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VIA ELECTRONIC MAIL [rule-comments@sec.gov]

November 11, 2021

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

File Number S7-12-15: Release Nos. 33-9861; 34-75342; IC-31702
Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation

Subject: The Identification of Two [2] Practical Expedients ("PEs") in the Valuation and Administration of "Clawed-Back" Stock-Based Compensation ("SBC")

Dear Ms. Countryman:

Our original response to the Securities and Exchange Commission's ("SEC") clawback proposal, dated August 22, 2015 is found on the SEC's invitations to comment webpage. The reader may rely upon that submission as support material in the following discussion.[1] We characterized the SEC's efforts as the 4th leg of a four-legged stool preceded by:

1. Anti-hedging Policies
2. Pay-for-Performance, and
3. Pay-Ratio between Named Executive Officer(s) and Median Employee Pay

Recent additional pronouncements from the FASB, i.e., Accounting Standards Update 2016-09 ("ASU 1") and ASU 2021-07 ("ASU 2") appear to have refocused SBC to a more practical status, at least from a corporate financial reporting [book] and tax standpoint.[2] We believe this clawback re-proposal will aid in that effort! The PEs' that are the subject of this addendum to our original comments address SBC practicality issues related to clawbacks. Our goal for this proposal is to suggest a realistic SBC "valuation" standard for the corporate executive insider ("Insider") that all parties to the valuation would be comfortable with, as well as an "administrative" protocol that would make the clawback of such SBC feasible. This change is advanced by establishment of a COntinuous Valuation Assessment / Linkage (COVAL™)

[1] The author's corporate governance odyssey began in 1985 with his direct identification and remedying of an incorrect insider trading policy statement at P&G [documented here - see pp. 1-2 of SEC Comment Letter, 2/13/2015 entitled, "Disclosure of Hedging by Employees, Officers and Directors" at http://www.sec.gov/comments/s7-01-15/s70115-1.pdf]. This should be reviewed as support in further discussion of P&G's governance milieu in re the issue of clawbacks. Reference is also made to the author's recent article entitled, "Insider! (Wealth Management for CEOs and Named Executive Officers [NEOs]) found at https://www.linkedin.com/in/timothyrwing

[2] ASU 2016-09 *Improvements to Employee Share-Based Payment Accounting* in March of 2016, requires all excess tax benefits and deficiencies from discrete ESO exercise to be recorded in the income statement as they occur. ASU 2021-07 Compensation—*Stock Compensation (Topic 718) Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards a consensus of the Private Company Council Share-Based Awards (a consensus of the Private Company Council),* offers nonpublic companies a practical expedient in determining share price for equity awards.

platform, interfacing listed exchange-traded options (LETOs) and their ESO compensation cousins, that is discussed in the Linkedin "Insider!" article mentioned above.

The Valuation Practical Expedient

Property Rights

The Black-Scholes Model is widely referenced as a default option model for both tax and financial reporting purposes, even though its theoretical and practical shortcomings are well documented. Why then is it used? Because it is well known and easy to use! Professionals and regulators are willing to look the other way on these shortcomings. Such is the case with the valuation of SBC in the hands of the Insider.

The Fifth Amendment to the U.S. Constitution says to the federal government that no one shall be "deprived of life, liberty or property without due process of law" [citation omitted]. The Fourteenth Amendment to the U.S. Constitution, ratified in 1868, uses the same eleven words, called the *Due Process Clause*[3], to describe a legal obligation of all states. A very important, salient point of the clawback issue is the question of *when*, if at all, SBC granted to insiders actually becomes their property, i.e., when they have the *full* and *unfettered* use of same.

The IRS has stipulated in Internal Revenue Code ("IRC") Regs. §1.83-3(d) *Transferability of Property* that…

> *"property is transferable if the person performing the services or receiving the property can sell, assign or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to* ***any*** *person (emphasis applied where indicated)."*

…with property *status* based on the person holding the property's ability to transfer same to someone else indicating ownership. The *Texas Gulf Sulphur* case [401 Fed 2d. 833], established in part the implementation of…

> *"Congressional purpose that all investors should have equal access to rewards of participation in securities transactions and that all members of investing public should be subject to identical market risks, including risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital." [SEC Act of 1934, Section 10b, 15 U.S.C.A., Section 78j(b)].*

Do transfer restrictions subject property, e.g., various SBC assets, to a *standard of value* other than the minority interest fair market value ("MIFMV") that identifies the common shares of publicly-traded companies ("PTCs") traded on national stock exchanges. This then is an "Ostrich" issue as regulators, financial reporting and tax professionals have buried their heads in the sand on the issue of the true value of SBC in the hands of Insiders. For the Insider *Agent* of his or her corporate employer, what role does his or her employment contract play, if such exists

[3] See http://www.law.cornell.edu/wex/due_process.

de facto or *de jure* in the world of negative discretion and clawbacks, in the valuation of his/her…property? We refer the reader to our "Insider!" article cited above [footnote 1] that highlights the governance practices at the Procter & Gamble ("P&G") Company.

P&G's 2021 Proxy and its 18-page *Compensation Discussion & Analysis* ("CD&A") section serves as an example. P&G corporate governance does not allow the use of employment contracts by Insiders. This from the Proxy at p. 66:

> *"employment contracts for executives are not necessary because our executives have dev eloped a focus on the Company's long-term success."*

The CD&A discussion present restrictions on P&G Insiders' ownership of SBC *property*. There are "blackout" periods or "windows" aggregating approximately one-third of the available trading days of P&G common stock due to the release of quarterly earnings. The CEO and the other P&G named executive officers or NEOs may not sell a certain portion of their P&G common stock holdings while employed by the company roughly equal to 8 times their salary in the case of the CEO and 4-5 times the salaries of the NEOs. The company also has "Equity Holding Requirements" reinforced when the CEO or any of the NEOs have not met the *Ownership Guidelines* that require the CEO to hold P&G shares for at least 3 years after ESO exercise [1 year for NEOs] or until such guidelines are met. P&G "Employee, Officer and Director Hedging" company policy prohibits short sales, pledging, collars or any other derivative transaction in an attempt specifically to…

> *"manage the risk of price movements in Company stock or to leverage the potential return of a predicted move in Company stock."*

The P&G policy on the *clawback* of compensation in the Proxy [p.49] is shown below…

> *"Clawback policy permits the C&LD Committee to recoup certain compensation payments in the event of a significant restatement of financial results for **<u>any</u>** reason…"*

…that may include violations of

> *"...certain plan provisions such as taking actions that may damage the reputation, goodwill, or stability of the Company."*

A *de facto* contractual Insider relationship exists at P&G in lieu of such a relationship *de jure* in the form of a *one-sided* corporate governance culture. The very real presence of the potential for *negative discretion* in employing clawbacks to SBC and other incentive compensation is clearly *open-ended* favoring the employer, which might also suggest that Insider SBC amounts are not *final* numbers that may be relied upon by the corporation as deductible compensation amounts and by the employee as includible in income in the filing of tax returns. This brings into play the imposition of variable accounting treatment ("VAT") on such amounts as there is also a requirement of a *mutual understanding* of the SBC's key terms and conditions to preclude

VAT.[4] This is not just a question of the *valuation* of SBC with restrictions on same included but also the *absolute* amounts of such SBC that are subject to clawbacks.

Whether a contract exists *de facto* or *de jure*, the employment relationship would suggest that the P&G Insider has some type of *contingent claim* on P&G SBC assets with value determined in a more straightforward manner, aided by information provided in P&G financial statements.[5] Exhibit I with information from the 2021 P&G Proxy shows outstanding, unexercised P&G ESOs, measured as to weighted average exercise exercise price ("WAEP") of $91.20 over their weighted average existence of 4.6 years, in an internal rate of return analysis ("IRR") compared to the P&G stock price as of 2020 year-end of $140, returning an IRR of 9.98%.

Exhibit I

Internal Rate of Return Analysis

IRR WAEP vs. Current Price [Proxy]			IRR LEAP [6] Value vs. Current Px		
9.98%	Date	Price	7.52%	Date	Price
	7/1/2016*	-$91.20		9/2/2021	-$131.10
	1/1/2021	$140.00		1/23/2023	$145.00

*The P&G ESOs shown in the 2021 Proxy had a weighted average remaining life of 5.4 years, indicating that their lives as of the Proxy date [for the 10 year P&G ESO grant] had been 4.6 years. This is the start date of the IRR calculation, ending on the Proxy date, i.e., year-end 2020.

The WAEP valuation of outstanding ESOs, 9.98%, is compared to a discounted cash flow ("DCF") analysis of LEAP option premium income ("OPI"), i.e., DCF_OPI. Using a P&G LEAP with the most distant contract term, i.e., January of 2023, a corresponding LEAP price of $12.00 and P&G stock at $144.05 as of a valuation date of September 3, 2021, an IRR is calculated. The LEAP contract price of $145 allows a gain of $.95 [$145 – 144.05] at contract term end should the stock be called away, i.e., assigned.

The timing of the respective cash flows is an issue as the "WAEP" approach considers cash flows received at period end while the DCF_OPI approach considers cash flows received at the beginning, available to the investor at contract inception although not taxed until contract termination. From a *time value of money* standpoint, we have enhanced the LEAP result from 7.52% to 7.7% by 1% over the period involved and reduced the WAEP result by 1% to 9.6%.

[4] *Financial Accounting Standards Board* [FASB], *Accounting Standards Code* [ASC] §718-10-25 provides that a "mutual understanding" does exist of the award's key terms and conditions on the approval date or within a "relatively short time period."
[5] See google search "contingent claim" – "Contingent claims are contracts whose outcomes depend on the evolution of one or more uncertain variables. Contingent Claims Analysis (CCA) is that branch of financial economics which focuses on the valuation of such contracts. Commercial examples of contingent claims include: futures and options contracts based."
[6] A LEAP or Long-term Equity Anticipation Security is a longer term version of a listed, exchange-traded option or LETO that trades on standardized options exchanges. Virtually every publicly-traded company has LETOs that trade on such exchanges.

The WAEP exceeds the LEAP approach 9.6% to 7.7% or by 1.9%. One should consider two additional important elements not mentioned in the analysis:

1. First, the WAEP analysis has income taxed at *ordinary income* tax rates of over 40% while CT tax would be *capital gain* in nature, taxed at 20% currently, relegating the 9.6% to 7.7% comparison a *tossup*.

2. Second, LEAP contract "term" structure analysis shows that the furthest contract term used in Exhibit I has the lowest implied volatility ("IV") and relative price basis i.e., rent-per-day, or OPI divided by the number of days in the LETO / LEAP contract. With a *matrix* of six contract dates [prices] for each contract term price, several contracts with IVs greater than the LEAP selected produce IRRs exceeding the 9.6% of the WAEP analysis.

The Administrative Practical Expedient

The "contingent claim" protocol discussed above presents publicly-available information that is readily available. The LETO price information may be accessed from option exchanges when needed and also represents readily ascertainable fair market values, ("RAFMV"), an important term in the lexicon of the IRS. The DCF_OPI analysis represents an *on-call* capability to determine equity values before the application of any discounts attendant to Insider restrictions. This is where the prescience of ASU 2 comes into play.

With ASU 2, the FASB has finalized an acceptable valuation standard, as a practical expedient, to be used by private companies in part for use as the exercise price or purchase price for a privately-held company's share price, in concert with IRC §409A and the valuation protocols discussed in the IRC regulations. More important is the second of three acceptable methods found in ASU 2's Basis for Conclusions section on p.14 at BC19 that represent "rebuttable presumptions of reasonableness" in meeting Treasury regulation requirements for the practical expedient to achieve a share FMV…

> *b. A valuation based on a formula that, if used as part of a nonlapse restriction with respect to the share, would be considered the fair market value of the share*

We turn to IRC§83(a) for some important connecting information. That code section stipulates that the FMV of property is…

> *"…determined without regard to any restriction other than a restriction which by its terms will never lapse."*[7]

This non-lapse restriction has become part of the fabric of the discussion over the years as to whether or not any form of SBC is entitled to some type of diminution in value due to the presence of restrictions. To further define this debate, accompanying Treasury Regulations have stipulated that a lapse restriction is one that is not a non-lapse restriction because it does not apply to subsequent holders of the property.[8] What the Service has always maintained is that the

[7] IRC §83(a) (1).
[8] Treas. Reg. §1.83-3(h) (ii).

presence of any restriction whatsoever is of no consequence in effecting FMV except for a restriction that basically is part of the security itself. This could be an important clarification by the IRS in possibly characterizing SBC affected by clawbacks. In P&G's, the practical expedient of a contingent claims analysis suggests that an all-encompassing "nonlapse restriction" exists as part of SBC for Insiders. As such, the contingent claims analysis could include a valuation "based on a formula" that might be acceptable to all parties, including the IRS.

The practice of incentive and more specifically SBC as it relates to Insiders and other key executive personnel is multidisciplinary. The SBC tax treatment is governed by IRC§83, *Property Transferred for the Performance of Services*. We have already stipulated that employees are taxed on the income that they receive assuming that they have actually received it. Certain taxpayers receiving SBC may make what is known as an IRC§83(b) *election*. The "election" requires a taxpayer to include in income in the year of such election the value of property [stock] received in a compensatory transfer in excess of that which was paid for same. That excess, or *bargain element* is usually taken in as income to the taxpayer with a similar amount claimed as a compensatory deduction by the employer.[9] That is until *Robinson*!

The Federal Circuit in *Robinson v, U.S.A [2003]* has reminded us that, one of the important indicia of such "property" ownership remains with the taxpayer whose responsibility it is to include the value of such property in income in the filing of tax returns.[10] The Federal Circuit overturned Treasury Regulation 1.183-6(a) as inconsistent with Section 83(h) allowing varying SBC "amounts" by both employer and employee.[11]

Robinson has built upon the January 9, 1996 appeal of *Theophilos* decided by the U.S. 9th Circuit Court of Appeals.[12] The 9th Circuit argued that a taxable event occurred in April of 1986 when the taxpayer entered into an *executory agreement* to purchase his employer's common stock. In their decision, the 9th Circuit relied upon Treas. Reg. §1.83-3(e):

> *"A contractual right to buy stock is not unsecured or unfunded if it is a binding obligation secured by valuable consideration. Thus, we hold that a contractual obligation to acquire stock, as well as an acquisition of stock, itself, is 'property' with the meaning of IRC §83, and if the contractual right to acquire stock is taxable under §83, the subsequent purchase is not."* [13]

The issue in *Theophilos* was an employer's obligation to deliver stock at some future time pursuant to an executory contractual employment agreement that may or may not be considered property under IRC §83, in conjunction with Treas. Reg.§1.83-3(e), where the emphasis was on a "binding obligation secured by valuable consideration." The court ruled the issue involved an *executory contract* that included an obligation to buy stock. That contract was valued dependent upon is terms, which included the inability of the contract holder to 'control' the stock pursuant

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[9] A *bargain purchase* is the purchase of an asset for less than its fair market value. In this context, a *bargain element* represents the difference between an ESO exercise price and the then fair market value of the underlying common stock times the number of shares being exercised.
[10] *James G. Robinson, et ux. v. Comm*, 335 F.3d 1365 (Fed. Cir. 2003), No. 01-102T, Tax Analysts Doc. No. 2002-15273, 2002 TNT 126-10
[11] 335 F.3d 1365 (Fed. Cir. 2003)
[12] *Theophilos v. Commissioner*, 85 F3d 440 (9th Cir. 1996), rev'g and rem'g 67 TCM (CCH) 2106 (1994).
[13] Id

to the terms of the stock option plan and agreement. Such contracts are characterized by performance by one or both parties to the contract where performance under the contract was yet to be performed or indeterminate.

The contingent claim to employer assets may have found a suitable platform then in the form of an executory contract that may suit both employer and employee and also be in concert with both the FASB, the SEC and most importantly…the IRS. The executory contract is held in a trust brokerage account that holds both employer common stock ("ECS") and ESOs employing also the utility of LETOs…for both valuation and administrative purposes. The processing of clawbacks is generally considered to be done on a pre-tax basis which places the onus on the employee who may have already paid tax on the SBC in question.

If there is a clawback, the practical issue for the effected executive from a tax standpoint, is *when* the *clawbacked* income becomes a component of taxable income (TI) on their tax return(s). If all events take place within the same taxable year there are few problems.[14] There are compliance and administrative issues for the executive taxpayer should income be reported on individual tax forms in one year with clawbacks occurring in a subsequent tax year.[15] This highlights a *mismatch* in tax treatment between the original income, taxed fully and completely upon its receipt, and its status as a *miscellaneous itemized deduction* when it is "backed out" of taxable income (TI) in the clawback years, where its *full* deductibility becomes a function of its excess over an amount equal to 2% of the excess over the taxpayer's adjusted gross income (AGI) for the taxable year.[16] At the very least, this can become a very confusing issue.

Example

A comprehensive example:

A Corporate Insider Trading Trustee ("CITT") is selected whose duty it is to…

> *"…provide oversight to the tax, regulatory, investment and governance matters related to employer stock /option transactions occurring within a trust established for purposes of clawback administration in the role of an ombudsman responsible to both parties to the trust, i.e., employer and employee.*[17]

…where such oversight generally proceeds as follows:

[14] **Rev. Rul. 79-311** 1979-2 C.B. 25
[15] IRC§1341 facilitates the "claim of right" doctrine giving a taxpayer a choice of deducting income when repaying clawbacked income equal either to the gross amount repaid or in getting a refundable credit with repayment for any added tax incurred by including such income amounts in income in the prior year. The issue becomes the taxpayer's unrestricted right to receive compensation in the repayment year and it is determined subsequently that there was not such unrestricted right.
[16] Id
[17] We have also separately proposed that a CITT role could be that of fiduciary representing interests of the Insider exclusively in such matters.

1. In conjunction with Insider's executory contract with employer XYZ Company ("XYZ"), a trust brokerage account is established holding XYZ ECS and ESOs granted to Insider. XYZ has LETOs, i.e., listed puts and calls that trade on national options' exchanges.[18]
2. Via contingent claims analysis and DCF_OPI, the XYZ ESOs are valued over the ESO term, e.g., 10 years.
    a. Aggregate DCF_OPI becomes the *default* contingent claim for XYZ ESOs, and
    b. Using the Capital Asset Pricing Model ("CAPM"), a target price is determined for XYZ ECS to the end of the clawback *lookback* period.
3. XYZ employer clawback may be aided by XYZ listed put purchases as follows:
    a. Extrapolated CAPM XYZ ECS "target price" put premium offsets [reduces] Insider default contingent claim, and
    b. Coincident with XYZ exercise at end of clawback *lookback* period, puts are purchased, i.e., married puts with similar income reduction of contingent claim.
4. As the executory contract is subject to a substantial risk of forfeiture, i.e., clawback, an IRC§83(b) election is made coincident with the filing of Insider's tax return, possibly also pursuant to an IRS private letter ruling.
5. As established by ASU 2, a "rebuttable presumption of reasonableness" is established with the contingent claims *formulaic* analysis that includes assessment of nonlapse restrictions with utility in private company valuations as a…*practical expedient.*

Summary

We hope the above discussion and the introduction of valuation and administrative practical expedients will help the corporate, regulatory and professional communities deal with the multi-disciplinary issue of clawbacks. What hasn't been considered is the potential role of the courts in interjecting themselves in the valuation and administrative arenas.

The contingent claims analysis suggested meshes nicely with the recent suggestions from the FASB in ASU 2 that speaks directly to the clawback issue as to the availability of a formulaic approach that considers also nonlapse restrictions, which we suggest would be present with an executory contract as part of its instrumentation.

There are at least three important collateral issues that the SEC's clawback efforts may help ameliorate.

1. Greater clarity in SBC book / tax treatment in re earnings disclosure and governance.
2. Private sector incentive plan inefficiencies, and
3. Government fiscal policy.

Senator Wyden of Oregon has proposed a "marked-to-market" protocol on ESO bargain element taxation before the actual exercise takes place…

[18]The administration of SBC plans for PTCs is the purview of specialized broker-dealer units, i.e., stock plan services ("SPS"). These professionals employ software, a dominant one being *EquityEdge* Online via ETRADE, that administer stock plans, i.e., exercise of ESOs and sale of ECS acquired and interface between PTC client and broker-dealer. *EquityEdge* "macros" or "workarounds" would need to be developed to prevent inadvertent insider-trading violations and to synchronize with client company insider-trading pre-clearance procedures.

> *"Derivatives not terminated or transferred would at the end of each taxable year, be treated is if they were terminated or transferred and then as if repurchased or entered into ("marked to market"), with gains or losses treated as ordinary with proper adjustment."*[19]

If Senator Wyden's "marked to market" protocol prevails, or any kind of variant thereof, then our suggestion of a COVAL™ platform may be of assistance in providing timely valuations acceptable to regulatory authorities.

We appreciate the opportunity to provide insight on this very important issue.

Best Regards,

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[redacted]

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[19] See https://www.finance.senate.gov/imo/media/doc/MODA%20Section-by-Section%20FINAL.pdf, SECTION-BY-SECTION OF DISCUSSION DRAFT: MODERNIZATION OF DERIVATIVES TAX ACT OF 2016, Senate Finance Committee Ranking Member, Senator Ron Wyden, May 18, 2016.