Remarks Of

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Current Issues of Interest

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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.

U.S. Securities and Exchange Commission
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Current Issues of Interest

I. Introduction

I am honored to participate in the first annual government relations conference of the Association of Publicly Traded Companies ("APTC"). I wish to encourage the members of the APTC to remain involved in the legislative and regulatory process, particularly insofar as issues involving our capital formation system are concerned. I have enjoyed working with your president and my ex-Senate staff colleague, Brian Borders, and look forward to the continuation of the dialogue that has been established between us. While differences in approach may be advocated from time to time, I know that I share with the APTC the goal of fair and efficient capital markets, free from unnecessary governmental regulation.

After I provide an update on the recently adopted passive market making rule and on the NASD's proposed short sale rule, it is my intention today to address briefly three issues that I believe are of interest to the APTC: securities litigation reform, executive compensation disclosure, and corporate governance reform. With respect to all of these issues, it is my impression that the Commission either has responded, or is attempting to respond, in a positive, constructive manner.

II. Passive Market Making

I believe that everyone here is familiar with Exchange Act Rule 10b-6. The purpose of the rule of course is to prevent participants in a distribution from artificially conditioning the market for the securities to facilitate such a distribution.

As a result of the rule, distribution participants and their affiliated purchasers, including market makers, had to refrain from making a market for a certain period of time (either two or nine business days) prior to the commencement of offers or sales of the securities. For a small to medium-sized issuer which may not be heavily traded, this often meant that there was either not a market for its shares or an illiquid market during this period of time. It was alleged frequently by NASDAQ/NMS issuers that

during this period of time, stock speculators were preying on their shares and unfairly capitalizing on this situation. This situation posed an impediment to the efficiency of the NASDAQ capital formation system, which is an integral part of our national capital formation system.

In response to this problem, on April 8, 1993, the Commission adopted a new rule, Rule 10b-6A, to permit NASDAQ market makers to engage in transactions in NASDAQ securities on a "passive" basis during the two business day cooling-off period when such transactions otherwise would be prohibited by the provisions of Rule 10b-6. In general, a passive market maker's bid is limited by the level of bids of market makers who are not participating in the distribution, and passive market making is allowed only in instances of significant market degradation, where market makers representing a substantial proportion of the trading volume otherwise would be required to withdraw from the market in order to comply with Rule 10b-6.

After the first nine months of operation of the new rule, the NASD will submit a report to the Commission summarizing the operation of passive market making. The Division of Market Regulation ("Division") will then prepare and issue a report for public comment evaluating the effectiveness of the rule. Once interested parties have commented, and the Commission has made its own evaluation, the Commission will then decide what, if any, revisions are appropriate.

Rule 10b-6A became effective on May 17, 1993. During the first three weeks of the rule's operation, four secondary offerings of NASDAQ securities eligible to use the new rule, did so. While it is too early to draw conclusions about the rule's effectiveness, a positive preliminary judgment can be made. For instance, despite initial concerns about the perceived complexity of the new rule, securities firms appear ready and willing to utilize it. Of course, in response to concerns raised by

commenters such as the APTC, the version of the rule adopted by the Commission was much simpler than the rule as proposed.

In addition, although the NASD has reported some transactional glitches and missteps by passive market makers as they become familiar with the operation of the new rule, overall, passive market making appears to be running smoothly. In fact, I understand that initial impressions of passive market making from syndicate managers have been favorable. I further understand that the NASD has reported no significant operational or compliance problems and has been able to address issues swiftly as they arise. In sum, passive market making is proving advantageous to NASDAQ issuers during the critical period when they are seeking to raise capital in the public markets through secondary offerings.

I understand that several more offerings may be utilizing passive market making in the coming weeks. The Division will have a more complete picture regarding the operation and effectiveness of Rule 10b-6A once the initial nine-month pilot period is over. I fully support efforts to reduce unnecessary regulatory burdens on the capital formation process, and I believe that Rule 10b-6A is an appropriate step toward that goal.

I recognize that the APTC, among others, suggested that Rule 10b-6 be eliminated entirely, or, alternatively, that the two business day cooling-off period of the rule be eliminated with respect to all NASDAQ/NMS and exchange-listed securities, and that the nine business day cooling-off period applicable to all other securities be reduced to two business days. I am not certain that I am prepared to support eliminating Rule 10b-6 entirely.

The Division currently is undertaking a comprehensive review of Exchange Act Rules 10b-6, 10b-7, and 10b-8 to address the significant changes and developments in the securities market since those rules were adopted or last amended. The Division is

preparing a concept release analyzing both the continuing need for regulation of trading activities during distributions of securities and, if appropriate, the form of such regulation, with a view toward simplifying and modernizing these rules. I anticipate that the Commission will attempt to address the APTC's remaining concerns through this rulemaking project, and I look forward to continuing to work with the APTC in this area.

III. NASD Proposed Short Sale Rule

Now, moving on to another subject in which I believe the APTC is interested, I would like to provide an update on the NASD's proposed short sale rule.

The NASD has proposed a rule change that would prohibit short sales of NASDAQ/NMS securities at or below the current inside bid when that bid is lower than the previous inside bid.[1] The proposed rule includes certain exemptions, including an exemption for "qualified market makers" that comply with criteria establishing them as "primary" market makers in the NASDAQ system.

The Commission received approximately 400 comment letters on the original NASD proposal. Many of the comment letters were critical of the primary market maker exemption as well as the absence of any exemption for options market makers.

In January of this year, the NASD amended its short sale rule proposal to provide a partial exemption from the rule for options market makers.[2] The Commission received 13 comment letters on the options market maker amendment, all of which were negative. The options market makers and the options exchanges, in

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1 Securities Exchange Act Release No. 31003 (August 6, 1992), 57 FR 36421 (August 13, 1992) (noticing for comment the NASD's proposal).

2 Securities Exchange Act Release No. 31729 (January 13, 1993), 58 FR 5791 (January 22, 1993) (noticing for comment the NASD's amendment to its proposal).

general, opposed the proposed exemption as being too complex. They also reaffirmed their belief that the rule is unnecessary. All of this indicates that the rule proposal probably still needs some additional tinkering before Commission action. However, I am inclined to favor a short sale rule for the NASDAQ/NMS marketplace.

As for the timing of Commission action on the NASD short sale proposal, given the controversial nature of this proposal, I would expect the Commission to act prudently and move cautiously. I anticipate that the rule proposal will undergo some further adjusting. I am well aware that the APTC ardently supports a short sale rule for the NASDAQ/NMS marketplace.

IV. Securities Litigation Reform

On the legislative front, securities litigation reform remains a controversial topic of interest. Legislation on the subject has been reintroduced in the House by Congressman Tauzin, and Senator Dodd has scheduled a hearing on the subject in the Senate.

While I do believe that meritless securities litigation is a problem, I am not a supporter of the current legislative attempts to achieve securities litigation reform. I prefer the reform that is already taking place judicially. Rule 11 sanctions are now beginning to be levelled by courts against both plaintiffs and defendants for taking meritless positions. Further, if certain amendments to the federal rules of civil procedure are adopted as recommended by the federal judiciary, Rule 11 will probably be invoked even more frequently. Moreover, the Supreme Court recently has narrowed the application of the civil liability provisions of RICO and has affirmed the right of defendants to seek contribution from persons who were jointly responsible with them for securities law violations.

These reforms, already taking place within the parameters of our existing litigation system, make a lot more sense to me than the well-intentioned but misguided

legislative vehicles currently being bounced around. I would rather encourage continued progress on the judicial reforms underway than to engage in the ill-fated legislative pursuit of such worn tort reform concepts as a loser pays rule or a comparative negligence standard.

The Commission has independently pursued its own litigation reform and will continue to do so. The Commission has recently published an administrative proceeding task force report and will begin to implement some of the reforms contained in that report during the remainder of this year. I view Commission activity of this nature as a positive development for securities litigation reform. However, the bottom line, at least for me, remains that the legitimate exercise of private rights of action in the securities area have proven to be an effective supplement to Commission enforcement actions and should not be eliminated.

V. Stock Option Valuation

Moving on to the subject of executive compensation, it appears to me that the new executive compensation disclosure requirements have enabled the marketplace to discern the compensation policy and practices of issuers. This was not possible before as a practical matter.

I recognize that compliance with these new requirements proved painful for issuers this year. Hopefully, this pain is a one time occurrence and that, once adjusted to the new requirements, compliance will be easier to achieve and much smoother next year. I understand that the Division of Corporation Finance intends to issue an interpretive release on the subject this summer which should also facilitate compliance in the future. I further understand that some technical changes to the disclosure requirements may be recommended as well.

The new executive compensation disclosure rules contain a requirement to disclose the value of employee stock options either on the basis of an assumed increase

in stock price, or through valuation using a model such as Black-Scholes. This provision was not especially popular with the corporate community at the time, but such unhappiness was nothing compared to the current unhappiness with the Financial Accounting Standards Board's ("FASB") project to require a valuation of employee stock options either on the date granted or on the date vested. Once this value is determined, it would be required to appear as a compensation expense on the company's income statement.

This accounting treatment would be quite a departure from the present day accounting treatment required by APB 25. Under the current accounting treatment, nothing needs to be expensed unless, at the time of grant, the option exercise price is lower than the present market price of the underlying common stock.

Supporters of the FASB project argue that the present treatment of option awards is inconsistent with the treatment of stock awards, which is expensed. They further argue that options have inherent value as of grant date and are given to executives as a replacement for cash bonuses, which would require expensing. Although these are valid points, experts could debate the best option value methodology until the turn of the century without reaching a consensus. The Commission had a not so pleasant taste of this controversy in its own executive compensation disclosure project.

In any event, it appears that the supporters of the FASB project have won. The FASB met on April 7 and authorized the staff to prepare an Exposure Draft for a new accounting standard which would require: (1) an accounting expense for the "fair value" of stock options and other equity-based instruments granted to employees after December 31, 1996, and (2) disclosure in footnotes to financial statements of the "fair value" of such grants made after December 31, 1993. Thus, starting next year all

stock option grants will need to be valued and disclosed in a footnote to the financial statements.

The next steps are expected to be the release of an Exposure Draft this summer; a six month or more public comment period during which field testing will occur; a public hearing at the end of the comment period (mid-1994); and the issuance of a final standard (if approved) in late 1994.

While I support a footnote disclosure requirement, I question whether an expense requirement is necessary. I would argue that the true cost to shareholders of a stock option is the dilution experienced with the issuance of new shares, which can be described adequately through disclosure. Unless I receive some indication that the FASB is considering reversing its initial decision, though, I intend to respect that decision.

Congress has conferred on the Commission statutory responsibility for defining the content of accounting principles for companies filing with the Commission or making public offerings of securities. Since the inception of the FASB, however, the Commission has looked to the private sector to establish and to improve accounting principles. I believe that this historical relationship should be maintained, even when the decision by the FASB is an unpopular one.

It is my hope, however, that the FASB will consider moving back the expensing implementation date. It does not appear to me that sufficient time has been allowed for the disclosure period before expense recognition is required in 1997. A long disclosure period is particularly warranted in this instance in my view since there is no consensus existing yet for any one option valuation methodology. I would encourage the FASB to move prudently and cautiously when selecting an option-pricing model. This evaluation process should be designed to achieve validity and reliability rather than implementation.

VI. Corporate Governance Reform

The last issue that I wish to mention briefly is that of corporate governance reform. I am of the view that the new proxy rules adopted by the Commission last fall have made it easier for shareholders to communicate with each other and with corporate management. This should be of benefit to all the participants in our capital formation system and should even improve the efficiency of that system. I am not certain that any additional reforms are necessary immediately.

I know that Chairman Markey has expressed concern with the paucity of independent board members on corporate boards, with the "independence" of the independent board members that are already present, and with the lack of confidential proxy voting. I share his concerns and welcome his ventilating these concerns through congressional hearings. I encourage the members of the APTC to become cognizant of these concerns and attempt to respond to them voluntarily in a responsible and timely fashion. I do not believe that legislation or rulemaking could address these concerns in other than an awkward, unwieldy, and clumsy fashion. Hopefully, that kind of action will not be necessary. The members of the APTC can act effectively to preclude the need for any legislation or rulemaking in this area, and I challenge you today to do so.

VII. Conclusion

Since I suspect that my time has more than expired, I will conclude. I have enjoyed participating in this conference. I look forward to working with each of you during the remainder of my Commission tenure. Communication solves a great many problems, and I intend to continue the dialogue that I have established with the APTC. We share a common interest in maintaining a fair and efficient capital formation system. We can and should work together toward achieving that objective.