SOCIETY
*for* Corporate Governance

**November 29, 2021**

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20548-1090

**Re: Release No. 33-10998; 34-93311; IC-34399; File No. S7-12-15**
**(Reopening of Comment Period for Listing Standards for Recovery of Erroneously Awarded Compensation)**

Dear Ms. Countryman:

The Society for Corporate Governance ("the Society") submits this letter in response to the reopening of the comment period on the Commission's Section 10D "Listing Standards for Recovery of Erroneously Awarded Compensation" ("Proposed Rules"). The Society is pleased to provide these additional comments to address the questions raised in the Commission's Reopening Release.[1] [2]

Founded in 1946, the Society is a professional membership association of more than 3,400 corporate and assistant secretaries, in-house counsel, outside counsel, and other governance professionals who serve approximately 1,600 entities, including 1,000 public companies of almost every size and industry.

*The Scope of the Final Clawback Rules ("Final Rules") Should Be Limited to Restatements That Are Material to Prior Period Financial Statements.*

The Commission asks whether the Final Rules should require compensation recovery in the case of both:

- restatements that correct errors that are material to prior period financial statements (sometimes informally referred to as "Big R" restatements) and
- restatements that are not material to previously issued financial statements but would result in a misstatement if the errors were left uncorrected in the current report or the

[1] The Society's September 18, 2015, comment letter ("2015 Letter") in response to the original release of the Proposed Rules ("Proposing Release") can be found via this link: https://www.sec.gov/comments/s7-12-15/s71215-60.pdf.

[2] In a November 3, 2021, letter, the Society requested a 30-day extension of the comment period for the Reopening Release. A 30-day comment period is not sufficient time for a complex subject like compensation clawbacks if the Commission wants to gather input from issuers and other stakeholders. https://www.sec.gov/comments/s7-12-15/s71215-9365252-261846.pdf.

error correction was recognized in the current period (also known as "Little r" restatements).

As discussed in our 2015 Letter, we continue to believe that only "Big R" restatements should trigger a clawback under the Final Rules. Almost by definition there is typically less impact on historical financial statements with a "Little r" restatement, and therefore less impact in historical compensation. Expanding the scope of these rules to include "Little r" restatements (a potential four-fold increase in restatements)[3] could force significantly more companies to pursue the costly recovery of incentive compensation in unwarranted circumstances,[4] with less chance of fulfilling the objective of the statutory requirement.[5]

*The Final Rules Should be Limited to Principal Officers and Those Who Contributed Directly to a Restatement.*

The Proposed Rules include a definition of "executive officer" that is modeled on the definition of "officer" under 15 U.S.C. 78p (Section 16 of the Exchange Act) and Rule 16a-1(f) and "would include a company's president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division or function, and any other person who performs policy-making functions for the issuer." For the purposes of developing clawback listing standards, this definition is overly broad and may encompass other executives who perform "policy-making functions" but have no oversight over the company's accounting. Using the Section 16 officer definition, coupled with the inclusion of "Little r" restatements, would significantly increase compliance costs for companies.[6]

As we noted in our 2015 Letter, we believe that the Final Rules should focus on individuals who had a material role in contributing to the events leading to the financial restatement. Requiring companies to adopt policies to pursue recovery actions against all Section 16 officers, including those (e.g., the chief human resources officer) who had no direct oversight over accounting or oversaw operations that were part of a restatement (especially "little r" restatements), would be unduly burdensome, unfair, and a waste of shareholder resources. Clawback actions are an extraordinary remedy and should be limited to those executives who are responsible for an

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[3] In 2019, "Little r" restatements (also known as "revision" restatements) accounted for almost 80% of the 484 restatements that year by SEC registrants, according to Audit Analytics. *See* Audit Analytics, "2019 Restatements: A Nineteen-Year Comparison," (July 2020), https://www.auditanalytics.com/doc/AA_RestatementReport_July2020.pdf.

[4] The burden on companies to recover compensation from executives after non-material "Little r" restatements would be grossly disproportionate to the comparably minor circumstances that contribute to these revision restatements. Furthermore, including revision restatements in the clawback rule could create an incentive for some companies not to pursue non-material corrections to their financial statements.

[5] As the Commission acknowledged in its Proposing Release, imposing more stringent clawback policies on companies could prompt some executives to demand larger pay packages and increase the cost to companies and their shareholders. *See* Listing Standards for Recovery of Erroneously Awarded Compensation, 80 Fed. Reg. 41,114 at 41,177 (July 14, 2015).

[6] The typical public company has between six and 12 officers who are subject to Section 16 reporting obligations. *See* Latham & Watkins, "Words of Wisdom: A Primer on Section 16 Officers," https://www.wowlw.com/Article/Index/143

accounting mistake; a company should have the discretion whether to expand its policy to allow recovery actions against other executives.

*The Final Rules Should Not Limit the Discretion of the Compensation Committee.*

The Commission also requested comment on whether the broad scope of the Proposed Rules could be made less burdensome by, for example, allowing compensation committees discretion to determine whether to pursue recovery of compensation in the event of a "Little r" restatement. As discussed in depth in our 2015 Letter, we continue to view the compensation committee (with input from the audit committee and the board's advisors) to be in the best position to determine who is responsible for the conduct that may necessitate a restatement, and whether to pursue a recovery in the event of any restatement – regardless of whether such restatements are material to prior period financial statements. There are also practical and legal issues that will affect a company's ability to do this. As stated in our earlier letter:

> [T]he 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). . . . 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[.]

As discussed in our 2015 Letter, affording compensation committees discretion to determine whether to recover excess compensation would mitigate problematic aspects of the Proposed Rule, including with respect to enforceability. Compensation committees are best situated to decide the materiality and practicality of recovering incentive awards if appropriate and the balance of what could be retrieved, as compared with the considerable expense of recovery, including in cases of former executives who have long left the company.

*Companies Should Not Have to Provide Additional Disclosure on Recoverable Amounts Beyond That Provided to the Exchanges.*

As noted above, the Society believes that the compensation committee is best situated to make determinations about whether to pursue recovery of excess compensation. It should be the responsibility of that committee, after consulting with its legal, accounting, and compensation advisors, to determine the "recoverable amount" of excess compensation.

The Proposed Rules would require an issuer to maintain documentation of how it estimated the recoverable amount and provide such documentation to the relevant exchange or association where the company is listed. The Reopening Release further asks whether investors would benefit from "the disclosure of how an issuer calculates the recoverable amount, including the analysis of the amount of the executive's compensation that is recoverable under the rule, and/or the amount that is not subject to recovery."

We believe that the Commission should not require a company to include disclosure of how the compensation committee determines the recoverable amount in its proxy statement or other regulatory filings with the SEC. Given the nature of restatements, such disclosures likely would relate to incentive compensation that was paid out several years before the just-concluded fiscal year and thus would require significant additional disclosure that would not be relevant to the information that companies are required to include in the Compensation Discussion & Analysis or other sections of their proxy materials. Including information on past incentive payouts could confuse some investors, would add additional length and complexity to proxy statements, and would entail additional legal, audit, compensation consulting, and other costs for the company without commensurate benefit to investors. As the Commission has noted, there are a number of possible methods to reasonably estimate the effect of an accounting restatement on stock price with varying levels of complexity and a range of related costs. If disclosure were required, some investors may file litigation to challenge a company's approach, saying they would have done that calculation differently.[7] To reduce the risk of such litigation, companies will need to provide lengthy disclosure to explain the bases for their determination of recoverable amounts.

*The Final Rules Should Not Apply Retroactively and Should Include an Exception for Compensation Paid Pursuant to Existing Agreements.*

The Society believes that the proposed definition of "incentive-based compensation" should be revised to include: (i) only awards granted after the effective date; and (ii) an exception for compensation paid pursuant to existing employment and equity award agreements.

The proposed definition of "incentive-based compensation" includes "any compensation that is granted, earned or vested based wholly or in part upon the attainment of a financial reporting measure." As such, the Proposed Rules would apply to any awards granted, ***earned, or vested*** on or after the effective date of the rules. Because the rules would include awards that are earned or vested after the effective date, the Proposed Rules would apply to awards that were granted prior to the effective date. We do not believe Congress intended for the rules to have retroactive effect.

The proposed definition of "incentive-based compensation" also does not include an exception for compensation paid pursuant to existing employment agreements. The Commission noted that existing contracts may be amended; however, in most, if not all, cases, an amendment will require the consent of both parties. It is unlikely that written employment contracts permit unilateral amendments, other than, perhaps, in the case of amendments that would not have, or potentially have, an adverse impact on the employee. An amendment that applies a clawback would most likely fall into the "adverse impact" category of amendments. The same holds true for award agreements. Employment agreements and award agreements often, if not always, include a provision that requires all amendments or modifications to be consented to in writing by both parties. In the absence of an express provision, companies that unilaterally change the terms of an employment agreement risk being in breach of contract and could face litigation with

[7] A company's disclosure of its calculation of the recoverable amount, including its analysis of the amount that is recoverable, may also lead to disputes with executives who presumably will seek to reduce those amounts. In addition, the disclosure of the recoverable amounts would also likely require the revealing of privileged attorney-client information, as these calculations often require detailed legal analysis.

executives. In addition, amending equity award agreements could potentially trigger a re-valuation of the award, which could have accounting consequences.

Thus, we believe that the Commission should adopt clawback rules that only apply to awards *granted* after the effective date of final rules and any such rules should not apply to compensation paid pursuant to existing employment agreements, unless executives consent to amendments to their agreements.

*The Trigger for the Look-Back Period Should Exclude the Subjective "Reasonably Should Have Concluded" Standard.*

As we and many other commenters noted in response to the Proposing Release, the Society believes that the first look-back period trigger in the Commission's proposed definition should not include the "reasonably should have concluded" language. In our view, this inherently subjective language invites shareholder litigation, which Congress presumably sought to avoid. In most cases, a restatement is likely to 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 noted in the Proposing Release, knowingly, recklessly, or negligently misreporting false or misleading financial information already subjects the company to liability. This should be an adequate deterrent, with sufficiently significant ramifications, to protect investors.

*Widespread Adoption of Clawback Policies Among Larger Issuers Emphasizes the Need for Flexibility in Application of the Final Rules.*

Finally, as the Commission noted in the Reopening Release, there has been an increase in voluntary adoption of compensation clawback policies in recent years. The adoption of a clawback policy has become a widely used best practice that is favored by both proxy advisory firms and institutional shareholders. A search of definitive proxy statements over the last 12 months on Intelligize indicates disclosure of clawback policies by 81% of Fortune 100 companies, more than 90% of companies in the S&P 500, and over 65% of companies in the Russell 3000 index. The vast majority of the polices provide for compensation committee discretion. In addition, the terms of current clawback policies at these companies vary, with key considerations being:

- **Covered individuals.** Clawback policies range from covering just the CEO and CFO to covering all executive officers.
- **Actions triggering a recovery.** These are typically tied to accounting restatements, and in most cases require misconduct by the executive.
- **Compensation look-back period.** Look-back periods typically range from one year to three years.

Issuers typically incur meaningful costs in connection with the adoption of clawback policies, including costs associated with the retention of compensation consultants to provide benchmarking data as well as legal advice regarding the enforceability of clawbacks. We believe the adoption of the Proposed Rules, especially if they were to apply to "Little r" restatements, would require issuers to incur significant expense to analyze the potential application and enforceability of their current policies. If the

Commission expands the scope of the clawback rules in this manner, many companies will need to draft more expansive policies and then obtain board approval.

Of the 95 of the 100 largest U.S. public companies that publicly disclosed a clawback policy as of June 2021, less than one-third of current policies are triggered by a restatement not involving fraud or misconduct; a plurality of policies are triggered by fraud or misconduct either in connection with or absent a restatement.[8] Among mid-cap companies, the percentage of clawback policies that were triggered by restatements without a showing of fraud or misconduct was just 18 percent in 2020.[9]

Given the widespread adoption of clawback policies by U.S. companies since 2015, we encourage the Commission to take a less prescriptive approach and allow companies the flexibility to continue to utilize their existing policies. Instead of imposing a more expansive version of the Proposed Rules, the Commission could simply direct the exchanges to require companies to adopt clawback policies and then provide annual disclosure in their proxy statements that describe the rationale for the company's clawback policy, any revisions to that policy, and the role of the compensation committee in making clawback decisions.

Respectfully submitted,

Ted Allen
Vice President, Policy & Advocacy
Society for Corporate Governance

Darla C. Stuckey
President and CEO
Society for Corporate Governance

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[8] *See* Shearman & Sterling, "Corporate Governance and Executive Compensation Survey 2021," 59, https://digital.shearman.com/i/1425392-corporate-governance-and-exec-compensation-2021/1.

[9] *See* ClearBridge Compensation Group, "ClearBridge100 Report for Mid-Cap Companies: Executive Compensation Policies: A Decade in Review," December 2020, 5.

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