STock/Option Consulting & Knowledge Services, Inc.
Wheaton, Illinois

VIA ELECTRONIC MAIL [rule-comments@sec.gov]

February 14, 2015

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

Subject: Disclosure of Hedging by Employees, Officers and Directors, **File No. S7-01-15**, RIN3235-AL49

Dear Mr. Fields:

The Securities and Exchange Commission (SEC) is proposing amendments pursuant to Section 955 of the *Dodd-Frank Wall Street Reform and Consumer Protection*, (the "Act"), Sections 14, 23(a) and 36(a) of the Exchange Act, as amended, and Sections 6, 20(a) and 38 of the Investment Company Act, as amended. Specifically, proposed Item 407(i) would require disclosure of whether any employee or director of the company or any designee of such employee or director, is permitted to purchase any financial instruments (including but not limited to prepaid variable forward contracts, equity swaps, collars, and exchange funds) or otherwise engage in transactions that are designed to or have the effect of hedging or offsetting any decrease in the market value of equity securities, that are granted to the employee or director by the company as compensation, or held, directly or indirectly, by the employee or director.

We have approximately thirty-one years of direct experience in this area beginning with our inadvertent discovery of an incorrectly worded policy memo on hedging by the Procter & Gamble Company ("P&G") in 1985. The following from the P&G policy memo dated March 12, 1984 to Non-Director Officers of the Procter & Gamble Company, subject – Insider Liability and Reports Under the Federal Securities Laws (at p.4):

> *"Options Market – Trading in options for P&G stock in the so-called options market is not now available for Company officers. Amex is the only exchange carrying options in P&G stock and its rules prohibit participation by insiders of the company whose stock is involved in the option…. In addition, the Company is concerned that option trading, which inherently involves betting or hedging on movements of the Company's stock, could well appear questionable or unseemly in the eyes of shareholders. Accordingly, the Company requests that you refrain from all forms of transactions in the "options market", for your protection and that of the Company."*

Our goals in this Comment are twofold:

1. Present a heretofore unknown consideration on these issues and,
2. Suggest an alternative course of action on the issue of hedging and its disclosure.

Background

Corporations may employ any policies for their employees to follow as long as those policies are lawful, but in P&G's case it would have been helpful if the policies were also *truthful*, as no such rule was in existence at the Amex, prohibiting P&G insiders from such trading. The P&G Legal Department didn't want their executives using listed, exchange-traded options or LETOs, so they seized upon a nonexistent Amex rule to support their policy prohibition. Upon learning of the Amex clarification, P&G Legal admitted to being "baffled" by a rule that they had relied upon for a decade. On April 23, 1985, in response to this clarification from the Amex, P&G Legal also averred on the legality of such transactions:

> *"We readily agree that the SEC does not have specific restrictions prohibiting the kind of option trading we are here discussing."*

However, egregious this incident may seem, and many corporate insiders at P&G considered it so, the comment on the "unseemly" nature of trading in the "options market" is more indicative of how the corporate legal community has dealt with the issue of hedging and similar trading over the past thirty years or so. They simply *"threw the baby out with the bathwater"* in dealing with financial instruments, conservatively used, that might assist corporate insiders in actually holding on to positions in employer common stock, rather than in disposing of same. It might be time for corporate counsel to finally step into the…*20th Century.*

We make the above point because we believe that there is a *one-sided* predilection against the use of such financial instruments without fair consideration of the positive and conservative aspects of their usage, which actually promotes the ownership of employer common stock. We believe such bias exists to this day within the corporate legal community and within regulatory bodies. In large measure, it is due to a lack of complete understanding of the instruments and their usage. **We advocate only the conservative uses of LETOs, both puts and calls, in matters related, not only to corporate insiders, but to investors in general.**

Discussion

Under Section C, Note 11, [page 23] of the subject SEC proposed rule on the issue of hedging, the question is asked whether the amendments in question should define the term "hedge" and, if so, what concepts other than the statutory reference to "offset [ting] any decrease in the market value of equity securities" would be necessary to define this term?

From a practical standpoint, the hedge definition referenced above is accurate and adequate for purposes of the amendment as the term is also often used by publicly-traded corporations or PTCs that hedge aspects of their business operations, whether they are currencies or raw materials, which declines they are trying to offset by virtue of various types of futures contracts. In these cases, such direct offsetting is also measured by "hedge effectiveness" from a financial reporting standpoint, which would be an obvious stated goal.

From the first paragraph of the Introduction of the proposed rule, in referring to Section 14(j) where hedging is addressed in the company proxy by establishing whether insiders are…

> *"…permitted to **purchase** financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities…"*

…where we emphasize the term "purchase" in the above paragraph and contrast same to Section III-A. Transactions Subject to the Disclosure Requirement in the proposed rule, at page 11…

> *"Similarly, **selling** a security future establishes a position that increases in value as the value of the underlying equity security decreases, thereby establishing the downside price protection that is the essence of the transactions contemplated by Section 14(j)."*

…as we know of no security future where the **"selling"** of which would result in an increase in value as the value of the underlying equity decreases, which leads us to our first, very important, absolute, *clarifying* statement.

We are aware of only two types of security transactions by corporate insiders that are *pure* hedges in that they benefit directly from a decline in the underlying employer common stock security. They are the *short sale* of either employer common stock or LETOs on same, both of which would be in *opening* transactions where an account credit is established; or the purchase of a put option unaccompanied by a companion position in employer common stock that would result in an account debit. We refer to all other types of hedging-related security transactions as *combined transactions* or CTs, where either employer common stock is combined with a derivative security or derivatives on employer common stock are combined in a contractual instrument that includes employer common stock within its terms.

The legalities of such hedging issues are well-established. For insiders, both the short sale and a put purchase unaccompanied by employer common stock are prohibited by Section 16(c) of the Securities Act of 1934, i.e., (the "Act").[1] These two transactions are certainly also the legitimate purview of the employer corporation *in re* the insider transaction as it would be their common stock that would be harmed by any potential transaction. **Beyond that, all other transactions accomplished by an insider are the responsibility of the insider as established by both Section 16(b) of the Act[2] and also by Rule 10b-5[3] as to their possession of material non-public information at the onset of the transaction in question.**

Why is the above clarifying comment important? We believe that an important factor for consideration in this Comment is the arcane, multidisciplinary nature of this issue across tax, regulatory, investment, financial reporting and valuation areas that have prompted a *paradigm congestion*, for the lack of a better term, resulting in a lack of real progress in this governance area. There has been an intellectual indifference.

The Progression of Securities Laws and Financial Instruments from 1973 to the Present

The modern historical background for this discussion on hedging by corporate personnel dates to the beginning of listed, exchange-traded options or LETO trading on the Chicago Board of Options Exchange or CBOE in 1973; and also the end of fixed commission rates within the

[1] **U.S.C.** § **78p (c)** (1964) [hereinafter cited as § **16 (c)].**
[2] **U.S.C.** § **78p (b)** (1964) [hereinafter cited as § **16 (b)].**
[3] **17** C.F.R. § 240.10b-5 **(1978).**

brokerage industry in May of 1975, i.e., "May Day", with the latter also being the impetus for a further proliferation of financial instruments.

The introduction of LEAPS or Long-term Equity AnticiPation Securities in 1990 was important as it established an option contract with a life, at the inception of the contract, of greater than six months, thereby eliminating the legitimate concern on the part of corporate counsel about an inadvertent violation of the short-swing profit rule at the closing of the contract where standardized LETO contracts up to that point in time had contract lives less than six months.

On January 10, 1991, the SEC revised the rules under Section 16 which went into effect on May 1, 1991.[4] These May1, 1991 Changes to the Securities Act of 1934, in our opinion, were the most profound as it relates to the current state of corporate governance and the issue of hedging. The practical result of this SEC action was to remove the exercise of an employee stock option or ESO from the category of *matchable* events for purposes of the short-swing profit rule and instead classify same as a *reportable* event. In other words, an ESO exercise was no longer a *purchase* for purposes of Section 16(b).

With the Regulation T or Reg T changes in 1988, a corporate insider had the ability to affect a *same-day-sale* of an ESO position, i.e., exercise and immediate sale, without triggering the short-swing profit rule, as the sale of the underlying stock would not be matched against a purchase. From 1991 on, any corporate insider could sell as much employer common stock as he or she wished at any of the quarterly window periods. This also introduced a *riskless* security transaction for the insider who never really needed to *own* any employer common stock at all as the electronic ESO exercise notice to purchase took place, oftentimes, at the same broker-dealer that would sell the employer common stock on the open market. The result was the trend toward corporate artifices, i.e., governance, to require executives to hold employer common stock.

Current Corporate Insiders Governance Practices

The following governance machinations are in effect as they relate to ownership of employer common stock, generally by key executives and more specifically by named executive officers or NEOs whose names are a matter of record in the corporate proxy.

Stock/Option Vesting – NEOs and other employees generally vest in employer common stock, options and other forms of executive compensation over some timeline, ratably on an annual basis, i.e., graded vesting, or at the end of some stated period of time, i.e., cliff vesting.

Window periods – generally, corporate insiders may only trade in employer securities during a period of time after the release of earnings on a quarterly basis.

Pre-Clearance Procedures – as a result of the *Insider Trading and Securities Fraud Enforcement Act* of 1988 (ITSFEA), insiders and board members must process their transactions in employer securities through a designated individual to assure compliance with the securities laws.

[4] **See Rel.34-28869, 56 Fed. Reg. 7242 (Feb. 21, 1991).**

Ownership Guidelines – NEOs, more often than not, are required to maintain an ongoing position in employer common stock as a multiple of their base pay, i.e., five times or so for CEOs and a lesser multiple for the other NEOs. So, this amount of employer stock then may not be sold while they maintain that position.

Hold 'Til Retirement Provisions – as stated, there are recent attempts to have NEOs maintain as much as 75% of their employer common stock positions until they reach the age of retirement. This may even extend to retroactive grants of employer stock and options.

Exercise Restrictions – often NEOs and other key executives may not sell stock acquired via employee stock options or ESO exercise until the passage of some time period.

Clawback Provisions – as the name implies, NEOs may find themselves and their compensation subject to *recoupment*, should there be allegations that they acted inappropriately in their financial reporting responsibilities.

And, of course, there are also hedging restrictions that are the subject of this discussion. What we have then is an emerging, *paradigm congestion*; with all of the above variables working together to potentially manifest what can only be described as *unintended consequences*.

Robinson v. U.S [2003][5]

With the above restrictions in mind, the reader should ask a simple question. Does the insider executive holding employer common stock subject to the above restrictions have the same thing, from a valuation standpoint, as a non-insider, employee holding the same employer common stock absent those restrictions? Is there a very real presence of a *lack of marketability* or LOM discount that should be applied to the value of employer common stock and ESOs due to the above restrictions? Will the issue simply be dismissed as a matter of intellectual indifference?

The above query is not a new one but it is one that has been easily dismissed by its antagonists. That may change with *Robinson* which is actually an Internal Revenue Code §83, *Property Transferred for the Performance of Services*, issue, that has, as one of its stipulations that employees have the responsibility for the filing of their individual tax returns and not their employer corporation, which has some significance when it comes to the value established upon the vesting of employer common stock, i.e., an item usually present on the employer's Form W-2. Why would an employee take issue with the dollar value of stock received from an employer? The obvious answer is because they have to pay tax on that value. This is now a compensatory issue at least in the Federal Circuit that could result in the filing of amended individual tax returns, placing corporate insiders at odds with their employers.

Conclusion

Many years ago, and maybe even today, the U.S. Army practiced *preventive maintenance*. They fixed things that were in danger of breaking before they were broken because they couldn't allow materiel critical to a mission to fail at the wrong time. We have a governance and regulatory

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[5] *James G. Robinson, et ux. v. Commissioner*, 335 F.3d 1365 (Fed. Cir. 2003), No. 01-102T, Tax Analysts Doc. No. 2002-15273, 2002 TNT 126-10

maelstrom currently manifesting itself on the issue of hedging that diminishes, in the minds of many, the value of employer common stock and ESOs.

Our **first recommendation** then is to minimize governance as much as possible and from a hedging, and disclosure, standpoint that would mean relegating any hedging policy, and specific discussion, to those issues that are clearly ***illegal***, i.e., short-sale provisions and put purchases under Section 16(c).

In addition, *ownership guidelines*, *exercise restrictions* and *clawback and hold 'til retirement provisions* should be reexamined in light of the hedging policy, as the inability to hedge has a direct effect on the value of the ownership position of the corporate insider, as discussed above.

Our **second recommendation** suggests that governance policies place the corporate insider at an unfair advantage. Corporate counsel is clearly conflicted on these issues. Who speaks for the corporate insider? For the lack of a better term, a Corporate Insider-Trading Transaction Trustee or CITT should be instituted, whose duty it is to manage the tax, regulatory, investment and governance matters related to employer stock/option transactions for the corporate insider in a near-fiduciary capacity, without undue influence from any party, including the insiders themselves, save quarterly meetings during window periods. The CITT, as an intermediary, would remove the corporate insider from the decision-making, and the scrutiny, on the above matters, save those that were the personal, legal responsibility of the executive.

The issue going forward is whether the corporate legal community, the executive compensation consulting complex and regulators continue to be *reactive* on these matters or adopt a more *proactive* stance.

We very much appreciate the opportunity to provide insight on this very important issue.

Best Regards,

Timothy R. Wing, MST
President & CEO
STock/Option Consulting & Knowledge Services, Inc.
Warrenville, Illinois
[redacted]
b: [redacted]
c: [redacted]

http://ssrn.com/author=1991087

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