Remarks Of

Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

"Corporate Policies on Troublesome Subjects"

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners, or the staff of the Commission.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

I. Introduction

I appreciate the opportunity to participate in the 1992 Sonat Legal Conference. Having spent the first twenty years of my life in Birmingham, I have observed with a great deal of pride the development of Sonat. It is also always a pleasure to visit my native state and, in particular, the Tuscaloosa area since I spent several enjoyable years as a resident of Tuscaloosa County.

It is my understanding that many of the participants here today expressed an interest in the subjects of securities litigation reform and environmental disclosure. As a result of that interest, included in the handout pertaining to my presentation should be: (1.) an article disclosing my thoughts on the subject of securities litigation reform,[1] and (2.) an article outlining the basic public company environmental disclosure requirements.[2] While all of this material is to some extent dated, I hope that you find the information useful.

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1 Roberts, "Gridlock on Securities Law," The Legal Times 22 (February 3, 1992).

2 Roberts, "Emphasis on Environmental Disclosure," The Alabama Lawyer 262 (July 1992).

In my presentation, I intend to focus on the need for a public company to have formal policies and procedures in place to deal with the troublesome subjects of executive compensation, insider trading, the dissemination of previously non-public information to the public, environmental disclosure, and other financial reporting issues applicable to Sonat. Hopefully, I will also convey some suggestions that will be helpful in forming the content of these policies and procedures. I note that a recent press article indicated that the growing number of lawsuits seeking huge penalties from management and auditors is prompting many public companies to sharpen internal control systems in order to prevent fraud.[3] If public companies are sharpening their internal control systems in order to prevent fraud, I consider such a development a positive one.

II. Executive Compensation

I am certain that everyone here is well aware that the subject of executive compensation has become one of the

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3 Berton, "CPA Institute Calls for Steps to Halt Fraud," Wall Street Journal. (September 24, 1992), at A14.

"hot button" issues in the public company area. The Commission is currently involved in a rulemaking effort to revise the executive compensation disclosure requirements, and it is difficult to predict with certainty what will be the final product. I believe it is fair to say that the product will contain a much more rigorous set of disclosure requirements. Obviously executive compensation has become a serious issue that will require additional corporate attorney and accountant time as well as additional corporate board consideration. It has been suggested to me that companies should consider establishing a separate executive compensation committee which is composed entirely of independent directors and which utilizes an independent compensation consultant.

Once the final executive compensation disclosure rules are adopted, I would encourage you to closely scrutinize the new rules, to review carefully the manner in which your company presently handles the issue of executive compensation, and to adjust your company's policies and

procedures to ensure the most appropriate treatment of this sensitive subject. One objective would be to place your company in the best possible position to defend its executive compensation policy and practice. The Commission's goal in revising the executive compensation disclosure rules is not to regulate the level of corporate executive compensation but rather to improve the adequacy and clarity of this disclosure with the desired result being a better informed shareholder.

III. Insider Trading and Dissemination of Sensitive Information[4]

Moving to the subject of insider trading, I believe that everyone here is also well aware of the Commission's active enforcement program, particularly with respect to insider trading. The insider trading prohibitions protect the integrity of our securities markets by ensuring that individuals trading in securities will not be disadvantaged by insiders or by those

[4] This material is derived primarily from remarks prepared by Harvey L. Pitt, of Fried, Frank, Harris, Shriver & Jacobson, entitled "The Application of Insider Trading Principles to the Handling of Sensitive Corporate and Market Information: A Practitioners View," and delivered at the American Bar Association Annual Convention, San Francisco, CA, August 9, 1992.

who inappropriately utilize their access to nonpublic corporate information.

While merger and acquisition activity has declined since the 1980s, combatting insider trading continues to be one of the most visible components of the Commission's enforcement program. The insider trading cases currently being brought by the Commission are more traditional, involving trading while in possession of corporate information, rather than market information such as possible tender offers. An example of the 1990s' insider trader case is a corporate officer selling ahead of a negative news announcement, such as the company's earnings being down, in an effort to avoid a loss.[5]

Companies must continue to grapple with the manner in which they handle and disseminate material, non-public information and should exercise care in the manner in which corporate insiders trade their company's securities.

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5 See remarks delivered by William R. McLucas, Director, Division of Enforcement, U.S. Securities & Exchange Commission, at the American Bar Association's Annual Convention, San Francisco, CA, August 9, 1992.

Companies should also document carefully their efforts to stay within the boundaries of propriety. After all, one objective is to avoid ever having to face the issues that arise in the course of a Commission investigation.

Any investigation into the potential misuse of confidential information by those with routine access to such information is bad news for the company. Anyone who has been involved in such an investigation invariably will state that the distraction posed by such an inquiry produces a tremendous ripple effect throughout the organization.

There exists a range of options to combat the risk of the misuse of confidential company information. One option is to require each director, officer, or other key employee with routine access to material, non-public information about the company to preclear personal trades in the company's securities through a designated officer. This officer would not approve any trades while the insider had access to material non-public information. This would also enhance insiders' compliance with their Section 16 reporting

obligations. For example, many large companies enhance their programs by prohibiting their executives from trading exchange-listed options on the company stock. Other companies prohibit their insiders from any open market purchases or sales of company securities, except during short "window periods" following the release of the Forms 10-Q or 10-K. Such restraints can help a company limit the opportunity for insider trading.

Further, public companies should be sensitive to the manner in which they disclose information to the public and to the manner in which they respond to public inquiries. In my opinion, reliable information should be gathered in a formal manner, reviewed by the accounting and legal staff and operations management, and then summarized for presentation by a designated spokesperson.

I also indicated that company efforts to avoid insider trading problems should be documented carefully. In order to establish an insider trading case, the Commission must demonstrate scienter. Carefully kept records of policies

distributed, training sessions attended, and trades precleared mitigate against an intent to defraud. Reasonable compliance efforts can protect both the company and its employees. I encourage everyone here to challenge your company to develop a responsible insider trading compliance policy.

IV. Environmental Disclosure and Other Financial Reporting Issues

A. Environmental Disclosure

I wish to spend the remainder of my time today focusing on several financial reporting issues. While I have provided you with a brief overview of the environmental disclosure requirements applicable to companies under federal securities law, I do wish to make a few additional comments on the general subject of environmental disclosure. I must say at the outset that it is my impression that accruals concerning environmental liability are not showing up in the financial statements as quickly as I believe that they should be.

It is the responsibility of management to accumulate on a timely basis sufficient relevant and reliable information to make a reasonable estimate of environmental liability. If

management determines that the amount of the liability is likely to fall within a range and no amount within that range can be determined to be the better estimate, the company is required to record the minimum amount of the range.[6] The additional exposure to loss should be disclosed in the footnotes to the financial statements if there is at least a reasonable possibility that a financial loss has been incurred. That disclosure should describe the environmental exposure, including an estimate, or range of estimates, of the loss (or if there is no reasonable estimate, it should so state). Changes in estimates of the liability should be reported in the periods that they occur.[7] The measurement of the liability should be based upon currently enacted environmental laws and upon existing technology. Companies are not expected to be clairvoyant with respect to future technology.

The recognition and measurement of the liability must be evaluated separately from the consideration of any expected

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6 FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.

7 *See* APB Opinion No. 20.

insurance recoveries. If information is available that a probable environmental liability has been incurred as of the date of the financial statements, the amount of the company's liability should be recognized and recorded, if it can be estimated, regardless of whether the company is able to estimate the amount of recoveries from insurance carriers.[8]

In assessing the probability of an insurance recovery, companies should consider the success of similar claims and the insurer's financial viability. It is only appropriate to reduce a probable liability with a probable insurance recovery, not a reasonably possible insurance recovery.

It is my understanding that many companies subject to potential SuperFund liability are stating in their disclosure documents that it is probable that insurance will cover all or most of the estimated potential environmental liability, while the pattern from the insurance industry side appears to be

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8 In contrast, however, the FASB emerging issues task force has recently provided guidance indicating that the cost of improvements necessary to prevent further environmental contamination, or to comply with new regulations, may be capitalized and amortized over succeeding periods rather than expensed immediately. EITF Issue No. 90-9, Capitalization of Costs to Treat Environmental Contamination.

that the insurance companies are fighting like mad to fend off their responsibility to pay for the company's liability. Such a pattern is confirmed by the recent report issued by the Rand Corporation Institute for Civil Justice ("Rand Report").[9] Rand extrapolated from its data that the nation's insurance industry spent $410 million on SuperFund related legal fees in 1989, and only $60 million for hazardous waste cleanup. The money that the insurance industry paid for legal services in 1989 amounted to almost 90% of the industry's total SuperFund spending. The Rand Report concluded that the current insurance focus was on questions involving coverage. Thus, the findings of the Rand Report suggest that some disclosures made by companies concerning the probability of insurance recoveries for SuperFund liabilities are questionable. In my opinion, the Commission should scrutinize carefully the disclosures in this area.

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9 J. Acton & L. Dixon, SuperFund and Transaction Costs, The Experiences of Insurers and Very Large Industrial Firms (Rand 1992).

Despite the growing importance of environmental issues, a recent survey by Price Waterhouse indicates that at the largest corporations, only 11% had adopted any written accounting procedures or policies to deal with environmental issues, and only 14% had established environmental oversight committees at the board of directors level.[10] I hope that your company falls in both the 11% and 14% categories. Further, a majority of companies (68%) stated that they did not accrue currently for future environmental expenditures. I hope that your company does not fall into this last category.

Identifying and interpreting environmental risks will continue to challenge corporate accounting and legal staff. I challenge everyone here to review your company's environmental disclosure policies and procedures to ensure that this sensitive and dangerous issue is being handled in the most appropriate manner. Again, it appears to me that

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10 See Surma and Vondra, "Accounting for Environmental Costs: A Hazardous Subject," Journal of Accountancy (March 1992), at 51.

reasonable compliance efforts would help protect your company.

B. Take-or-Pay Obligations of Gas Pipelines[11]

I wish to move at this point to a brief discussion of a financial reporting issue specifically pertaining to gas pipeline companies. Gas pipeline companies subject to take-or-pay obligations should provide sufficient information to enable an investor to understand the magnitude of the commitment and the nature and extent of uncertainties bearing upon the obligation's ultimate effect on future operations and liquidity. These disclosures typically include: (1.) the company's accounting policies governing the provision for losses attributable to unfavorable pricing commitments and for current and potential claims under the contracts; (2.) disclosure of the total dollar amount of suppliers' asserted and unasserted claims for deliveries not taken under take-or-

11 This material is derived primarily from remarks prepared by Robert A Bayless, Associate Director, Division of Corporate Finance, U.S. Securities & Exchange Commission, entitled "Current Accounting Issues and Related Developments Affecting the Division of Corporate Finance," and delivered to the SEC and Financial Reporting Institute at the University of Southern California, May 21, 1992.

pay contracts and for deliveries taken but for which the settlement amount is disputed; and (3.) a schedule of commitments for each of the next five years and thereafter, in dollars, under contracts not having variable, market-based pricing, accompanied by an explanation of the extent to which provisions have been made for unfavorable pricing. Other information may be required if a material oversupply situation is reasonably possible.

In addition, it is my understanding that the Commission's Division of Corporation Finance is of the view that any liability recognized in connection with its take-or-pay obligations and related litigation should not be reported net of probable future revenues resulting from the inclusion of such costs in allowable costs for rate-making purposes. Costs meeting the criteria of paragraph 9 of FAS 71 should be presented on the balance sheet as a regulatory asset and should not be offset against the liability. Contingent recoveries through rates that do not meet the criteria of

paragraph 9 should not be recognized either as an asset or as a reduction of the probable liability.

C. Management's Discussion and Analysis[12]

The last financial reporting issue that I intend to cover is the Management Discussion and Analysis ("MD&A") provision contained in Item 303 of Regulation S-K. The Commission recently announced that administrative proceedings under the Exchange Act were instituted against Caterpillar Inc. ("Caterpillar") for violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated thereunder.[13] Simultaneously with the institution of these proceedings, the Commission accepted Caterpillar's Offer of Settlement in which it consented to the entry of a Cease and Desist Order and in which it agreed to implement and maintain procedures designed to ensure compliance with the MD&A requirements.

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12 Id.

13 In the Matter of Caterpillar Inc., Securities Exchange Act Release No. 30532 (March 31, 1992).

The Commission determined that Caterpillar failed to adequately disclose the importance of its Brazilian subsidiary's 1989 earnings to Caterpillar's overall results of operations in the MD&A portion of Caterpillar's 10-K for the year ended December 31, 1989. The Commission also determined that Caterpillar failed to adequately disclose known trends and uncertainties regarding its Brazilian operations in its 1989 10-K and in its Report on Form 10-Q for the quarter ended March 31, 1990.

Caterpillar's MD&A disclosure did not permit investors to see the company through the eyes of management. In effect, the Commission questioned how Caterpillar's MD&A discussion could not reflect that the company's 1990 results would lag considerably behind those for 1989, due to the dramatic decline sustained by its Brazilian subsidiary, particularly when the anticipated decline was the source of contemporaneous presentations to Caterpillar's board of directors. It appears to me that the Commission is clearly

sending the message that companies would be advised to review their MD&A compliance procedures.

I have been advised that the "involvement of senior management in the preparation of MD&A disclosure is essential. Compliance with the MD&A requirements can only be accomplished through an evaluation by management, with the assistance of counsel and accountants, of the disclosure to be provided to determine if it conveys management's understanding of the causes of the company's future prospects."[14]

The Commission previously issued an interpretive release on MD&A which set forth the Commission's views regarding several disclosure matters that should be considered by companies in preparing MD&As.[15] This release emphasized the distinction between prospective information that is required to be disclosed and voluntary forward-looking disclosure. The release states that if there is a known trend,

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14 Strauss, "In the Matter of Caterpillar, Inc.; The SEC Continues to Emphasize the Importance of MD&A Disclosure," 3 Journal of Corporate Disclosure and Confidentiality 88 (1992), at 93.

15 Securities Act Release No. 6835 (May 18, 1989).

demand, commitment, event or uncertainty, management must make two assessments to determine what prospective information is required.

First, management must determine whether the known trend, demand, commitment, event or uncertainty is likely to come to fruition. If management determines that it is not reasonably likely to occur, no disclosure is required.

Second, if management cannot make the determination that the event is not likely to occur, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the company's financial condition or results of operations is not reasonably likely to occur. Each final determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time the determination is made. The release clarifies that the safe harbor rules apply not only to voluntary forward-looking

statements, but also to prospective information that is required to be disclosed.

Item 303 compels management to disclose the significant implications of environmental laws on the future operations of a company. The Caterpillar case should make it clear, if it was not already, that the Commission treats MD&A disclosure very seriously. I would not be surprised if an MD&A environmental related enforcement case materialized in the near future.

V. Conclusion

In conclusion, you should be acutely aware of your company's responsibilities to investors under our federal securities laws. To ensure continued proper disclosure, you should revisit your company's disclosure from the prior filing and should determine whether recent events or estimates would require additions or modifications. At a minimum, it appears to me that you should advise your company to establish policies mandating full compliance with all disclosure requirements and to establish self-monitoring

mechanisms to ensure that corporate officers and employees are faithfully complying with such policies. A similar set of policies and self-monitoring mechanisms should also be established to combat the risk of the misuse of confidential company information.