Keith Paul Bishop

September 13, 2015

Via Email (rule-comments@sec.gov)

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

Re: File No. S7-12-15

Dear Ms. Morris:

I am writing to comment on the Securities and Exchange Commission's ("**Commission"**) proposal to adopt a new rule and rule and form amendments ("**Proposed Rules"**) to implement Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**").[1] The Proposed Rules are set forth in Commission Release Nos. 33-9861; 34-75342; IC-31702 ("**Proposing Release**").

1. Background.

I am an attorney in private practice in Irvine, California. I am writing in my individual capacity and not on behalf of my law firm or any of my law firm's clients.

I previously served as California's Commissioner of Corporations and in that capacity administered and enforced California's securities laws. I have taught as an adjunct professor at the University of California, Irvine and Chapman School of Law. I have also served as Co-Chairman of the Corporations Committee of the Business Law Section of the California State Bar and Chairman of the Business and Corporate Law Section of the Orange County (California) Bar Association. As indicated above, this letter is written in my individual capacity and not on behalf of either of these groups.

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[1] 15 U.S.C. §§ 77a *et seq*.

2. <u>Issuers should be permitted to forego recovery of erroneously awarded incentive compensation if recovery would violate applicable state law</u>.

In the Proposing Release, the Commission specifically requested comment on whether foreign private issuers should be permitted to forego recovery of erroneously awarded incentive compensation if recovery would violate home country law.[2] Inexplicably, the Proposing Release fails to consider the possibility that recovery of such compensation may violate state laws applicable to issuers (whether foreign or domestic).

(a) The Proposing Release fails to recognize the distinction between officer status and the employment relationship. Preliminarily, it is important to note the distinction between status as an officer and status as an employee.[3] Although an officer may often be an employee, not every officer is an employee and not every employee is an officer.[4]

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.[5] In contrast, the laws applicable to an employment relationship

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[2] The Proposed Rules do not define "home country". I note that the term is defined in Form 20-F as the "jurisdiction in which the company is legally organized, incorporated or established and, if different, the jurisdiction where it has its principal listing." It is unclear whether the Commission intended this definition (which contemplates that more than one "home country"). For the sake of clarity, I recommend that the Commission define "home country law" in the final rule.

[3] The California General Corporation Law explicitly recognizes the distinction between status of an officer and contractual employment rights:

> "Except as otherwise provided by the articles or bylaws, officers shall be chosen by the board and serve at the pleasure of the board, subject to the rights, if any, of an officer under any contract of employment. Any officer may resign at any time upon written notice to the corporation without prejudice to the rights, if any, of the corporation under any contract to which the officer is a party."

Cal. Corp. Code § 312(b).

[4] To avoid undue complexity, this letter generally refers to corporations and corporate law, although it is recognized that not every issuer is organized as a corporation.

[5] *See, e.g.*, Cal. Corp. Code § 312 and Nevada Revised Statutes (NRS) 78.130. The internal affairs doctrine is a "conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs — matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders — because otherwise a corporation could be faced with conflicting demands." *Edgar v. MITE Corp.*, 457 U.S. 624, 64 5(1982).

are not subject to the internal affairs doctrine.[6] 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.

For this reason the Proposed Rules' focus on home country law will be misplaced in many cases. What is relevant is the law applicable to the issuer's 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. As a result, Proposed Rules are "arbitrary, capricious, and abuse of discretion, or otherwise not in accordance with law."[7]

(b) State employment law statutes may prohibit recovery of previously paid compensation. Wage protection statutes are intended to protect wages earned by employees from deductions or recoupment by employers. For example, the California legislature has enacted a statute forbidding employers from recouping wages that have been paid:

> "It shall be unlawful for any employer to collect or receive from an employee any part of *wages theretofore paid* by said employer to said employee."

Cal. Lab. Code § 221 (emphasis added). The California Supreme Court has held that incentive compensation, such as bonuses and profit-sharing plans, also constitutes wages under the statute. *Schachter v. Citigroup, Inc.*, 47 Cal. 4th 610, 618 (2009).[8] In addition Section 219 of the California Labor Code prohibits prospective waivers of Section 221.[9]

It is unclear whether a recoupment of incentive compensation would violate this or similar statutes of other states. The absence of any exception for state law under the Proposed Rules will place issuers in the difficult position of running the risk of violating state law or stock exchange listing rules.

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[6] *See Ruiz v. Affinity Logistics Corp.*, 667 F.3d 1318 (9th Cir. 2012) (reversing trial court's decision to apply the law of the state of incorporation to question of employment stastus).

[7] 5 U. S. C. § 706(2).

[8] Although the Supreme Court in *Schacter* found that forfeiture of a restricted stock award did not violate Section 221, it did so because it found that the conditions precedent to the vesting had not been satisfied (the employee had voluntarily terminated his employment prior to vesting). The case did not address whether an employer could recoup previously paid incentive compensation.

[9] Consequently, issuers may not adopt policies that purport to waive the protections of Labor Code Section 221.

(c) The exception of home country law but not state law is arbitrary, capricious, and an abuse of discretion. In proposing a limited exception in the case of home country laws, the Proposing Release recognizes that the Proposed Rules may run afoul of foreign (other country) laws. However, the Commission omits any analysis or discussion of whether an issuer might violate *state* law, such as Section 221 of the California Labor Code. Consequently, the Proposing Release provides no rationale, much less any justification, for distinguishing between violations of home country laws and state laws. The Commission's failure to articulate *any* rationale renders the Proposed Rules arbitrary, capricious, and abuse of discretion, or otherwise not in accordance with law." As explained by the United States Supreme Court, the Commission must articulate "a satisfactory explanation for its action including a rational connection between the facts found and the choices made." *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

(d) The exception for home country law should not be limited to laws in effect before the date of publication of the Proposed Rules. The Proposed Rules would provide an exception for home country laws that were in effect before the date of publication of the Proposed Rule. This exception is illogical and likely to impose a significant cost on issuers. The Commission should not place issuers in the position of having to choose between violating applicable law and the listing standards of the applicable exchange.

(e) The Commission has failed to consider the economic effect of the disparate treatment of domestic and foreign private issuers. The Section 3(f) of the Securities Exchange Act of 1934 ("**Exchange Act**") and Section 2(c) of the Investment Company Act require the Commission to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. 15 U.S.C. § 78c(f); 15 U.S.C. § 80a-2(c). In addition, Section 23(a)(2) of the Exchange Act requires the Commission to consider the impact that any new rule would have on competition and to not adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. 15 U.S.C. § 78w(a)(2). Domestic issuers will be at a significant competitive disadvantage vis-à-vis foreign private issuers under the Proposed Rules.

The Commission's failure to "apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation" makes promulgation of the rule arbitrary and capricious and not in accordance with law. *Business Roundtable v. SEC*, 647 F. 3d 1144 (2011), *Chamber of Commerce v. SEC*, 412 F.3d at 144, and *Pub. Citizen v. Fed. Motor Carrier Safety Admin.*, 374 F.3d 1209, 1216 (D.C. Cir. 2004).

(f) Issuers should not be required to obtain a formal opinion of counsel. The Proposed Rules require that before concluding that it would be impracticable to recover any amount of erroneously awarded compensation based on violation of home country law, the issuer must obtain an opinion of counsel "not unacceptable" to the applicable exchange that recovery would result in a violation. This is both an unreasonable and an impracticable standard. It is possible, if not likely, that in many cases the question of the lawfulness of recoupment will be a matter of legal uncertainty. Even though counsel may believe that it is highly likely that recoupment will violate the applicable home country law, counsel may be unwilling to issue an opinion that "recovery would result in a violation". Further, it is possible that opinion practices in other countries may prohibit opinions of that type.

Even if the issuer should be able to obtain such an opinion, the Commission has failed to consider what would happen if the applicable exchange finds the opinion unacceptable. The issuer will then be forced between choosing to violate the law or the stock exchange list rules.

(g) Section 954 does not preempt state employee protection statute. Notably, the Commission avoids any analysis or discussion of preemption, either express or implied, in the Proposing Release.

As an initial matter, there is no basis whatsoever for express preemption of state employment statutes in the Proposing Release. Section 954 is completely silent as to both state law and preemption.[10] Absent an express Congressional command, the only basis for preemption is implied preemption.[11] However, the Commission must overcome the presumption against preemption, which it fails to do because it fails to address the question at all.[12] In any event, the case for implied preemption is unsustainable.

First, the Proposing Release cites no legislative history to support a Congressional intent to preempt state employment law and the structure of Section 954 militates against implying any such intent. In enacting Section 954, Congress required the Commission to adopt requirements for national securities exchanges and national securities associations.[13] Specifically, the Congress directed the Commission to adopt rules requiring national securities exchanges to prohibit the listing of securities of issuers that have not developed and implemented compensation recoupment policies. Congress could have, but notably did not, empower the Commission to adopt rules directly requiring issuers to adopt and implement recoupment policies.

Second, the Congress did not require all issuers to adopt recoupment policies. Because issuers may choose to list or delist their securities on national securities exchanges, they may in effect opt-in or opt-out of any requirement to adopt and implement a recoupment policy. It seems highly unlikely that Congress intended to vest issuers with the power to override state employment laws. Voluntary issuer compliance coupled with the absence of a direct federal conflict means that compliance with state

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[10] *Compare* Section 313 of the Dodd-Frank Act (providing that a state insurance measure is preempted only to the extent prescribed determination is made after notice).
[11] *Ting v. AT&T*, 319 F.3d 1126, 1135 (9th Cir. 2003).
[12] *California v. ARC America*, 490 U.S. 93, 101 (1989).
[13] For convenience, this letter refers to national securities exchanges although it is recognized that the Section 954 also refers to national securities associations.

employment law does not stand "as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress".[14]

3. The period covered should be the three-year period preceding the date on which the issuer is required to prepare an accounting statement.

The Proposed Rules deviate from Section 954 by defining the recovery period as "three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement". This departure from the statutory language is likely to impose needless complications on issuers. Many issuers have adopted recoupment policies in response to Section 954.[15] In many cases, these policies echo the language selected by Congress (*i.e.*, the "3-year period preceding the date on which the issuer is required to prepare an accounting restatement").[16] The Proposing Release recognizes that issuers with existing policies will need to conform those policies to the Proposed Rules. However, the Proposing Release, without providing any support, concludes that these issuers "likely would not incur significant additional costs". I disagree. Issuers will likely incur significant costs because the Proposed Rule deviates significantly from the statutory text. Issuers will incur additional legal fees and may face litigation risks associated with attempts to "change the rules of the game" by re-writing their policies. The Commission should consider, not assume away, these costs.

4. Issuers should be permitted to seek recovery should be on an after-tax basis.

The Proposed Rules require that recoupment of incentive compensation be made on a pre-tax basis. Section 954 is silent with respect to the impact of taxes on recoveries. In virtually every case in which recoupment will be required, the executive will have received compensation and paid taxes on that compensation in tax years preceding the year in which recoupment is required. Under federal tax law, these executives will not be permitted to amend their income tax return(s) for those year(s). Requiring that recovery be made on a pre-tax basis will likely place these executives in a significantly worse tax position. This transforms recovery of excess compensation into a financial penalty.[17] The Proposing Release provides no analysis or support for the position that Congress intended to impose additional penalties on executives beyond recoupment.

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[14] *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

[15] In the Proposing Release, the Commission estimated "64 percent (305 issuers) of the issuers that comprise the S&P 500 and approximately 50 percent (713 issuers) of the issuers that comprise the S&P 1500 report having a recovery policy of some form."

[16] Although the Proposing Release states "the staff was unable to determine if the start and end dates of the look-back window would cover the proposed required look-back period in the proposed rule", I was able to identify policies that echoed the statutory language.

[17] As the Commission notes in the Proposing Release, recoupment is required on an essentially "no-fault" basis.

As noted above, many issuers have voluntarily adopted recoupment policies following the enactment of the Dodd-Frank Act. Some policies explicitly permit issuers to take into account the tax impacts. These issuers will likely incur significant costs in attempting to conform their policies.

5. <u>The Commission should not redefine "executive officer" as "officer"</u>.

Section 954 refers to "executive officers". Even though the Commission Rule 3b-7 already defines "executive officer" for purposes of the Exchange Act, the Commission has proposed to use the definition of "officer" in Rule 16a-1(f). The difference between the two definitions is slight. However, Congress was presumably aware of the fact that the Commission has separately defined "executive officer" and "officer". Congress chose to use the term "executive officer" and the Commission should respect Congress' choice. Further, defining a statutory term by a different, but similar term, is needlessly confusing. Finally, a departure from the statutory language will impose unwarranted burdens on those issuers that have adopted policies using the statutory term.

6. <u>The Commission should provide issuers with much broader discretion on when they must seek recoupment</u>.

The Proposed Rules provide issuers with almost no discretion in deciding whether to pursue a claim for recoupment. The only exceptions would if the direct costs of enforcing recovery would exceed the recoverable amounts or recovery would violate home country law. The latter exception is discussed is Section 2 above. The fundamental problem with the Proposed Rules is that they fail to recognize that running a business in the best interests of the stockholders requires the exercise of business judgment. No rule can anticipate all of the unique circumstances that an issuer might face in determining whether recovery is in the best interests of the company and its stockholders. Any rule that requires boards of directors to forego their business judgment by limiting their discretion to a finite list of considerations is not in the best interests of the stockholders.

The Proposing Release's single-minded focus on the recoverable amount overlooks numerous factors that any rational decision maker would make in determining whether to pursue a recoupment claim. Most significantly, the Proposing Release fails to consider the likelihood of recovery. It will be the rare case in which recovery is certain. Thus, a rational issuer would assess the potential recovery against the odds of recovering it. A 50% chance of recovering a dollar isn't worth a dollar, it is worth 50 cents. An issuer should not pay more than 50 cents to recover 50 cents (leaving aside consideration of the time-value of money). A more sophisticated analysis would evaluate the recovery against a range of probabilities. In most cases, the amount of "upside" will be bounded by the issuer's determination of the amount of erroneously awarded compensation.

Consider the following example. An issuer determines that it is required to recover erroneously awarded compensation in the amount of one dollar. It further judges that it has a 10% chance of recovering a dollar, a 20% chance of recovering 80 cents, a

20% chance of recovering 50 cents and a 50% chance of recovering nothing. How much should a rational issuer spend on the recovery? No more than 36 cents ($1 * .10 = $.10 plus $.80 * .20 = $.16 plus .50 * .20 = $.10).

The above example focuses simply on the probability of recovery. A rational issuer, however, would focus on a number of other factors. For example, is the claim, even if winnable, collectible?[18] A million dollar judgment against a judgment proof debtor is worth little more than nothing. An issuer might also rationally consider other factors, including the potential costs of a counterclaim or negative publicity. These costs might well outweigh the amount of any recovery.

The Commission has specifically requested comment on whether boards of directors should be able to exercise discretion regarding the means of recovery and whether deferred payment should be permitted. I strongly urge the Commission to provide broad discretion in this regard. As noted above, rational decision makers will consider collectability. In some instances, an individual may lack the resources to repay erroneously awarded compensation. The Proposed Rules should clearly authorize boards of directors to exercise their business judgment in approving repayment plans. The Proposed Rules, moreover, should make it clear that such repayment plans do not constitute a prohibited personal loan under Section 402 of the Sarbanes-Oxley Act of 2002.[19]

The Commission has also requested comment on whether the Proposed Rules should impose a time limit on recovery. Any time-limit would be arbitrary and capricious because issuers will face a variety of circumstances beyond their control. Executive officers may oppose an issuer's claim to recoupment on a variety of grounds and litigation is likely to result in lengthy delays.

7. <u>Issuers should be permitted to forgo or net overpayments</u>.

The Commission has requested comment on whether netting of overpayments should be permitted. Issuers should have discretion to forego or limit recovery if the accounting adjustment results in erroneously paid compensation in one year but would result in the payment of additional compensation to the same executive in other years. For example, an accounting restatement may result in expenses being recognized sooner so that compensation in the early years was erroneously paid, but will be earned in later

[18] The Commission should be well aware of the difficulties of collection. *See* "A Maze of Paper | SEC Judgment Against Raider Paul Bilzerian: $62 Million. Collected: $3.7 Million", *The Wall Street Journal* (Sept. 16, 2014) (finding that the Commission collected only 42% of the amounts defendants were ordered to pay or disgorge in the three years ended September 30, 2013).
[19] 15 U.S.C. § 78(m)(k).

years.[20] It seems pointless and costly to require the issuer to recover compensation only to repay it. The Proposed Rules, moreover, should make it clear that issuers may make recoupment policies mutual. If erroneously paid incentive compensation is subject to recoupment, then an executive should be entitled to receive erroneously withheld incentive compensation. In fact, failure to pay such compensation may constitute a breach of contract on the part of the issuer.

8. Issuers should be permitted to indemnify executive officers when required to do so under applicable state or home country law.

The Proposed Rules take a hard line against issuers indemnifying executive:

> We believe that indemnification arrangements may not be used to avoid or nullify the recovery required by Section 10(D) [Section 954]. Section 10D's listing standard requirement that "the issuer will recover" is inconsistent with indemnification because a listed issuer does not effectively "recover" the excess compensation from the executive officer if it has an agreement, arrangement or understanding that it will mitigate some or all of the consequences of the recovery. (footnote omitted)

(a) State law may require issuers to indemnify employees. The Proposing Release overlooks potentially contrary provisions of state law. Although the Commission acknowledges that some indemnification arrangements may be statutory, it fails to consider the fundamental question of whether preemption may be required as a matter of state law.

For example, the California Labor Code requires an employer to indemnify "his or her employee for all necessary expenditures or losses incurred by the employee in direct consequence of the discharge of his or her duties, or of his or her obedience to the directions of the employer, even though unlawful, unless the employee, at the time of obeying the directions, believed them to be unlawful." Cal. Lab. Code § 2802.

As is discussed above in Section 2, the Proposing Release entirely fails to address the question of preemption. For the same reasons, state statutes imposing indemnification obligations on issuers are not preempted by Section 954 and may not be preempted by listing standards adopted by the national securities exchanges.

(b) Issuers may be subject to preexisting contractual obligations to indemnify executive officers. The Commission neglects the legal constraints on an issuer's ability to rewrite contracts unilaterally. In many instances, an executive officer's relationship with the issuer will be governed by a variety of contracts, including an employment agreement, indemnification agreement and various plan documents.

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[20] The Proposing Release does not address the accounting treatment of the compensation subject to recovery and how that would affect the determination of the unearned incentive compensation.

The Commission has failed to consider the presumption that Congress legislates prospectively, not retrospectively. In many cases indemnification arrangements (whether in bylaws, employment agreements or indemnification contracts) will pre-exist the enactment of Section 954 or the SEC's adoption of final rules. As U.S. Supreme Court Justice Justice Rufus Peckham wrote over a century ago:

> There are certain principles which have been adhered to with great strictness by the courts in relation to the construction of statutes as to whether they are or are not retroactive in their effect. The presumption is very strong that a statute was not meant to act retrospectively, and it ought never to receive such a construction if it is susceptible of any other. It ought not to receive such a construction unless the words used are so clear, strong and imperative that no other meaning can be annexed to them or unless the intention of the legislature cannot be otherwise satisfied.[21]

Consistent with this presumption, the Proposed Rules should operate prospectively only and should not override pre-existing contractual arrangements.[22]

(c) The Commission has misinterpreted the meaning of "will". The Commission has misinterpreted the meaning of "will" in Section 954. Subsection (a) provides that the "Commission shall" and subsection (b) provides that the rules of the Commission under subsection (a) "shall require each issuer". In contrast, the statute provides only that the "issuer will recover". It is unlikely that Congress chose different words out of a desire simply to achieve an elegance of variation. A more reasonable interpretation is that Congress intended these words to have different meanings with "shall" expressing an obligation and "will" expressing a simple futurity.

Very Truly Yours,

/s/ Keith Paul Bishop

[21] *U.S. Fidelity & Guaranty Co. v. U.S.*, 209 U.S. 306, 314 (1908).
[22] As discussed above, the Proposing Release is too facile in asserting that issuers can simply amend preexisting contracts.