Council of Institutional Investors
The Voice of Corporate Governance

Via Email

August 27, 2015

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

Re: File Number S7-12-15

Dear Mr. Secretary:

The purpose of this letter is to provide you with the Council of Institutional Investors (CII or Council) comments on the Securities and Exchange Commission's (SEC or Commission) proposed rule on Listing Standards for Recovery of Erroneously Awarded Compensation (Proposal).[1] CII is a nonprofit association of employee benefit plans, foundations and endowments with combined assets under management exceeding $3 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of American workers.[2]

As you know, it is well documented that dramatic failures in corporate governance were a key cause of the financial crisis[3] and improving corporate governance can help restore and maintain trust in the integrity of the U.S. financial markets.[4] Congress responded, in part, by enacting Subtitle E of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) entitled Accountability and Executive Compensation.[5]

[1] Listing Standards for Recovery of Erroneously Awarded Compensation, Securities Act Release No. 9861, Exchange Act Release No. 75,342, Investment Company Act Release No. 31,702, 80 Fed. Reg. 41,144 (proposed July 14, 2015), *available at* http://www.gpo.gov/fdsys/pkg/FR-2015-07-14/pdf/2015-16613.pdf.

[2] For more information about the Council of Institutional Investors (CII) and our members, please visit CII's website at http://www.cii.org.

[3] *See, e.g.,* Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report xvii (authorized ed., Jan. 2011) ("We conclude dramatic failures of corporate governance . . . were a key cause of this crisis."), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[4] *See, e.g.,* Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 22 (July 2009) ("Improved corporate governance requirements would . . . help to restore trust in the integrity of U.S. financial markets."), http://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf.

[5] Public Law 111-203, 124 Stat. 1900 (July 21, 2010), *available at* http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

The stated Congressional intent of Subtitle E, that includes Section 954, Recovery of Erroneously Awarded Compensation, was to "empower[] shareholders in a public company to have a greater voice on executive compensation and to have more fairness in compensation affairs."[6]

CII was an active proponent of including a provision in Dodd-Frank that would strengthen clawbacks.[7] In a December 2008 letter to Members of Congress, we stated that "any financial markets regulatory reform legislation [should include] . . . **Stronger Clawback Provisions:** At a minimum, senior executives should be required to return unearned bonus and incentive payments that were awarded due to fraudulent activity or incorrectly stated financial results."[8]

The following June, in testimony before the Subcommittee on Securities, Insurance, and Investment of the Committee on Banking, Housing, and Urban Affairs, CII's Executive Director further explained:

> The Council believes a tough clawback policy is an essential element of a meaningful "pay for performance" philosophy. If executives are rewarded for "hitting their numbers" – and it turns out they failed to do so – they should not profit. While Section 304 of the Sarbanes-Oxley Act gave additional authority to the SEC to recoup bonuses or other incentive-based compensation in certain circumstances, some observers have suggested this language is too narrow and perhaps unworkable. The Council does not advocate a re-opening of the Sarbanes-Oxley Act, but it does recommend that Congress consider ways to cover cases where performance-based compensation may be "unearned" in retrospect but not meet the high standard of "resulting from misconduct" required by Section 304.[9]

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[6] Rep. S. Comm. on Banking, Hous. & Urb. Affairs, S. 3217, S. Rep. No. 111-176, at 31 (Apr. 30, 2010), *available at* http://www.banking.senate.gov/public/_files/Comittee_Report_S_Rept_111_176.pdf.

[7] *See, e.g.,* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors et al., to The Honorable Nancy Pelosi, Speaker of the House 2 (Dec. 2, 2008), https://www.calpers.ca.gov/docs/governance/2008/cii-corporate-governance-reform-advocacy.pdf [hereinafter 2008 Letter].

[8] *Id.*

[9] *Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance: Hearing Before S. Subcomm. on Securities, Insurance, & Invest. of the Comm. on Banking, Hous. & Urb. Affairs,* 111th Cong. at 13 (July 29, 2009) (Testimony of Ann Yerger, Exec. Dir. of CII), http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=e64b1840-5e6e-4a88-a8f6-3f01b2462404.

CII's position supporting the strengthening of federal clawback provisions was based, in part, on CII's membership-approved policies on "Pay for Performance," which at the time stated:

> The compensation committee should ensure that sufficient and appropriate mechanisms and policies (for example, bonus banks and clawback policies) are in place to recover erroneous bonus and incentive awards paid out to executive officers, and to prevent such awards from being paid out in the first instance. Awards can be erroneous due to fraud, financial results that require restatement or some other cause that the committee believes warrants withholding or recovering incentive pay. The mechanisms and policies should be publicly disclosed.[10]

CII's position was also based on the recommendations of the Investor's Working Group ("IWG").[11] In its July 2009 seminal report on improving the U.S. financial regulatory system, the IWG concluded:

> **Federal clawback provisions on unearned executive pay should be strengthened.** Clawback policies discourage executives from taking questionable actions that temporarily lift share prices but ultimately result in financial restatements. Senior executives should be required to return unearned bonus and incentive payments that were awarded as a result of fraudulent activity, incorrectly stated financial results or some other cause. The Sarbanes-Oxley Act of 2002 required boards to go after unearned CEO income, but the Act's language is too narrow. It applies only in cases where misconduct is proven—which occurs rarely because most cases result in settlements where charges are neither admitted nor denied—and only covers CEO and CFO compensation. Many courts, moreover, have refused to allow this provision to be enforced via private rights of action.[12]

[10] Council of Institutional Investors, Policies on Corporate Governance, § 5.5d Pay for Performance (2009) (on file with CII).
[11] Investor's Working Group at 23.
[12] *Id.* Following its issuance, the July 2009 report of the Investor's Working Group (IWG) was reviewed and subsequently endorsed by the CII board and membership. For more information about the IWG, please visit CII's website at http://www.cii.org/content.asp?contentid=141.

We note that the legislative history of Section 954 explicitly references the recommendation of the IWG, stating:

> The Committee believes it is unfair to shareholders for corporations to allow executives to retain compensation that they were awarded erroneously. This proposal will clarify that all issuers must have a policy in place to recover compensation based on inaccurate accounting so that shareholders do not have to embark on costly legal expenses to recoup their losses or so that executives must return monies that should belong to the shareholders. The Investor's Working Group wrote "federal clawback provisions on unearned executive pay should be strengthened."[13]

Two years following the enactment of Dodd-Frank, CII membership approved some modest clarifications to its position on clawbacks in preparation for commenting on SEC rulemaking to implement Section 954. As revised, CII's current clawback policy states:

> The compensation committee should ensure that sufficient and appropriate mechanisms and policies (for example, bonus banks and clawback policies) are in place to recover erroneous bonus and incentive awards paid in cash, stock or any other form of remuneration to current or former executive officers, and to prevent such awards from being paid out in the first instance. Awards can be erroneous due to acts or omissions resulting in fraud, financial results that require restatement or some other cause that the committee believes warrants withholding or recovering incentive pay. Incentive-based compensation should be subject to recovery for a period of time of at least three years following discovery of the fraud or cause forming the basis for the recovery. The mechanisms and policies should be publicly disclosed.[14]

In light of our past and present policies and related public positions on clawbacks, CII generally supports the Proposal. The following are the Council's specific responses to select questions contained in the "Request for Comment" sections of the Proposal:

1. Should the listing standards and other requirements of the proposed rule and rule amendments apply generally to all listed issuers, as proposed? If not, what types of issuers should be exempted, and why? Please explain the rationale that justifies exempting any particular category of issuer.[15]

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[13] S. Rep. No. 111-176, at 111.
[14] Council of Institutional Investors, Policies on Corporate Governance, § 5.5 Pay for Performance (updated Apr. 1, 2015), http://www.cii.org/files/committees/policies/2015/04_01_15_corp_gov_policies.pdf.
[15] 80 Fed. Reg. at 41,148 (emphasis added).

CII generally believes that the listing standards and other requirements of the Proposal should apply generally to all listed issuers. As an organization that was actively involved in supporting the inclusion of a clawback provision in Dodd-Frank, we agree with the Commission's conclusion that the language and intent of Section 954 called "for a broad application of the mandated listing standards."[16] More specifically, as indicated, the legislative history explicitly states that "*all* issuers *must* have a policy in place to recover compensation . . . ."[17]

We also agree with the Commission that "shareholders of [all listed issuers, including smaller reporting companies] . . . would benefit from a policy to recover excess incentive-based compensation and that applying the proposed rule and rule amendments to these issuers will further the statutory goal of assuring that executive officers do not retain incentive-based compensation that they received erroneously."[18]

14. Should any revision to previously issued financial statements that results in a reduction in incentive-based compensation received by an executive officer always trigger application of an issuer's recovery policy under the proposed listing standards? Why or why not?[19]

CII generally believes that any revision to previously issued financial statements that results in a reduction in incentive-based compensation received by an executive officer should always trigger application of an issuer's recovery policy. In our view, establishment of a broad clawback arrangement is an essential element of a meaningful pay for performance philosophy.[20] If executive officers are to be rewarded for "hitting their numbers"—and it turns out they failed to do so—the unearned compensation should generally be recovered notwithstanding the cause of the revision.[21]

We note that our view on this issue is generally consistent with the recommendation of the IWG.[22] As indicated, the IWG was referenced in the legislative history of Section 954 of Dodd-Frank.[23]

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[16] *Id.* at 41,146.
[17] S. Rep. No. 111-176, at 111 (emphasis added).
[18] 80 Fed. Reg. at 41,147.
[19] *Id.* at 41,151 (emphasis added).
[20] *See, e.g.,* Testimony of Ann Yerger at 13; *see, e.g.,* Paul Hodgson, Wall Street Pay: Size, Structure, and Significance for Shareholders 16 (Nov. 30, 2011) (CII White Paper) (on file with CII) (opining that one positive improvement in Wall Street pay, post-crisis has been "strengthened clawback policies . . . to a performance-based policy . . . .").
[21] Testimony of Ann Yerger at 13; *see, e.g.,* Andrew Ackerman, SEC Proposes Broadened Corporate 'Clawback' Rules, Wall St. J., July 1, 2015, at 1 (quoting Securities and Exchange Commission Chair Mary Jo White that "'[e]xecutive officers should not be permitted to retain incentive-based compensation that they should not have received in the first instance'"), http://www.wsj.com/articles/sec-proposes-broadened-corporate-clawback-rule-1435763570.
[22] Investors' Working Group at 23.
[23] S. Rep. No. 111-176, at 111.

The relevant IWG recommendation states in broad terms that "executives should be required to return . . . incentive payments that were awarded as a result of . . . *incorrectly stated financial results or some other cause*."[24]

Finally, we note that the adoption of our position on this issue would also address the "'practical questions from an issuer's perspective'" that have been raised by corporate lawyers.[25] Some corporate lawyers have suggested that under the Proposal issuers would have difficulty determining whether a series of immaterial error corrections could be considered a material error when viewed in the aggregate.[26] Our proposed approach removes that difficulty.

17. Is it appropriate to treat the earlier of the two proposed dates as ''the date on which an issuer is required to prepare an accounting restatement'' for purposes of triggering the Section 10D recovery obligation? If not, why not? Would using these dates provide sufficient certainty and transparency for issuers, investors and exchanges to determine when recovery would be triggered for purposes of compliance with the proposed listing standards? Are there additional triggers we should consider including?[27]

CII generally believes that the proposed dates for purposes of triggering the Section 10D recovery obligation would provide sufficient certainty and transparency for investors to determine when recovery would be triggered for purposes of compliance with the proposed listing standards. We note that while the proposed dates are different than the date suggested by our membership-approved policy,[28] they share at least two salutary features: (1) they permit recovery of incentive-based compensation received after the date of an erroneous financial statement filing; and (2) they discourage issuers from improperly delaying filing a restatement to avoid recovery.[29]

23. Alternatively, is the proposed definition of ''executive officer'' too broad? Should we instead limit the recovery policy to ''named executive officers,'' as defined in Items 402(a)(3) and 402(m)(2) of Regulation S–K or otherwise define a more narrow set of officers subject to recovery?[30]

CII generally believes that the proposed definition of "executive officer" *is not* too broad. More specifically, we believe the Proposal's definition is generally consistent with the intent of the use of the term "executive officer" in Section 954.

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[24] Investors' Working Group at 23 (emphasis added).
[25] William Baker III et al., Latham & Watkins, Client Alert White Paper No. 1862, How to Navigate the SEC's Proposed Mandate on Clawbacks 3 (Aug. 4, 2015), http://www.jdsupra.com/legalnews/how-to-navigate-the-sec-s-proposed-94486/.
[26] *Id.*
[27] 80 Fed. Reg. at 41,152 (emphasis added).
[28] § 5.5d Pay for Performance ("discovery of the fraud or cause forming the basis for the recovery").
[29] 80 Fed. Reg. at 41,151-52.
[30] *Id. at* 41,153 (emphasis added).

As indicated, the IWG recommendation referenced in the legislative history to Section 954 supported strengthening federal clawback provisions for a broad category of "senior executives."[31] Similarly, as indicated, we have long advocated that "[a]t a minimum, senior executives" should be subject to a clawback provision.[32] We, therefore, generally agree with the Commission's conclusion that "applying the recovery policy to all executive officers would more effectively realize the statutory goal of Section 10D because officers with policy making functions and important roles in the preparation of financial statements set the tone for and manage the issuer."[33]

51. Is the proposed issuer discretion not to pursue recovery of incentive-based compensation consistent with the purpose of Section 10D? Is the scope of this discretion appropriate? Why or why not?[34]

CII generally would not object to the proposed issuer discretion not to pursue recovery of incentive-based compensation. As indicated, the legislative history for Section 954 states that the provision was intended to require that all issuers establish a policy "so that executives *must return* monies that should belong to the shareholders."[35] We, however, generally agree with the Commission that the proposed issuer discretion is "consistent with the protection of investors because it would save issuers the expense of purs[u]ing recovery in certain circumstances where the costs of recovery could exceed or be disproportionate to the recoverable amounts, and for foreign private issuers, would avoid such issuers having to choose between potential de-listing or violating home country laws, either of which could be detrimental to shareholders."[36]

Our qualified support for the proposed issuer discretion is contingent upon the final rule adopting *all* of the following proposed requirements that the Commission included in the Proposal to "mitigate potential abuse of this discretion":[37]

- Any determination that recovery would be impracticable would need to be made by the issuer's committee of independent directors that is responsible for executive compensation decisions and the determination would be subject to review by the listing exchange
- Before concluding that it would be impractical to recover any amount of excess incentive-based compensation based on enforcement costs
  - the issuer would first need to make a reasonable attempt to recover that incentive-based compensation,

[31] § 5.5d Pay for Performance.
[32] 2008 Letter, *supra* note 7, at 2; *see, e.g.,* CII White Paper at 16 (indicating that a strong clawback policy should "apply to all executives in the event of a restatement, regardless of who was responsible").
[33] 80 Fed. Reg. at 41,153.
[34] *Id.* at 41,162 (emphasis added).
[35] S. Rep. No. 111-176, at 111 (emphasis added).
[36] 80 Fed. Reg. at 41,162.
[37] *Id.*

  - the issuer would be required to document its attempts to recover, and provide that documentation to the exchange, and
  - the issuer would be required to disclose why it determined not to pursue recovery
- Before concluding that it would be impractical to recover because doing so would violate home country law
  - the issuer first would need to obtain an opinion of home country counsel, not unacceptable to the applicable national securities exchange, that recovery would result in such a violation, and
  - the relevant home country law must have been adopted in such home country prior to the date of publication in the Federal Register of proposed Rule 10D-1.[38]

We believe that the presence of *all* of the above proposed requirements in the final rule is necessary and appropriate to ensure a strong clawback provision where executives "face a credible threat of lost compensation."[39]

84. How would the proposed Item 402(w) disclosure be used by institutional and retail investors, investment advisers, and proxy advisory firms in making voting decisions and recommendations on matters such as director elections and executive compensation?[40]

CII generally agrees with the Commission that the proposed Item 402(w) disclosure of the "listed issuer's activity to recover excess incentive-based compensation during its last completed fiscal year . . . would inform shareholders' voting and investment decisions."[41] We believe, consistent with our membership-approved policies, that executive compensation is a critical and visible aspect of a company's governance and that pay decisions, including decisions relating to the issuer's clawback activities, are one of the most direct ways for shareowners to assess the performance of the board.[42] Thus, the Item 402(w) disclosures would likely be useful to institutional investors when casting votes for the election of directors generally.

The information might be particularly useful to institutional investors when casting votes for the election of the members of the compensation committee. As indicated in our clawback policy, we believe that the compensation committee should have the primary responsibility and accountability for the effective operation of the policy.[43]

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[38] *Id.*
[39] Letter from Laurel Leitner, Senior Analyst, Council of Institutional Investors, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Company 2 (May 19, 2011), https://www.fdic.gov/regulations/laws/federal/2011/11c07Ad73.PDF.
[40] 80 Fed. Reg. at 41,168 (emphasis added).
[41] *Id.* at 41,165-66.
[42] *See* § 5.1 Introduction.
[43] *See* § 5.5d Pay for Performance.

We also believe that the compensation committee should have the primary responsibility and accountability for ensuring that information about the policy is "clearly, comprehensively and promptly disclosed, in plain English . . . ."[44]

85. Should we require that the disclosure required by proposed Item 402(w) be tagged in XBRL format, as proposed? Should we require a different format, such as, for example, eXtensible Markup Language (XML)? Would tagging these disclosures enhance the ability of shareholders and exchanges to assess issuers' compliance with their recovery policies? Alternatively, instead of requiring that either of these disclosures be tagged, should tagging this disclosure be optional?[45]

CII generally believes that the disclosure required by proposed Item 402(w) should be tagged in XBRL format as proposed. As we recently commented in response to a similar question posed in the Commission's proposed rule on Pay Versus Performance:

> While we acknowledge that XBRL presents some challenges, as explained in our comment letter to the Commission in response to its 2010 Concept Release on the U.S. Proxy System:
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> > The Council supports the use of standardized data-tagging for proxy–related materials . . . as a means of increasing transparency and expanding shareowners' ability to track governance practices, compare practices among peers, make informed voting decisions, and follow the results of shareowner meetings. Data-tagging would also facilitate companies' ability to keep abreast of their peers' governance practices, and may result in a reduction in errors in proxy advisers' reports for shareowner meetings.
>
> We note that less than three years after the issuance of our comment letter, the SEC's own Investor Advisory Committee issued a recommendation in support of tagging executive compensation data in the proxy statement. The supporting statement for that recommendation explains:
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> > [T]he tagging of compensation data will facilitate comparisons among public companies. Such data has grown in importance in the era of Say-on-Pay.[46]

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[44] *See* § 5.5h Disclosure Practices.

[45] 80 Fed. Reg. at 41,168 (emphasis added).

[46] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Brent J. Fields, Secretary, Securities and Exchange Commission 5-6 (June 25, 2015) (footnotes omitted), http://www.cii.org/files/issues_and_advocacy/correspondence/2015/06_25_15_letter_sec_953(a).pdf.

For all of the above reasons, we agree with the Commission's conclusion that "requiring the data to be tagged would lower the cost to investors of collecting this information and would permit data to be analyzed more quickly by shareholders, exchanges and other end-users than if the data was provided in a non-machine readable format."[47]

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We very much appreciate the opportunity to provide input to the Commission in response to the Proposal. Should you have any questions or require any additional information about CII's views on this, or any other matter, please feel free to contact me at 202.261.7081 or jeff@cii.org.

Sincerely,

Jeff Mahoney
General Counsel

[47] 80 Fed. Reg. at 41,166.