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November 22, 2021

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Listing Standards for Recovery of Erroneously Awarded Compensation
File No. S7-12-15

Dear Ms. Countryman:

We are submitting this letter in response to the solicitation by the Securities and Exchange Commission (the "Commission") for comments on the Commission's proposed new Rule 10D-1 (the "Proposed Rules") under Section 10D of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), added by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The Proposed Rules direct national securities exchanges and national securities associations to establish listing standards that would require each issuer to (i) develop and implement a policy providing for the recovery, under certain circumstances, of incentive-based compensation based on financial information required to be reported under the securities laws that is received by current or former officers, and (ii) require disclosure of such policy. The Proposed Rules were set forth in a release published in the Federal Register on July 14, 2015 (Release No. 34-75342) (the "Proposing Release"). The comment period was reopened in Release No. 34-93311) (the "Reopening Release").

We respectfully request that the Commission consider the following recommendations for changes and clarifications to the Proposed Rules that will ultimately be adopted (as so adopted, the "Final Rules"), consistent with the objective of investor protection under the Dodd-Frank Act.

Introduction

Business and economic conditions for listed companies have changed fundamentally since the date of the Dodd-Frank Act and the Proposed Rules. These changes have in turn changed the economic effects of the Proposed Rules, which are subject to a request for comment (No. 10) in the Reopening Release. In light of wide ranging developments further discussed below, we believe that the broad application and principles based scope described in the Proposing Release should be more specifically tailored in the Final Rules to facilitate orderly implementation and administration by issuers and the exchanges.

- As noted in the Reopening Release, many issuers have adopted voluntary clawback policies since the date of the Proposing Release to reduce the risk of unearned compensation. *See* Reopening Release, Note 4. Voluntary policies, coupled with a continuing trend to annual say-on-pay votes and engagement with stockholders, already address some of the objectives under Section 954 in ways that are specific to a particular issuer. We believe that the Final Rules should take into account these trends and developments.

- As a result of the current pandemic and related economic disruptions, issuers and investors alike are focused on retention of employees, including experienced management. Under the oversight of Boards of Directors, senior management are currently addressing pandemic-related health and safety, business strategy and supply chains issues, all of which place a premium on retaining experienced management. As a result of these developments, we believe that the interests of investors are not served if the Final Rules create broad uncertainties around existing and future executive compensation arrangements for all listed companies.

- Extreme market volatility surrounding the pandemic and supply chain disruptions, among other factors, may lead to inaccuracies in any assumptions or methodologies that might be used to calculate recovery amounts tied to stock price. As noted in the Proposing Release, it may be difficult to establish the relationship between an accounting error and stock price due to confounding factors. As a result, we recommend that recovery amounts not be tied to perceived effects of a restatement on stock price.

- Any complex methodologies required by the rules create the risk of protracted uncertainties, as well as the risk of potential disputes with management and investors over varied calculations of recoverable amounts. These uncertainties and potential litigation risk divert management attention from the business, and therefore are not consistent with investor protection. For this reason and other reasons described in this comment letter, we believe that the Final Rules should focus on recovery amounts that may be calculated on an objective basis without recourse to complex methodologies and varied assumptions.

- To the extent that any rules are perceived to create a substantial risk of forfeiture, performance-based incentive compensation may be devalued relative to other forms of compensation. Performance-based compensation has been designed to align management incentives with stockholder interests and is generally favored by investors.

- In practical terms, for any awards not determined on an objective basis by using accounting based metrics, issuers may be unable to comply with required listing standards. Broad principles based requirements may create prolonged uncertainties about amounts subject to recovery while third parties are engaged to apply complex and varied methodologies with a range of assumptions that reflect recent market uncertainties.

- In the case of any noncompliance with listing standards and ultimate delisting that may result from uncertainties under the Final Rules, reduced market liquidity for the issuer's securities would harm rather than protect investors, and would not further the broad purposes of the Dodd-Frank Act.

1. Transition Period to Avoid Conflicts with Existing Incentive Plans and Employment Contracts

We believe that a transition period, a phase-in period for smaller reporting companies, and "grandfathering" provisions would allow issuers time to harmonize the requirements of the Final Rules with existing incentive plans and employment contracts between an issuer and its executive officers. Under the Proposed Rules, each issuer would be required to recover all excess incentive-based compensation received by current and former executive officers on or after the effective date of the Final Rules that results from attaining a financial reporting measure based on financial information for any fiscal period ending on or after the effective date of the Final Rules.[1] The Proposed Rules would apply to any awards granted, earned, or vested on or after the effective date. Because awards earned or vested after the effective date may be subject to an extended vesting schedule, awards granted prior to the effective date of the Final Rules may be subject to recovery even if contrary to the existing plan or outstanding award agreements.

In many or most cases, an issuer's current employment contracts with executives do not include recovery provisions that conform to the specific requirements of the Proposed Rules. We believe that transition and phase-in provisions are in the interest of issuers and investors, to avoid reopening existing compensation arrangements with all executive officers across the board with a short deadline for compliance.

We believe that a transition and phase-in period and an exception for pre-existing arrangements between the issuer and its officers would help to avoid the potential for retroactive effects. We note that the United States Court of Appeals for the District of

[1] Proposed Rule: Listing Standards for Recovery of Erroneously Awarded Compensation, 3-4 https://www.sec.gov/rules/proposed/2021/33-10998.pdf.

Columbia previously invalidated the retroactive application of another Dodd-Frank Act provision.[2]

2. Expand Board of Directors' Discretion

The Proposed Rules require that listed companies must recover compensation in compliance with their recovery policies except to the extent that it would be impracticable to do so, such as where the direct expense of enforcing recovery would exceed the amount to be recovered or, for foreign private issuers, in specified circumstances where recovery would violate home country law.[3] We believe that the Commission should permit an issuer's Board of Directors ("Board") more discretion in whether or not to pursue recovery of erroneously awarded incentive-based compensation, consistent with the Board's fiduciary or other legal duties under state law.

The Board oversees the management of the company and is able to effectively assess factors like the likelihood of success of recovery efforts, the long-term impact of recovery on the company, and the direct and indirect material costs. Accordingly, the Board would be in the best position to make an informed decision that would protect the interests of the issuer and its stockholders. If the Board makes a good faith determination consistent with its state law duties that a pursuit would be futile or not in the best interest of the issuer and its stockholders, the Board should be permitted to refrain from doing so. To mandate the Board pursue such recovery absent any discretion imposes unnecessary costs on the issuer.

Incentive-based executive compensation is linked to company performance. The Proposed Rules define the amount of incentive-based compensation to be recovered as the amount received by an executive officer that exceeds the amount the executive officer would have received had the incentive-based compensation been determined based on the restated financial statements.[4] If a corporate executive pursues excessively risky activity that results in a financial restatement, unearned executive compensation must be returned under the Proposed Rules.

Under the first prong of "impracticability," it appears the measure under the Proposed Rules is limited solely to a cost analysis. Specifically, the exception is permitted only after the issuer (i) makes a reasonable attempt to recover any excess incentive-based compensation, (ii) has its independent directors make an affirmative "impracticability" determination with documentation of recovery attempt(s), and (iii) provides such documentation to the national securities exchange on which the issuer is listed and disclose reasons as to why it has decided

[2] Koch v. S.E.C., 2015 WL 4216988, at 8 (D.C. Cir. July 14, 2015).
[3] Proposed Rules at 4.
[4] Proposed Rules at 4.

not to pursue recovery, or risk being delisted. These attempts and calculations result in great costs to the issuer, beyond mere direct costs to third parties as currently proposed. In addition, the Proposed Rules specify that recovery is required from current and former executive officers who received incentive-based compensation during the three fiscal years preceding the date on which the issuer is required to prepare an accounting restatement to correct a material error, on a "no fault" basis, without regard to whether any misconduct occurred or an executive officer's responsibility for the misstated financial statements.[5] This means that all current and former executive officers, regardless of any responsibility for the restatement, are likewise subject to the clawback policy.

Given the above limitations, the Board should have discretion over whether to seek recovery and how much recovery to seek. The Board should also have discretion over the method in which it chooses to pursue such recoveries. For example, the executive involved may be in possession of material non-public information at the time the clawback is initiated. If the executive would need to sell shares for cash in order to comply with the clawback policy, he or she may be in violation of insider trading rules and regulations. In certain instances, it might be more economically feasible to enter into a payment plan with the executive involved. The Board also needs to consider the potential reputational harm to the issuer. If a clawback subjects the issuer to lengthy litigation and irresolvable disputes, the issuer will not only incur significant costs, but its stockholders will also be negatively impacted. Further, if the Board pursues a recovery that appears unwarranted, the issuer could face difficulties in recruiting and retaining key personnel to lead the company.

Under the second prong addressing conflicts with foreign law, the exception should be expanded to include any conflicts with state law and other regulations. In particular, if state wage and hour laws prevent the recovery of incentive-based compensation because the amount is considered "wages" under the relevant statutory provision, the Board should have the discretion to forgo the recovery.

3. The Value of Independent Compensation Committees

In addition to Board discretion, we recommend that the Final Rules specifically authorize an issuer's compensation committee to implement clawback enforcement actions in a manner the compensation committee deems most appropriate. The Commission mandates that, subject to certain exceptions, the compensation committees of companies listed on national stock exchanges be comprised solely of independent, outside directors.[6] The benefits of having independent directors are well recognized, among which are disinterested decision-

[5] *Id.*
[6] Exchange Act Section 10C(a)(1).

making and increased corporate transparency.[7] An issuer's compensation 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).[8] Deciding whether erroneously awarded incentive-based compensation should be recovered is not unlike other decisions the compensation committee regularly makes. Moreover, the compensation committee also has direct knowledge of the specific facts and circumstances associated with incentive compensation and any potential recovery. Therefore, we believe that the Final Rules should permit the compensation committee specific authority in implementing clawback actions under an issuer's unique circumstances.

4. "Little R" Restatements should not Trigger Recovery

In addition to limiting the exercise of the Board's and the compensation committee's business judgment to act in the best interests of stockholders, we believe the Proposed Rules omit to specifically reference Generally Applicable Accounting Principles ("GAAP") when referring to financial restatements that will trigger clawback recoveries.

Currently, the Commission's rules require compliance with GAAP by domestic issuers in most cases, including during the preparation and issuance of financial statements. In this case, however, the Proposed Rules do not specifically reference GAAP's existing framework for the determination, and handling, of material errors in issued financial statements. Specifically, when an error is material, GAAP provides that the financial statements must be restated – what is informally referred to as a "Big R" restatement. GAAP, however, allows that when an error, or even series of errors, in issued financial statements is immaterial to investors, such errors can be corrected in a future filing with a revision – what is informally referred to as a "Little R" restatement.

Here, the Proposed Rules suggest that "issuers should consider whether a series of immaterial error corrections, whether or not they resulted in filing amendments to previously filed financial statements, could be considered a material error when viewed in the

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[7] See, *e.g.* D. Ferreira, M. Ferreira & C. Raposo, *Board Structure and Price Informativeness*, Journal of Financial Economics, 99 (2011), 523-545; C.S. Armstrong, J.E. Core & W.R. Guay, *Do Independent Directors Cause Improvements in Firm Transparency*, J. Financ. Econ., 113 (3) (2014), 383-403 (finding corporate transparency, in aspects of information asymmetry, disclosure, and information intermediation, improves following increase in the proportion of independent directors).

[8] SEC Comment Letter by Rick E. Hansen, Chair, Securities Law Committee, Society of Corporate Secretaries and Governance Professionals, New York, New York, https://www.sec.gov/comments/s7-12-15/s71215-60.pdf.

aggregate."[9] The Proposed Rules do not appropriately reference the GAAP principles on which they rely governing the formulation and issuance of financial statements in the first place. Specifically, the Proposed Rules do not provide that "Little R" restatements should not serve as the trigger for a clawback recovery. "Little R" restatements occur routinely, and issuers and their auditors are well-versed in evaluating an array of both qualitative and quantitative factors when assessing whether an error, or even a series of errors, rises to the level of materiality, thus warranting a "Big R" restatement, or whether such errors are immaterial to investors, based on the foregoing criteria, and can therefore be handled as "Little R" revisions in future financial statements.

We note that the Proposed Rules specifically contemplate exempting a number of other revision types, such as discontinued operations, segment changes, and changes in accounting principles, that are not considered material error corrections. Clarifying that "Little R" restatements should not serve as the trigger for clawback recoveries, even when considered in the aggregate, would be consistent with other language of the Proposed Rules to allow for routine, immaterial "error" correction in the financial statements.

5. Exclusion of Incentive-Based Compensation based on Stock Price or Total Shareholder Return

The Proposed Rules define compensation based on stock price or total shareholder return ("TSR") as incentive-based compensation.[10] We believe that the calculation of excess incentive-based compensation should exclude stock price and TSR measures because it can be difficult to determine the effect of any accounting error on stock price.

TSR measures the return an investor would receive if he or she bought one share of common stock at the beginning of the measurement period, accumulated dividends during the measurement period (generally assuming such dividends are re-invested in shares of common stock at the spot market price), and then sold the common stock at the end of the measurement period. For absolute TSR, the payout is measured as a function of the company's TSR compared to the company's own predetermined goals. For relative TSR, the payout is measured as a function of the company's TSR ranking compared to its peer group. It must be noted that TSR is not an incentive measure. The stock price of a company and its peer group is not within the control of the CEO or any other executive officers and, therefore, TSR should not be used as a determination of company performance under the lead of any

[9] Proposed Rule at 7.
[10] Proposed Rule at 4-5.

executive. Instead, TSR should be seen as a long-term value generator because it measures the change in stock price between two dates.

In fact, a stock price change could be attributed to any number of reasons during the performance period. Stock price fluctuations can be highly speculative in nature. They do not necessarily correlate to the financial performance of a company. Since recalculation of company stock price and TSR requires specific expertise, companies typically engage third parties to perform complex analyses and calculations. In the event of a financial restatement, these third parties would have to conduct event studies or other statistical analyses to calculate estimates of stock price and TSR due to the financial restatement. Such studies are time-intensive and expensive. Statistical studies are not precise, and instead are based on assumptions and subjective qualitative decisions. As a result, it is impossible to determine what the stock price and TSR would have been absent a financial restatement. Therefore, an issuer would be unable to establish the actual amount of excess incentive-based compensation awarded with any degree of certainty or precision.

We appreciate the opportunity to participate in this process and would be pleased to discuss our comments or any questions the Commission or the Staff may have. You may contact Anthony Eppert, Emily Cabrera, James Davidson, Melinda Brunger, Mike O'Leary, and Scott Kimpel of this firm.

Sincerely,

HUNTON ANDREWS KURTH LLP