when an issuer's incentive-based compensation is based upon performance relative to a peer group.

5. The Proposed Rule should not preclude indemnification or issuer-paid insurance in cases where the executive officer is not at fault.

6. The possibility of private causes of action under Rule 10D-1 underscores the need to permit issuer indemnification.

7. The Proposed Rule should permit issuers to release potential recoupment claims.

8. The Proposed Rule does not adequately consider the impact of the Proposed Rule on equity and other compensation plans.

Primary Comments

The Definition of "Accounting Restatement" Should Refer to Generally Accepted Accounting Principles or the Applicable Basis of Accounting Used to Prepare Financial Statements. [1]

Under the Proposed Rule, the clawback policy would apply to any incentive-based compensation received by an executive officer during the three full fiscal years immediately preceding the date an issuer is required to prepare an accounting restatement to correct a material error. The Proposed Rule defines "accounting restatement" as the "result of a process of revising previously issued financial statements to reflect the correction of one or more errors that are material to those financial statements."[2]

The proposed definition accords generally with the relevant accounting literature and Commission staff guidance,[3] which indicate that when an error is material, the financial statements must be restated—sometimes informally called a "Big R" restatement. A "Big R" restatement requires an issuer to revise previously issued financial statements and refile financial statements via an amendment to Form 10-K or 10-Q, as applicable. In contrast, when an error is immaterial to the prior year(s), the error can usually be corrected in a future Form 10-K or 10-Q—sometimes informally called a "Little R" restatement.

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[1] Proposing Release, Request for Comment ("RFC") No. 12.

[2] The Proposing Release also lists a number of events (such as retrospective application of a change in accounting principle and retrospective revision for stock splits) that do not constitute restatements. See Proposing Release, pages 25-26.

[3] See, for example, ASC 250-10-20 (defining restatement as "the process of revising previously issued financial statements to reflect the correction of an error in those financial statements") and Staff Accounting Bulletin No. 90 (available at www.sec.gov/interps/account.shtml).

We believe that only so-called “Big R” restatements” should trigger a clawback under the Proposed Rule. We agree that the definition of “accounting restatement” should reference “errors that are material to [the] financial statements.” However, since the Commission’s rules generally require compliance with Generally Accepted Accounting Principles (“GAAP) by domestic issuers,[4] we also believe that the proposed definition of “accounting restatement” should be revised to reference GAAP and the relevant accounting literature, or the applicable basis of accounting used to prepare the financial statements (e.g., International Financial Reporting Standards). This would avoid any confusion between the Proposed Rule and the accounting standards that govern the financial statements

Disclosure of Materiality Conclusions Should Not Be Required.[5]

The Commission requests comment on whether an issuer should be required to disclose its evaluation of certain errors when such errors are determined to be immaterial or not the result of material noncompliance. We do not believe an issuer should be required to disclose the basis for its materiality conclusions.

If prior period errors or adjustments are not material, a “Big R” restatement would not be required.[6] Under GAAP, immaterial prior period errors or adjustments are permitted to be corrected in current period financial statements with appropriate disclosure in the financial statement notes. In our view, this provides adequate transparency to investors. Requiring an issuer to explain how it reached the conclusion of immateriality would require the exposition of numerous factors, given the context-based nature of the materiality determination, which would overwhelm, rather than inform, and could unnecessarily alarm, investors. Such disclosure is not currently required in connection with restatements, and requiring such disclosure in connection with the Proposed Rule is not reasonable.

The Proposed Definition of When an Issuer is “Required to Prepare An Accounting Restatement” Should be Revised and Clarified in Three Important Ways.[7]

Section 10(b)(2) requires exchanges and associations to adopt listing standards that require issuers to adopt and comply with policies that require the recovery of excess incentive-based compensation “during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement.” Section 10D does not specify when a listed issuer is “required to prepare an accounting restatement” for purposes of recoupment.

The Commission has proposed that an issuer would be “required to prepare an accounting restatement” upon the earlier of: (i) the date the issuer concludes, or should have reasonably

[4] Rule 4-01(a) of Regulation S-X.
[5] Proposing Release, RFC No. 13.
[6] See FASB Accounting Standards Codification 105-10-05-6 (“The provisions of the Codification need not be applied to immaterial items.”) and Staff Accounting Bulletin No. 99 n. 50 (“This SAB is not intended to require that misstatements arising from insignificant errors and omissions (individually and in the aggregate) arising from the normal recurring accounting close processes, such as a clerical error or an adjustment for a missed accounts payable invoice, always be corrected, even if the error is identified in the audit process and known to management.”)
[7] Proposed Rule 10D-1(c)(2)

concluded, that the issuer's previously issued financial statements contain a material error, or (ii) 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.[8] A note to the Proposed Rule would indicate that the first proposed date generally is expected to coincide with the occurrence of the event described in Item 4.02(a) of Form 8-K.[9]

We generally support the Commission's proposed definition, though we believe it should be revised and clarified in three important ways. First, we believe that the first trigger in the proposed definition should not, contrary to Item 4.02(a), include "or reasonably should have concluded." In our view, this language and the subjective conclusions it calls for, only opens the door to litigation which Congress purportedly sought to avoid. In most cases, a restatement will be followed by a derivative suit claiming the issuer should have reached its conclusion regarding a material error sooner than it did. As the Commission notes in the Proposing Release, knowingly, recklessly, or negligently misreporting false or misleading financial information already subjects the company to liability. This should be a sufficient deterrent, with sufficiently significant ramifications, to protect investors.

Second, we believe that recoupment based upon a court or agency restatement order should not be required or permitted until the order is final and non-appealable.[10] The second trigger in the proposed definition should take into account due process, when an issuer is successful on appeal of a court's or regulator's order to file a restatement. In such a case, no recoupment should be required. For an unsuccessful outcome, the relevant date should be calculated and recoupment efforts initiated only when the order to restate is final and non-appealable. At that point, the date of the initial restatement order should be designated as the starting point of the three-year lookback.

Third, we do not believe that the issuer's receipt of a notification from the independent auditor regarding non-reliance on the audit report on the financial statements should be conclusive that the issuer "reasonably should have concluded" that prior financial statements contained a material error.[11] While auditors do not issue such notices without significant bases, disagreements can and do occur and issuers need to be allowed to let the resolution process take place. The board's judgment in this regard should control.

The Proposed Rule Should Cover Only the Issuer's Principal Executive Officer, Principal Financial Officer, Principal Accounting Officer, and, in Addition, Any Other Executive Officer That the Board of Directors or Compensation Committee Determines to Have Had an Important Role in Contributing to the Events Leading to a Financial Restatement.[12]

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[8] Id.
[9] A Form 8-K filing is triggered under Item 4.02(a) "[i]f the registrant's board of directors, a committee of the board of directors or the officer or officers of the registrant authorized to take such action if board action is not required, concludes that any previously issued financial statements, covering one or more years or interim periods for which the registrant is required to provide financial statements under Regulation S-X (17 CFR 210) should no longer be relied upon because of an error in such financial statements as addressed in FASB ASC Topic 250, Accounting Changes and Error Corrections, as may be modified, supplemented or succeeded. . ."
[10] Proposing Release, RFC Nos. 17-19.
[11] Proposing Release, RFC No. 18.
[12] Proposing Release, RFC Nos. 20-23.

Section 10D(b)(2) requires exchanges and associations to adopt listing standards that require issuers to adopt and comply with policies that provide for recovery of excess incentive-based compensation from "any current or former executive officer of the issuer who received incentive-based compensation." Section 10D does not define "executive officer" for the purposes of the recovery policy.

The Proposed Rule defines "executive officer" as the issuer's "president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), [and] any other officer who performs a policy-making function, or any other person who performs similar policy making functions for the issuer.[13]

We are concerned that this expansive definition of "executive officer" may, in certain circumstances, unnecessarily capture individuals who, as a practical matter, do not have direct control over or impact on the preparation of financial statements or who may not have had an important role in contributing to the events leading to a financial restatement. In our view, the proposed definition, combined with the no-fault framework of the Proposed Rule, could impose a disproportionately punitive and unfair burden on one or more such officers. Targeting such individuals will likely contribute little to improving accounting systems, enhancing the quality of financial statements, or reducing the chance of a misstatement.

Accordingly, we believe the definition of "executive officer" should focus on executives with key roles in preparing and reviewing the issuer's financial statements or who, as determined by the board or compensation committee, had a role in contributing to the events leading to a financial restatement. Specifically, we propose that the definition of "executive officer" cover only the issuer's principal executive officer, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), and, in addition, any other officer in charge of a principal business unit, division, or function or who performs a policy-making function and whom the board of directors or compensation committee determines to have had an important role in contributing to the events leading to a financial restatement. Our proposed definition specifically covers those officers who have senior level accountability for the preparation of issuer financial statements and top-level tone setting for the organization. In addition, our proposed definition vests the issuer's board or compensation committee with discretion to identify any other officers who should be subject to recoupment based upon the particular facts and circumstances of the restatement. We also believe this revised definition is consistent with Section 10D, particularly in light of the fact that the Commission's proposed definition is not required by statute.

The Definition of "Incentive-Based Compensation" Should Exclude Equity Awards That Vest Solely On The Basis of Continued Employment or the Passage of Time, Even if the Value of Such Awards Fluctuates With the Value of The Issuer's Stock . [14]

Section 10D(b)(2) requires exchanges and associations to adopt listing standards that

[13] The Proposed Rule definition is based on the definition of "officer" in Rule 16a-1(f).
[14] Proposing Release, RFC Nos. 26-27, 29-30.

require issuers to adopt and comply with recovery policies that apply to "incentive-based compensation (including stock options awarded as compensation)" that is received, based on erroneous data, in "excess of what would have been paid to the executive officer under the accounting restatement." The Proposed Rule defines "incentive-based compensation" as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure," such as stock price and total shareholder return.[15]

We are concerned that the Proposed Rule could be interpreted broadly to include any equity award for which the value is determined with reference to stock price but nonetheless vests solely upon completion of a specified employment period or the passage of time. The Proposing Release suggests that such equity awards—which we understand to include nonqualified and qualified stock options, restricted stock awards, and other equity awards that vest solely on the passage of time—do not constitute "incentive-based compensation" even though their ultimate value fluctuates with the value of the issuer's stock.[16] We agree with the Commission's classification of these equity awards and urge the Commission to state explicitly in the text of the Rule that incentive-based compensation does not include equity awards that vest solely based on completion of a specified employment period or the passage of time, even though their ultimate value fluctuates with the value of the issuer's stock.

The Proposed Rule Should Not Limit the Discretion of the Compensation Committee, and the Proposed Definition of "Impracticable" is Too Limited.[17]

Section 10D requires that "the issuer will recover" incentive-based compensation, and does not address whether there are circumstances in which an issuer's board of directors may exercise discretion to recover. Under the Proposed Rule, an issuer must recover erroneously awarded compensation in compliance with its recovery policy except to the extent that the recovery would be "impracticable" or would violate home country law. We believe the Proposed Rule unduly restricts the discretion of an issuer's compensation committee and fails to consider other circumstances in which recovery is not in the best interest of the company or its shareholders.

An issuer's compensation committee is in the best position to understand the specific facts and circumstances associated with any potential recovery. In its role, the committee is regularly required to make decisions affecting executive compensation (e.g., defining and articulating executive compensation, reviewing and approving all compensation and benefit plans designed to support compensation strategy, and reviewing programs relative to corporate governance best practices). It makes these decisions by evaluating what is in the best interest of the company and its shareholders and what is required by law. Deciding whether excess compensation should be recovered is not unlike other decisions the compensation committee regularly makes, and as such, we do not believe the committee's discretion should be restricted in this way. By taking into account the mandates of Rule 10D-1 and acting in accordance with its fiduciary duties, the compensation committee is best suited to determine whether recovery of

[15] Proposed Rule 10D-1(c)(4).
[16] See Proposing Release at 47.
[17] Proposing Release, RFC Nos. 51-52.

excess compensation should be sought.[18]

In the event the Commission believes some type of standard for determining whether recovery may be foregone is required, we propose that the definition of what is deemed "impracticable" be expanded. As proposed, there are only two instances where recovery is considered impracticable, one based on a cost/benefit analysis and the other based on illegality.

a. Cost/Benefit Analysis. We take issue with recovery being considered "impracticable" only if the direct expense paid to a third party to assist in enforcing the policy would exceed the amount to be recovered.

First, we believe the costs associated with recovery should not be limited only to the direct expense paid to a third party in enforcing the policy. Issuers are likely to incur a wide variety of other costs. For example, issuers attempting to enforce the policy may incur costs associated with defense of counter-claims. Issuers will also undoubtedly incur a number of internal costs (e.g., resources required to work with, manage or monitor the third party's efforts). Indirect costs, such as opportunity costs, should also be considered (consider the internal staff that will likely be required to spend time on seeking the recovery – legal, accounting, executive compensation and payroll). These types of expenses could be substantial in nature. Finally, we believe that issuers should be permitted to consider the likelihood of actual recovery even if the issuer succeeds on the merits of its recoupment claim.

As an alternative to the compensation committee being given full discretion to determine if recovery is appropriate (as discussed above), we propose that the compensation committee, at a minimum, be given the discretion to determine what costs may be included in the calculation of the recovery efforts. To do so, we recommend that the definition of what is "impracticable" be expanded. Specifically, recovery would be considered "impracticable" if the "costs an issuer would reasonably incur in enforcing the policy would exceed the amount to be recovered." The costs that would be reasonably incurred would be determined by the compensation committee. We do not believe a list of defined costs needs to be delineated in the final rule; however, a list of potential costs that may be considered by the compensation committee in its determination could prove helpful to issuers.

Second, we believe that a compensation committee should be permitted to exercise its discretion to delay enforcement of the policy when the risks arising from immediate enforcement would be likely to result in harm to the issuer that would exceed the potential benefit of recovery. We note that such assessments of risk may be independent of the costs referred to above. For example, a compensation committee should be permitted to exercise its discretion to delay enforcement of the policy when it reasonably determines that an attempt to enforce the policy may have a material adverse impact on its defense of a securities class action arising from the accounting restatement.

b. Illegality. The Proposed Rule requires that a determination of impracticality based on violation of law be supported by an opinion of counsel "that recovery would result" in a violation

[18] The Commission acknowledges in the Proposed Rule that there are circumstances in which pursuing recovery of excess incentive-based compensation may not be in the interest of shareholders. See Proposing Release at 68.

of law. We note that many non-U.S. jurisdictions, and most or all states of the United States, have laws protecting employees' rights to receive earned compensation. There is significant uncertainty concerning the application of those laws to recoupment policies. Therefore, we believe that the applicable opinion standard for impracticality should be that recovery "may result" in a violation of applicable law. The Proposed Rule would require an issuer to incur legal expenses for the opinion of counsel, and that cost should be included in the calculation of the recovery efforts discussed above.

The Commission Should Provide Additional Guidance on What Constitutes a "Reasonable Attempt" to Recover Excess Compensation. [19]

Under the Proposed Rule, before the compensation committee may conclude that it would be impracticable to recover any amount of erroneously awarded compensation based on the expense of enforcement, the issuer must first make a "reasonable attempt" to recover. This concept is problematic.

First, the Proposed Rule provides no guidance as to what constitutes a "reasonable attempt." While we do not think there is a one-size fits all prescription for what constitutes a "reasonable attempt," we do believe the Commission should provide examples of or guidance concerning what it would consider to be a reasonable attempt by the issuer. Consider the following scenario: An issuer has provided written notice to a formerly employed executive who has received excess compensation. The notice informs the former executive that he/she has been paid in excess, specifies the amount, and provides the methods in which recovery can be made. The executive does not respond. Does the Commission consider this a reasonable attempt to recover or would it require additional action by the issuer to satisfy this obligation? And, if so, how much time, effort, and expense must an issuer expend before an attempt will be considered "reasonable"?

Second, we do not believe it will always be necessary for a reasonable attempt to be made in order for the compensation committee to determine that recovery is "impracticable." For example, consider when the amount to be recovered is *de minimis* in amount. Because there is no *de minimis* exception or threshold to the recovery amount, issuers are expected to recover any amount of excess compensation in connection with every accounting restatement, no matter how small. In such cases, we believe the compensation committee may very well determine that the recovery is "impracticable" and not in the best interests of the issuer or its stockholders without first having to seek recovery to make that determination. Similarly, we believe the compensation committee should be permitted to determine that recovery is "impracticable" when the person from whom recovery would be sought is deceased. While we would agree that making a reasonable attempt to recover may be fair in many cases, we do not believe that a reasonable attempt to recovery should be a prerequisite to the committee's ability to determine if recovery is "impracticable."

The Proposed Rule Should Include an Exception For Pre-Existing Employment Agreements.

The Proposing Release fails to consider the effects of the Proposed Rule on pre-existing

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[19] Proposing Release, RFC No. 53.

contracts.[20] Rather, the Commission assumes that existing contracts may simply be amended:

> Further, we do not view inconsistency between the proposed rule and rule amendments and existing compensation contracts, in itself, as a basis for finding recovery to be impracticable, because issuers can amend those contracts to accommodate recovery.

(footnote omitted).[21]

However, amendment of an existing contract generally requires both mutual assent and consideration. *American Building Maintenance Co. V. Indemnity Ins. Co.*, 214 Cal. 608, 615 (1932). Moreover, most written contracts, including executive employment and indemnification agreements, include a provision along the following lines:

> No provisions of this Agreement may be modified, waived or discharged except by a written document signed by a duly authorized Company officer and Executive.

The Proposed Rule would require recoupment of erroneously awarded incentive compensation from both current and former executive officers. However, it is likely that former executive officers will have no incentive to modify contracts in a manner detrimental to themselves and even current executive officers may be hesitant to agree to such an amendment. Thus, issuers will be placed in the position of either violating their polices or breaching their contracts. This could result in significant costs to issuers that the Proposing Release failed to consider. We therefore recommend that the Proposed Rule includes an exception from the requirement that an issuer recover erroneously awarded compensation if recoupment would result in a breach of an existing employment agreement.

The Proposed Rule Should Not Require Recoupment If Recoupment Would Violate State Law.

The Proposing Release fails to address the possible application of state employment laws on an issuer's ability to require recoupment. Some state labor laws prohibit recovery of wages after they have been paid. For example, Section 221 of the California Labor Code provides that "It shall be unlawful for any employer to collect or receive from an employee any part of wages theretofore paid by said employer to said employee."

We believe that it is important to recognize that neither Section 10D nor the Proposed Rule impose a direct mandate on issuers. Rather, Congress has required the Commission to impose a requirement on the exchanges. Issuers are not required to list their securities on an

[20] Employment contracts implicated by the Proposed Rule include not only employment agreements, but also indemnification agreements, compensation plans and award agreements, and issuer charter provisions.

[21] The federal government, unlike the states, is not subject to the Impairment of Contract Clause found in Article 10, Section 1 of the United States Constitution ("No State shall . . . pass any . . . Law impairing the Obligation of Contracts."). *Pension Benefit Guaranty Corp. v. Gray & Co.*, 476 U.S. 717, 733 (1984). However, it is subject to the Takings Clause found in the Fifth Amendment to the United States Constitution ("nor shall private property be taken for public use, without just compensation"). Based on the SEC's observation that issuers may amend their contracts and the lack of any discussion in the Proposing Release of the SEC's power to abrogate existing contracts that are not amended, we assume that the SEC is not asserting that it or Congress has the power to impair existing contracts without consent.

exchange and listed issuers may delist their securities. Further, the stock exchanges are private entities, not federal agencies. Given the absence of any express preemption of state employment laws in Section 10D and that fact that issuers may choose whether to subject themselves to the listing standards of the stock exchanges, we believe that there is no basis for preempting of state labor protection statutes such as Section 221. Accordingly, we recommend that the Proposed Rule include an exception for such statutes.

The Proposed Rule Should Not Apply Retroactively.

The Proposed Rule would apply to any awards granted, earned, or vested on or after the effective date of Rule 10D-1. Because it includes awards that are earned or vested after the effective date, and such awards may have lengthy vesting periods, the Proposed Rule theoretically picks up awards that were granted prior to the effective date. We do not believe Congress intended for the final rules to have retroactive effect. Thus, we believe that Rule 10D-1 should only apply to awards that are granted after the effective date of final rules.

Secondary Comments

The Proposed Rule Should Not Apply to Issuers Who Are Issuers of Only Nonconvertible Listed Debt. [22]

Section 10D provides that the Commission shall, by rule, direct the exchanges to "prohibit the listing of any security of an issuer that does not comply with the requirements of [Section 10D]." Section 10D does not specifically address whether the implementing rules should apply to all issuers with listed securities, including foreign private issuers and issuers of listed debt whose stock is not also listed. The Proposed Rule would require exchanges to apply the disclosure and recovery policy requirements to all listed issuers, with only limited exceptions.

We believe that the listing standards and other requirements of the Proposed Rule should not apply to issuers who are issuers of only nonconvertible listed debt. Holders of nonconvertible listed debt make their investment decision based on the issuer's creditworthiness. Debtholders rely on publicly available information about the issuer as well as credit ratings. Importantly, indentures set forth financial and other covenants that protect a debtholder's investment. Unless provided for in the indenture, debtholders have no say over executive compensation. Except as may be prohibited by the indenture, an issuer is free to pay executive compensation in whatever amount it deems appropriate and based on whatever performance or other criteria it chooses, and debtholders make their investment decision aware that the only restrictions on the issuer's operations, including compensation, are those set forth in the indenture governing its listed debt. Thus, an issuer of listed nonconvertible debt with no public equity is currently free to compensate its executives as its board deems appropriate, without debtholder "say on pay," subject only to contractual restrictions with the debtholders. While a restatement of a debt issuer's financial statements could impair the value of publicly traded debt, so could many other circumstances. Debtholders accept this risk, which is reflected in a bond's rating and coupon. Requiring debt-only issuers to recoup incentive compensation upon a

[22] Proposing Release, RFC Nos. 1-2.

restatement, as proposed, is tantamount to adding a contractual provision for which the issuer does not receive consideration.

We believe that the Commission must consider a significant unintended economic cost of requiring recoupment.[23] Issuers without listed equity may reconsider listed debt and instead choose not to list their debt, or to access private debt markets, which could negatively impair liquidity and affect pricing.

The Proposed Rule Should Not Require an Issuer to Recover Compensation Through the Offset, Reduction, or Withholding of Compensation if Doing So Would Violate Sections 401(a) or 409A of the Internal Revenue Code or Section 206(d)(1) of the Employee Retirement Income Security Act. [24]

The Commission should provide in Proposed Rule 10D-1(b) that in no event shall the issuer be required to recover compensation through the offset, reduction or withholding of amounts from the other compensation of an executive officer if such offset, reduction or withholding would violate Sections 401(a) or 409A of the Internal Revenue Code of 1986 (the "Code") or Section 206(d)(1) of the Employee Retirement Income Security Act of 1974 ("ERISA"), each as amended. Under Section 401(a) of the Code and Section 206(d)(1) of ERISA, benefits provided under certain tax-qualified pension, profit-sharing and stock bonus plans may not be assigned or alienated. These federal laws therefore prohibit a creditor from attaching a tax-qualified plan benefit to satisfy a debt.

In the case of a clawback, it would be impermissible under the anti-alienation rules for the issuer to draw upon any portion of a tax-qualified plan in which the executive officer participates to recover erroneously awarded compensation. Furthermore, Section 409A of the Code and its accompanying regulations prescribe very specific payment dates for deferred compensation. Under those rules, the payment of an amount as a substitute for a payment of deferred compensation is treated as a payment of the deferred compensation itself.[25] The regulations specifically provide that, where an employee's right to deferred compensation is subject to attachment by the employee's creditors, the deferred compensation is treated as having been paid. Because Section 409A prohibits the acceleration of deferred compensation, such substitution is impermissible. The Commission should ensure that the issuer and executive officer are not in violation of these federal laws by clarifying that the issuer shall not be required to recoup compensation from an executive officer by offsetting, reducing or withholding other compensation if these actions would violate such laws.

Issuers Should Be Allowed to Adjust the Amount of Compensation Required to be Recovered

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[23] Section 3(f) of the Exchange Act and Section 2(c) of the Investment Company Act require the Commission to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. 15 U.S.C. 78c(f); 15 U.S.C. 80a-2(c). Further, Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact that any new rule would have on competition and to not adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. See 15 U.S.C. 78w(a)(2).
[24] See Proposing Release at 74-78.
[25] See Treasury Reg. §1.409A-3.

Based Upon a Reasonable Estimate of the Offsetting Impact.

When an accounting restatement results in a change in the timing of the recognition of a financial reporting item such that an executive officer received erroneously awarded compensation in certain periods but would have received increased incentive-based compensation in one or more different periods, the issuer should be allowed to adjust the amount of compensation it is required to recover based on a reasonable estimate of the offsetting impact.

A Financial Statement Restatement by a Peer Group Member Should Not Trigger a Recovery Requirement When An Issuer's Incentive-Based Compensation is Based Upon Performance Relative to a Peer Group.

The Commission should confirm that a financial restatement by a peer group member does not trigger a recovery requirement when an issuer's incentive-based compensation is based on performance relative to the peer group. The only trigger for recouping erroneously awarded compensation from an executive officer under the Rule should be a financial restatement by the issuer itself.

The Proposed Rule Should Not Preclude Indemnification Or Issuer-Paid Insurance in Cases Where the Executive Officer is Not At Fault.[26]

As proposed, Rule 10-D-1 would prohibit a listed issuer from indemnifying any executive officer or former executive officer against the loss of erroneously awarded compensation and from purchasing third-party insurance to fund potential recovery obligations. The Commission states that, in its view, issuer payments in connection with such a policy "would frustrate Section 10D's ultimate purpose of preventing an executive officer from retaining compensation that the executive would not have received if the accounting was done properly and was not entitled to."[27] Assuming that the Commission adopts its proposed definition of executive officer (as opposed to a modified definition like that we have suggested in this letter), the Society believes that the Proposed Rule should not preclude indemnification or issuer-paid insurance in cases where the executive officer is not at fault.

We do not believe the plain language of Section 10D would prohibit an issuer from indemnifying an executive officer. We respectfully suggest that the adoption of any rules under Section 10D that prohibit indemnification typically permitted under state corporate statues would expand the scope of Section 10D beyond the scope intended by Congress.

The expansive proposed definition of executive officer and the no-fault framework of Section 10D seem to be further justification for allowing an issuer to indemnify an executive officer. The Proposing Release references two decisions where courts have found indemnification of officers to be inappropriate in the context of litigation surrounding executive compensation and stock sales. But both of these decisions pertain to facts where the officer or

[26] Proposing Release, RFC Nos. 93-96.
[27] Proposing Release, page 96.

insider seeking indemnification is associated with inferences of fraud or misconduct.[28] We believe these cases are distinguishable, as Section 10D is not based on these types of allegations or inferences.

Specifically, we believe it is appropriate for issuers to indemnify executive officers where the indemnification obligation is conditioned on a finding of no-fault or the executive officer being successful in the defense of a recoupment action under Section 10D.[29] Accordingly, we specifically request that Proposed Rule 10D-1(b)(1)(v) be amended to specifically allow this type of indemnification. To do otherwise will expand the application of Section 10D beyond its express provisions and deny executive officers access to rights that are part of the basic foundation of corporate governance regimes.

The Possibility of Private Causes of Action Under Rule 10D-1 Underscores the Need to Permit Issuer Indemnification and Insurance.

Rule 10D-1 is designed to result in the promulgation of listing standards that will be enacted and enforced exclusively by a national securities exchange or association. However, in the past private litigants have brought claims in an attempt to individually enforce violations of these types of regulations. While many courts have found that such a private cause of action does not exist, the issue has not been addressed in a uniform manner.[30] Accordingly, upon adoption of Rule 10D-1, it is quite possible that private litigants may attempt to enforce its provisions against executive officers individually. We believe that the possibility of these questionable claims further underscore the need for Rule 10D-1 to provide for issuer indemnification and insurance as described above.

The Proposed Rule Should Permit Issuers to Release Potential Recoupment Claims.

Section 3(f) of the Exchange Act requires the SEC when engaging in rulemaking to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The Proposing Release does not meet this requirement because it fails to consider the effect of the Proposed Rule on the ability of issuers to settle claims.

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[28] See *Cohen v. Viray*, 622 F.3d 188 (indemnification disallowed for claims under Section 304 of the Sarbanes-Oxley Act, which expressly requires misconduct of the chief executive officer or chief financial officer); *First Golden Bancorporation v. Weiszmann*, 942 F.2d 726 (contractual indemnification for a shareholder was disallowed for short-swing profit claims under Section 16(b) of the Exchange Act, which is a "prophylactic anti-fraud statute" meant to "deter transactions which have a high potential for fraud.").

[29] For example, see Section 145(c) of the General Corporation Law of Delaware (the "DGCL"), which provides an indemnitee that "has been successful on the merits or otherwise in defense of any action, suit or proceeding…. shall be indemnified against expenses (including attorney's fees) actually and reasonably incurred by such person in connection therewith." California and Nevada similarly mandate indemnification to the extent that an agent is successful on the merits. Cal. Corp. Code § 317(d) and NRS 78.7502(3).

[30] For example, federal district courts in Texas appear to be divided on this issue. Compare *Cook v. Goldman, Sachs & Co.*, 726 F. Supp. 151, 156 (S.D. Tex. 1989) (implied private cause of action exists), with *Porter v. Shearson Lehman Bros., Inc.*, 802 F. Supp. 41, 63 (S.D. Tex. 1992), and *Lange v. H. Hentz & Co.*, 418 F. Supp. 1376, 1383 (N.D. Tex. 1976) (implied private cause of action does not exist). The Fifth Circuit Court of Appeals apparently has not addressed this discrepancy. *Lang v. French*, 154 F.3d 217, 222 n. 26 (5th Cir. 1998).

Often, it is in the best interests of issuers and their stockholders to settle claims. In many cases, settlement will not be possible unless the issuer agrees to provide a release of claims against the claimant. For example, a former executive officer may file suit against an issuer for breach of contract and wrongful termination. Although the issuer may believe that it has valid defenses and even possible counter-claims, it may nevertheless determine that it is in its best interests to settle the suit in order to mitigate litigation costs and other potential damages and distractions. However, the former executive may be unwilling to release his or her claims against the issuer without obtaining a release from the issuer of any and all known or unknown claims that it may have against the executive.[31]

Because parties enter into settlement agreements to effect complete and final resolutions of their claims, settlement agreements typically include very broad releases such as the following:

> Issuer hereby waives, releases and discharges executive and her agents, heirs, representatives, and assigns, from any and all claims, rights, actions, complaints, causes of action, suits, damages, attorneys' fees, costs and liabilities of any nature whatsoever, whether or not now known, that Issuer ever had, now has, or may claim to have through the date of execution of this Release by reason of any act, event or omission, including any claims related to or arising out of (i) Executive's employment or the termination of that employment; and (ii) any federal, state or governmental constitution, statute, regulation or ordinance.

Moreover, some states, such as California, have enacted statutes that broadly define the scope of general releases:

> A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor.

Cal. Civ. Code § 1542.

The Proposed Rule would create a significant impediment to litigation settlements because they do not include an exception for releases of potential recoupment claims. This will impose costs directly on issuers and indirectly on the economy as litigation will be needlessly prolonged. The Proposing Release failed to consider these costs.

The Commission's failure to consider fully the effects of the Proposed Rule also violates the Administrative Procedure Act, 5 U.S.C. § 551 *et seq.* *Business Roundtable v. SEC*, 647 F. 3d 1144 (2011), *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C.Cir.2005), and *Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C.Cir.2004). We therefore recommend that Proposed Rule 240.10D1(b)(1)(iv) include an exception from the requirement that an issuer recover erroneously awarded compensation to permit issuers to release claims for recoupment in connection with a good faith settlement of claims with a former employee or

[31] Releases are also exchanged in settlement of class action and derivative litigation involving directors and former directors.

director.

The Proposed Rule Does Not Adequately Consider The Impact Of The Proposed Rule On Equity And Other Compensation Plans.

Most issuers have adopted equity and other compensation plans that are administered either by the issuer's board of directors or a board committee (typically the compensation committee). These plans often include provisions such as the following:

> Any determination, decision or action of the Committee in connection with the construction, interpretation, administration, or application of the Plan shall be final, conclusive and binding upon all persons participating in the Plan and any person validly claiming under or through persons participating in the Plan.

The Proposing Release does not consider the effect of such a provision on issuers. If a committee has determined that incentive compensation has been earned, provisions such as this would make that determination "final, conclusive and binding." At a minimum, the Proposed Rule would require all issuers with such a provision to amend their plans. However, any such amendments would likely operate prospectively only. In fact, plans often prohibit amendments that impair the rights of a participant with respect to an outstanding award issued to the participant, unless the participant impaired by the amendment or modification consents to such change in writing. As discussed above, it is unlikely that plan participants, particularly those no longer employed by the issuer, will consent to an amendment that results in significant economic costs to themselves.

The Proposing Release does not consider the significant costs associated with the plan amendments necessitated by the Proposed Rule. The Proposing Release also fails to consider the effect of the Proposed Rule on issuers that may be sued by plan participants who do not consent to changes in "final, conclusive and binding" determinations made by boards and committees pursuant to preexisting compensation plans.

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We appreciate the opportunity to provide comments on the Proposed Rules and Proposed Amendments and would be happy to provide you with further information if needed.

Respectfully submitted,

/s/ Rick E. Hansen

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Chair, Securities Law Committee

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