Background:

The Securities and Exchange Commission has solicited public comments on rule amendments to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which adds new Section 14(j) to the Securities Exchange Act of 1934. Section 14(j) directs the commission to require companies to disclose whether employees 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 value of equity securities either (1) granted to the employee or director by the issuer as part of the compensation of the employee or director, or (2) held, directly or indirectly by the employee or director.

Comments:

I fully support the proposed amendment and am writing to offer a few suggestions on its formulation and enforcement. Currently, companies are required to disclose detailed information about executive and director compensation because investors and the public have a legitimate interest in corporate transparency. Financial hedges should be an important part of this disclosure system, because they can allow employees to offset their risk exposure and effectively pocket a risk-free return. If this is not disclosed to the public, then companies can give the misleading impression that the interests of employees are aligned with shareholders when in fact they are not.

The public notice points out that the rule should be sufficiently principles-based to avoid the possibility that issuers follow the letter of the rule while violating its spirit. In particular, the Commission requests comments on the proper definition of "equity security" for the purposes of the rule.

I believe that an expansive definition of "equity security" is required. This expansive definition would include not only equity securities for the company in question, but also those of parents and subsidiaries, including relationships with majority control and ownership and not just full ownership. Including this language in the rule is critical, because the multi-layer subsidiary form has become much more common in recent years and such complexity is directly connected to corporate malfeasance (Pretchel and Morris 2010). It is precisely those employees and directors that receive equity securities from the parent company or subsidiaries that may be most tempted (or inclined) to engage in hedging that shareholders and the public would find most questionable. Of course, this rule will not prevent all Enron-like fraud, but taking into account the complex legal structure of contemporary corporations will perhaps deter some dubious practices.

The definition of "equity security" should also not be limited to those registered under Exchange Act Section 12 or securities that trade in an established public market. Companies may have legitimate reasons for compensating employees with equity securities other than those of a company's listed common stock, but if anything such practices deserve additional scrutiny rather than protection from disclosure. Companies that are particularly dependent upon capital – that is, dependent upon the investing public for financing – are most likely to have opportunistic management that seeks to extract resources from the company (Boies and Prechel 2002). The practice of compensating employees with obscure, unlisted equity securities is one possible mechanism for rent extraction, and so shareholders and the public have a right to know whether employees can hedge these exotic instruments. Accordingly, the concept of "hedge" should be expanded beyond the statutory reference to "offsetting any decrease in the *market value* of equity securities (emphasis added)" to include valuations for securities that are illiquid or not traded at all. The Commission should use its discretion to include "fair value" if market price is unavailable and apply the standard valuation procedures for such securities.

In summary, I support the proposed rule and believe that it should be structured to provide investors and the public a comprehensive and accurate account of company hedging policies for employees. At an estimated three hours per year for the first three years, the cost of compliance is quite low, and I do not believe that my suggestions would entail significantly greater compliance costs.

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References:

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Pretchel, Harland, and Theresa Morris. 2010. "The Effects of Organizational and Political Embeddedness on Financial Malfeasance in the Largest U.S. Corporations: Dependence, Incentives, and Opportunities." *American Sociological Review* 75:331-354.