Remarks Of

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"The Road Well Traveled"

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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.

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"The Road Well Traveled"

I. Introduction

I appreciate the opportunity to address the Society members again concerning certain issues that while are not new, remain of interest. Although things appear to have calmed down a bit at the Commission since the release of the new Section 16 rules in 1991 and the executive compensation rules in 1992, to some extent, the same roads are once more being traveled by the Commission. This time, however, it is not with a view to reconstruct, but with a view to adjust and to fine tune. Today, I intend to discuss where I stand with respect to these two rulemaking areas, particularly the area of Section 16, and, if I have time, I will conclude with your other favorite subject...namely shareholder proposals.

II. The New Rules Under Section 16

As you well know, the Commission spent years reviewing the old rules under Exchange Act Section 16 with a view to reconstructing a consistent and theoretically defensible regulatory framework in light of developments in the employee benefit and derivative securities areas. The old rules had been adopted on a piecemeal basis over 50 years and presented a "crazy quilt" scheme.

I recognize that the new rules have received some negative attention in Society circles, but they did accomplish a number of advances. For one, the new rules, for the first time, contained definitions of key terms such as "officer" and "beneficial owner." Of course, you know that derivative securities were treated in a comprehensive manner such that those pesky option exercises no longer triggered Section 16(b) short-swing profit recovery and no longer created artificial new six month holding periods. In addition, the new rules created a new form to report exempt transactions on an annual, rather than monthly, basis. Finally, the addition of Item 405 of Regulation S-K

appears to have caused a dramatic increase in Section 16(a) reporting compliance, which is a circumstance that I view as positive.[1]

III. The Section 16(a) Enforcement Program

Since I have mentioned compliance, let me take a moment to review the Section 16(a) compliance program. Before the rules were adopted in January of 1991, there were several years in which more than a third (and as much as a half) of all transactions reported were reported late. Since 1991, it appears that non-compliance is almost nonexistent in comparison -- certainly down to the single digit percentile. This is not to say that this problem has been eliminated or that Section 16 insiders are now all saints. It has taken a number of embarrassing proxy disclosures and Commission enforcement actions to drive the "need for compliance" message home.

The first few cases of delinquent reporting that reached the Commission after the new rules were adopted were resolved with the Commission issuing a cease and desist order against future violations of Section 16(a).[2] There have been three enforcement cases worthy of special note since that time.

The first case involved Bettina Bancroft, a director of Dow Jones & Company.[3] Bancroft was significantly late in reporting sales of her stock, and she argued, as a defense, that she had instructed the company holding her stock to satisfy her reporting obligations. However, neither Bancroft's contract with the company nor her file with them contained any such instructions, and she apparently had taken no steps to ensure that the filings were being made. While she may have honestly believed the reports were being filed, she was nevertheless found culpable. The message one should take

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[1] Item 405 of Regulation S-K; 17 C.F.R. 229.405 (1991).

[2] E.g., SEC v. Maximilian de Clara, Release 34-30666 (May 7, 1992).

[3] In the Matter of Bettina Bancroft, Release No. 34-32033 (March 23, 1993).

from the Bancroft case is that regardless of arrangements made for the filing of Section 16(a) reports, the individual insider remains responsible for compliance.

This is not to say that the Commission will refuse to credit a good faith effort to establish an agency relationship for the purpose of ensuring timely filing. Although the filing requirements, much as the short-swing profit recovery provisions, are enforced through a strict liability standard, it has been my experience that the Commission will take into account the facts and circumstances of a violation when crafting a sanction.

I recognize that the corporate bar favors Commission recognition of a Bancroft type defense as a shield against a Commission enforcement action under Section 16(a). Although the defense put forward by Ms. Bancroft did not prevail, I am of the view that there may be room for such a defense under the appropriate circumstances.

In my opinion, for an insider to escape sanction, four elements should be satisfied. First, there should be a clear and unambiguous written delegation of authority to a responsible third party who is in a position to monitor the trades of the insider, such as someone in the corporate secretary's or the general counsel's office. Secondly, there should be a clear and unambiguous written acknowledgement of the delegation by the person who is to make the filings. Third, the insider must cooperate with the person making the filings by timely informing that person of each transaction conducted. Fourth, the insider must nevertheless remain vigilant in overseeing the performance of the third party, with respect to filings. This should include obtaining, retaining and timely reviewing copies of all filings made on the insider's behalf. Assuming good faith compliance with these four elements, I would be inclined not to support an enforcement recommendation against a tardy insider.

There are a few other enforcement cases that warrant your attention, namely those in which the Commission levied a fine against an insider. Initially, the Commission limited its Section 16(a) sanctions to a cease and desist order, but recently

there have been some egregious cases discovered that have warranted a monetary fine. In some cases, the Commission found instances where an officer or director allegedly engaged in insider trading and apparently attempted to hide the transactions by not filing Forms 4.[4] There should be no surprise in this room that against these insiders, the Commission sought monetary fines and/or injunctions.

Apart from those instances of alleged fraud, however, there have been two cases involving fines in which the only violations alleged were Section 16(a) ones. The first case was SEC v. Harry E. Hagerty Jr., who was late with 33 Forms 4 and 5, and was fined $15,000.[5] The most recent case, SEC v. Clyde W. Engle, released last week, involved a person controlling a number of smaller public companies.[6] Engle allegedly was late with 221 forms reporting transactions with a value in excess of $44 million, including short-swing transactions yielding profits of $35,000. The related companies were charged with over 200 violations of Section 16(a) as well. Engle agreed to a cease and desist order, a $75,000 fine, and an undertaking to establish a Section 16(a) compliance program.

As you can see, the Commission is taking its Section 16(a) enforcement responsibilities very seriously. As with other types of enforcement actions, the Commission attempts to be tough and aggressive on the one hand and fair and reasonable on the other. Although this balance is difficult to maintain at times, I assure the Society that above all, the Commission strives to "do the right thing" in its enforcement program, even in the Section 16 area.

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[4] See SEC v. Gary Lubliner, Litigation Release 13638 (May 18, 1993); SEC v. John B. Walker, Litigation Release 13579 (March 25, 1993); see also SEC v. Robert S. Shulman, Litigation Release 13619 (April 22, 1993); SEC v. Edward R. Downe, Litigation Release 13260 (June 4, 1992).

[5] Release 34-32657 (July 19, 1993).

[6] Release 34-33029 (October 7, 1993).

IV. The New Rules Revisited

Moving back to the Section 16 regulatory scheme put in place in 1991, after two and a half years, it appears that the new rules are working pretty well, albeit after a rough start. Unfortunately, as you know, the new Rule 16b-3 for employee benefit plans has yet to become effective. In fact, the Commission recently voted to extend the effective date to September 1994.[7]

The reasons for the delay should be well-known to this audience, but in a nutshell, there have been practical concerns raised that the new Rule 16b-3 exemption is too burdensome, especially for qualified plans. The staff of the Division of Corporation Finance has been analyzing the new rules and soliciting and listening to suggestions from practitioners as to ways to improve and to simplify the rules. It is my understanding that practitioners have not been shy about making recommendations.

I expect that the next action from the Commission will likely be a proposing release which will solicit formal comment from persons, such as the members of this audience, concerning Commission recommendations to improve the rules. I anticipate that this release will focus on Rule 16b-3, but you should not be surprised if there are other proposed changes as well.

As for the timing of any such proposal, it is difficult to predict. While I understand that the staff is finalizing their recommendations, given the other pressing matters before the Commission, I would not anticipate that the new Section 16 proposals will enjoy the highest priority. Thus, one should remain patient, as was required for the prior set of rules. I remain hopeful, nevertheless, that the Commission will be able to both propose and adopt rule changes before September 1, 1994.

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[7] Release 34-32574 (July 2, 1993).

Now let me take a few minutes to give you my perspective of the changes that I believe are necessary in the Section 16 regulatory framework. At the outset, however, let me say that in my opinion, wholesale changes are not necessary. Instead, with a little fine-tuning, these rules could be simplified and improved significantly.

It is my understanding that some leading commentators in the area continue to criticize the need for two different definitions of "beneficial ownership" under Section 16. As you know, there are two definitions contained in the rules -- one for the purpose of determining who is a ten percent beneficial owner and the other more broadly applicable definition that is based upon pecuniary interest. The commentators suggest that only the pecuniary interest definition is needed. I disagree. Although there is validity in the argument that two definitions can be confusing, the statutory purpose of Section 16 does not lend itself easily to a single definition.

As all of you are aware, Section 16 was the original prophylactic against insider trading. By singling out ten percent beneficial owners along with officers and directors, it appears to me that Congress was focusing on the persons having some measure of control over the company such that ready access to material nonpublic information may be available to them. For a shareholder to have some measure of control over a company, that shareholder should have a significant voice through its ability to vote its shares contrary to management. Thus, when referring to the beneficial ownership of large shareholders for the purpose of determining insider status, Congress must have meant ownership of the voting power or the power to dispose of the stock, which could be used as a weapon against management. This view is in accord with the definition and purpose of Section 13(d) of the Exchange Act.

There is a concern that through the use of a Section 13(d) analysis, this definition subjects each member of a so-called "13(d) group" to Section 16, regardless of the size of their holdings. One response to this concern would be to permit group

filings under Section 16(a) on a single form. That would reduce the administrative headache somewhat. However, to reject a Section 13(d) control analysis because it is possible that an insignificant group member with no control may be ensnared in the Section 16 net is akin to throwing out the baby with the bathwater.

Another area of controversy is the breadth of the definition of "derivative security." There has been considerable interest from the corporate bar in excluding what are known as "cash-only" securities from the definition, and thereby excluding them from the purview of Section 16. While I am sensitive to the argument that cash-only securities, in limited circumstances, can present the same opportunity for abuse of material nonpublic information as other equity securities and that an exclusion for cash settled securities may have the unintended result of promoting cash-based compensation over the traditional equity-based compensation, I am persuaded on balance that it may be beneficial to simplify significantly the regulatory scheme by excluding cash-only securities. This exclusion, however, should be limited to compensatory arrangements.

The most popular call for change comes in the area of broad-based qualified plans such as a 401(k) plan. In particular, the safeguard contained in new Rule 16b-3(d), which effectively prevents an insider from purchasing issuer stock in a plan within six months of withdrawing or selling issuer stock in the plan, has come under sharp attack. While this provision was intended to prevent short-swing trading in a plan, I can see that it may complicate the rule unnecessarily, without providing any real protection for shareholders. Thus, I would be inclined to support the deletion of that requirement.

I am an advocate of reducing the length and complexity of Rule 16b-3. While I would leave intact the basic safeguards of disinterested administration, shareholder approval, and ten day window periods, I think there are a number of ways to reduce the verbiage and unnecessary requirements.

Although the idea is unlikely to be popular with this audience, I am inclined to support the retention of a shareholder approval requirement. While I do acknowledge that it can be costly to a company and that its prophylactic effect against insider trading does not remain free from doubt, such a requirement does further corporate democracy and provides a disinfectant effect as a result of the "sunshine" surrounding the shareholder approval process. This requirement appears to be very popular with shareholders and members of Congress, just as the ten day window trading period is popular with the corporate community, even though the prophylactic effect against insider trading presented by window periods is not free from doubt either. Lastly, as evidence of the popularity of a shareholder approval requirement, I note that the performance-based exemption contained in the new tax bill's $1 million salary cap contains a shareholder approval requirement.

Although I am inclined to support retention of the basic framework of new Rule 16b-3, there are provisions that could be deleted. For example, the tax code imposes transferability restrictions upon qualified options. This requirement has been contained in Rule 16b-3 for years as well. I question whether such a prohibition represents much of a safeguard against insider trading. In addition, the new regulatory framework adopted in 1991 has equated derivative securities with other forms of equity securities. It seems curious to me that a rule would permit the free transfer of stock received under a plan, but not an option. I fail to see what additional abuse opportunities are presented by employee options.

In addition, I think there is ample opportunity to simplify the exemption for stock appreciation rights. For one, I am of the opinion that tax withholding transactions should be exempt without regard to the timing of the election to exercise.

There are a number of other minor adjustments that could be accomplished to simplify the rules further, but I will spare you the details. Let me close out my

discussion of the new rules under Section 16 with a few observations. First, the new rules can be credited with restoring Section 16(a) compliance to acceptable levels. Secondly, the new derivative securities regulatory framework has yet to be challenged in court to my knowledge, even though some leading commentators expected plaintiffs to challenge the exercise exemption and expected the corporate bar to challenge the idea that a grant should equate to a purchase. Third, the alarm, which was expressed in the months following the adoption of the new rules, that the new rules would be an interpretive nightmare (as evidenced by a flurry of interpretive letters) thus far has proven to be unfounded.

In the past year or so, the number of Section 16 interpretive letters has dwindled to a trickle, far below the number of letters that were issued regularly under the old rules. Granted that some of the quiet is attributable to the fact that new Rule 16b-3 has yet to be phased-in, I am willing to speculate, nevertheless, that even after the amended rule is finally phased-in, the number of interpretive requests will remain lower than experienced under the old rules. I take this as a positive sign that the new rules are, in fact, clearer than the old rules. Therefore, other than the delayed phase-in of Rule 16b-3, I think that the new rules have been a success.

V. Executive Compensation

Changing gears to the executive compensation rules, the rules adopted last October also appear to be a success. A release issued in August proposed four significant changes, the most important, in my opinion, being the inclusion of executives that departed during the year.[8]

In my view, the original rules created a loophole of sorts in that shareholders were frustrated in their attempt to scrutinize "golden handshakes" bestowed upon departing executives. This disclosure can be very important to shareholders.

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[8] Release 33-7009 (August 6, 1993).

The comment period for these proposals expired yesterday. It is my understanding that the staff has received approximately a dozen comment letters. I would expect some sort of an adopting release to be issued before the end of the year in order that any changes would apply to the upcoming proxy season.

The August release further contained a review of the executive compensation disclosure contained in last year's proxies. In a Herculean effort, the staff reviewed approximately 1000 proxies to determine compliance with the new rules. The conclusion reached was that the disclosure reviewed was good overall, but the quality varied considerably. More specifically, the disclosure concerning the compensation committee was described as a positive first time effort. To me, this means that the compensation committee disclosure quality overall was spotty and that there exists plenty of room for improvement.

Without going into specifics, let me simply urge each member of this audience to comply with both the letter and the spirit of the executive compensation disclosure requirements. The single most important watch word for you in the upcoming proxy season should be "specificity." Be specific as to performance criteria. Be specific as to other bases used in determining compensation. Be specific as to why the CEO earned what he or she did. Hopefully, the August release will improve the compensation committee disclosure.

VI. Shareholder Proposals

Specificity has been elusive also in the area of what is "ordinary business" for purposes of Exchange Act Rule 14a-8, the shareholder proposal rule. This has been an area that has always sparked considerable controversy, as you well know.

I have always been of the view that employment related decisions, below the executive level, so long as they are legal, fall within the meaning of "ordinary business." Of course, the key word here is the term "legal."

However, I have been informed that Judge Wood has recently issued an order enjoining the Commission as a result of the issuance of the Cracker Barrel no-action letter. I understand that this order indicates that the Commission position in Cracker Barrel violated the Administrative Procedures Act ("APA") because such a position was entered into in a manner that is inconsistent with the Commission's 1976 interpretive release concerning shareholder proposals. Apparently, according to Judge Wood, the Commission could not adopt the Cracker Barrel position without following the notice and comment process set forth in the APA and changing the 1976 interpretive release. With all due respect, I am not sure that I see the logic of Judge Wood's reasoning. While adopted by the Commission, the 1976 interpretive release was not issued in accordance with the APA's notice and comment process. It does not make much sense to me to require that process to be followed when an interpretive release is changed. I do not see much of a distinction between an interpretive release adopted by the Commission and the Commission affirmation of a staff no-action position. It is illogical, at least to me, to say that the latter violates the APA but not the former.

There is no doubt though that in general, the rulings from the Commission and the staff in the shareholder proposal area do continue to produce confusion. While clarity and consistency would be nice, it may be difficult to achieve. The judgments in this area become very difficult and expose the Commission to substantial criticism. Nevertheless, now that a litigation outcome pattern is more definite, the Commission may attempt clarity and consistency in this area either through an interpretive release or a rulemaking project, or may attempt to withdraw from serving as a referee altogether with respect to these issues and to leave them for issuers, shareholders, states, and courts to decide. While the former approach is more responsible, the latter approach is easier and sidesteps the criticism so common in this area.

VII. Conclusion

Since my time has expired, let me wrap up. The issues discussed today are not new. All of us in this room have been confronting the problems with these rules, or the lack of rules, for years. While I am happy to report that, in my opinion, the Commission is on the road toward resolution of the remaining problems with respect to both Section 16 and the executive compensation disclosure rules, I fear that the road to resolution of the shareholder proposal problem is not yet on the map. Perhaps the present detour into federal court will show us the way. I will look forward to working with each of you as we collectively attempt to reach the appropriate destination in that area.