The Fundamental Distinction Overlooked By The SEC

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Yesterday marked the close of the comment period on the SEC’s proposed incentive compensation clawback rules. You can read my comments here. The proposed rules are fundamentally flawed because the SEC failed to recognize that different bodies of law apply to officers and employees.

Although it should go without saying, not every officer is an employee and not every employee is an officer. Under the internal affairs doctrine, the law of the jurisdiction of incorporation will generally determine what officers an issuer must have, how they are appointed and how they may be removed. See, e.g., Cal. Corp. Code § 312 and NRS 78.130. In contrast, the laws applicable to an employment relationship are not subject to the internal affairs doctrine. For example, in Ruiz v. Affinity Logistics Corp., 667 F.3d 1318 (9th Cir. 2012) the Ninth Circuit Court of Appeals reversed the District Court’s decision to apply the law of the state of incorporation to question of employment status. Under Section 291 of the Restatement (Second) of the Conflicts of Laws, the rights and duties of a principal and agent are determined by the local law that, with respect to the particular issue, has the most significant relationship to the parties and the transaction. Thus, local employment law generally applies regardless of where a particular enterprise has been chartered.

The SEC either missed or disregarded the differences between officer status and employee status. Consequently, the SEC’s proposal to allow foreign private issuers to forego recovery if doing would violate home country law is fundamentally flawed. The relevant law is the law applicable to the issuer’s employment relationship with the executive officer. For example, a foreign private issuer may enter into an employment relationship with an executive officer that is governed by California law. Conversely, the law of a foreign country may be applicable to a domestic issuer’s relationship with an executive officer. Providing an exception to a foreign private issuer in the first case makes as little sense as denying an exception to the domestic issuer in the second case. As a result, the SEC’s proposal is “arbitrary, capricious, and abuse of discretion, or otherwise not in accordance with law.” 5 U.S.C. § 706(2).

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