Clinton Carlisle

University of Colorado Law Student

[redacted]

April 20, 2015

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

Re: Proposed Amendments to Item 402 of Regulation S-K Regarding Disclosure of Hedging, **File No. S7-01-15**

Dear Mr. Fields:

I write to suggest changes to the amendment regarding disclosure of hedging by employees, officers, and directors (the "EODs"). In my capacity both as an investor and a future attorney in the securities law sector, my suggestion is this: in order to effectively discourage hedging activities and produce the best net effect to the investor/shareholder, the issuer should report whether the EODs *are in fact* hedging, rather than if the issuer simply allows or restricts hedging. However, this requirement should only extend to officers and directors, because the hindrances on the corporation to report hedging activities for employees are too significant in cost, in that collecting data on the employee's investment activities can be extremely costly for large corporations, where the cost will be passed on to the consumer. At the officer and director level, the cost is outweighed by the information which is provided to the investor. With the currently proposed regulation, shareholders and prospective investors may know the issuer's policy on hedging, but they are not assured that the insiders are in fact following the hedging policy. In the case of current shareholders, it would allow the shareholder assurance that no officer or director is hedging, and if they are, that the shareholders have powers granted to them under general corporate law, such as the power to vote the hedging director off of the board, or to pressure the board to review the officer's conduct. This ensures the shareholder and the prospective investor that the officer or director's interests are aligned with those of the shareholder, as well as that the equity incentive plan adopted by the issuer is being effected as it was intended upon adoption. If insiders are allowed to hedge their equity holdings in the issuer, it decreases the alignment of incentives between the insider and the shareholder. A reasonable shareholder would want to know if an insider is not bearing the full downside of the risk of a drop in stock price, which could indicate the use of inside information, or the insider's general belief that the issuer's stock is not as valuable as the market believes it to be. Additionally, it decreases the effectiveness of any equity incentive programs adopted by the issuers in order to promote these incentives. The meaningful points of this will be discussed further in Part II. I also briefly suggest implementing a delayed implementation schedule for smaller reporting companies and emerging growth companies that have not been required to consider this issue previously.

For this disclosure, I also suggest that the SEC define "hedging" activities in this provision through the use of an "of the same kind" definition style, with one notable exception, discussed in Part III. By including in the definition of "hedging" the three most common instruments that are used by corporate insiders, as well as leaving the broad definition that requires the reporting of all instruments that create the same effect, the regulation can more sufficiently guide disclosure to suit the market. I discuss this further in Part III.

Additionally, I suggest that the disclosure also be required in the annual report, to capture those smaller reporting and emerging growth companies which are currently reporting, but are not holding an annual meeting for one reason or another, and therefore not drafting a proxy statement on Schedule 14A or information statement on Schedule 14C. For those companies that are releasing a proxy or information statement annually, they could simply include the required disclosure by reference to the proxy or information statement filed within 120 number of days, such as currently allowed for Part III information for an issuer's annual report.

Part I – The Issue with the Proposed Regulation

In forming my opinion, I have assumed, both from my knowledge of the general aim of the SEC, as well as from the Proposed Rule Release, that the reasoning and effect behind the proposed rule is one of two things depending on the audience:

In the case of the prospective investor:

1. That the investor will be informed to the extent that they can adjust the valuation of the share price of the issuer, and therefore;

2. That the investor will discount those issuers' shares where it knows that the issuer allows hedging by EODs;

3. That as a result of the discount, issuers will be incentivized to restrict hedging activities by EODs in order to keep a high stock price and increase the financing ability of the issuer, and therefore the investor will be best protected by having EODs aligned with their interests.

OR, in the case of current shareholders,

1. That the shareholder will be informed to the extent that they can choose the directors who will theoretically best serve their interests; and

2. That directors who hedge against the issuer's share are not aligned with the shareholders' interest to the same extent as those directors who do not;

3. That as a result of this, directors will be inclined to restrict hedging for themselves and others in order to make themselves more attractive to shareholders, and therefore the shareholders will be best protected by having a board that is more aligned with their interests.

Both of these protect the consumer in terms of information available and aligning the interest of the leaders of the corporation with that of the shareholders and investor.

The basic theory of my comment is that requiring the disclosure of the issuer's policy towards hedging by its EODs will not have the intended effect for multiple reasons:

1. **Limited Disclosure Requirements.** §229.402 (b)(xiii) of Regulation S-K already requires that non-exempt issuers disclose the issuer's policies regarding hedging the economic risk of ownership for named executive officers, which currently results in such a broad disclosure that investors do not know the extent of the restriction without additional research, and there is nothing in this proposal that will elicit any different result;

2. **Limited Effect of Hedging Disclosures.** Investors may not discount the issuer's stock on the basis that "hedging" is "restricted." Because of the thin requirement in the proposed regulation, as well as the requirement already present in 402(b) which only requires a short sentence on the hedging policies, it is likely often overlooked by the investor unless they are engaged in diligent research, and therefore the investor does not meaningfully react to the hedging disclosure;

3. **Limited Recourse for shareholders.** In order for a shareholder to effectively pursue a remedy based on false and misleading statements or based on general corporate law, the shareholder must have access to sufficient information to formulate a cause of action. Because the disclosure requirements are limited, the shareholder is not likely to have the amount of information needed easily available to him. For instance, the new proposed regulation does not require that issuers disclose to shareholders whether insiders are obeying the policy disclosed in the proxy statement, only what their policy is.

Because my opinion is that the proposed regulation would not have the intended effect of protecting and informing shareholders and investors, I would like to expand the regulation in order to provide more tangible benefits to current shareholders and prospective investors. I'd like to discuss each of these reasons in more detail below.

Reason #1: Limited Disclosure Requirements

My first and most important reason rests on an analysis that §229.402(b)(xiii) of Regulation S-K has had a limited effect on the current disclosures by companies that are affected by that rule. I note that the proposed regulation will extend the requirement to disclose the issuer's policy on hedging by EODs to smaller reporting and emerging growth companies, as well as provide additional clarifications to the existing requirements. For this I am in agreement. However, the current disclosures required under §229.402(b)(xii) of Reg. S-K are so menial that unless the prospective investor or current shareholder is looking for them specifically, I propose that it is being overlooked by a sizable portion of the interested parties. For example, in the table below are some of the most recent disclosures that purportedly comply with §229.402(b)(xiii), which, according to my research, appear to accurately reflect the amount of disclosure common in similar large-cap companies:

	Company Name	Number of Times "Hedging" is Mentioned	Total Pages	Citation
	Starbucks Corporation	3	61	Definitive Proxy Statement on Schedule 14A filed on January 1, 2015.
First, located where required	"**Anti-Hedging Policy** . . . In November 2010, the board of directors amended our Insider Trading Policy to prohibit Starbucks partners from engaging in hedging transactions designed to offset decreases in the market value of Starbucks securities, including certain forms of hedging and monetization transactions, such as 'zero-cost collars' and 'prepaid variable forward contracts.'"			
Second	"What We Do . . . Prohibit partners from engaging in hedging transactions in Starbucks stock or pledging Starbucks stock"			
Third	"[O]ur executive compensation program includes . . . [p]rohibition on hedging and pledging Company stock that applies to all partners"			
	Hewlett-Packard Company	3	96	Definitive Proxy Statement on Schedule 14A filed on February 2, 2015.
First, as required	"Alignment With Stockholders . . . We ***prohibit*** executive officers and directors from engaging in any form of ***hedging*** transaction, and with limited exceptions [none in 2014], from holding HP securities in margin accounts and ***pledging*** as collateral for loans"			
Second	"The HRC Committee has adopted a policy prohibiting our executive officers from engaging in any form of hedging transaction (derivatives, equity swaps, forwards, etc.) including, among other things, short sales and transactions involving publicly-traded options. In addition, with limited exceptions, our executive officers are prohibited from holding HP securities in margin accounts and from pledging HP securities as collateral for loans."			
Third	Same as primary			
	Apple Inc.	2	68	Definitive Proxy Statement on Schedule 14A filed on January 22, 2015.

First, as required	"**Prohibition on Hedging and Short Sales.** The Company prohibits short sales and transactions in derivatives of Company securities, including hedging transactions, for all directors and officers of the Company."			
Second	"What We Don't Do . . . Permit short sales and transactions in derivatives of Company securities, including hedging transactions"			
	The Walt Disney Company	1	67	Definitive Proxy Statement on Schedule 14A filed on January 16, 2015.*
First, located where required	"No Hedging or Pledging. Named executive officers (and other employees subject to the Company's insider trading compliance program) are not permitted to enter into any transaction designed to hedge, or having the effect of hedging, the economic risk of owning the Company's securities and they are prohibited from pledging Company securities."			

*DEFA14A filed on February 11, 2015, which does not disclose any material changes or additions regarding the Company's hedging policy.

In addition to the interested parties that are not seeing the current disclosure, I propose that there is also a group of investors and shareholders, especially those who are non-sophisticated parties, that do not understand what the implications of a "no hedging" policy really are. If my suggestion is implemented, it will solve this by allowing investors and shareholders the security that the company has actively engaged in research about whether their officers and directors are engaged in hedging activities, rather than simply assuming that these individuals are following the company Policy.

Perhaps more interesting, a study by Bettis, Bizjak, and Kalpathy (2013) entitled "Why Do Insiders Hedge Their Ownership? An Empirical Examination" analyzes reports of issuer's hedging policies between the years 1996-2006, after §229.402(b)(xiii) of Regulation S-K became effective. Prior to 2006, the study only found an average of one firm a year that reported that they banned the use of hedging instruments. Following the adoption of §229.402(b)(xiii), the study was able to identify 151 firms having formal policies banning hedging transactions that were reported in proxy statements. In all the formal policies identified during the term of the study, 72% had complete bans, about 4% allowed hedging transactions with board approval, and about 24% had partial bans. However, not all insiders were treated the same under these bans. Only 24% of firms banned all employees from using hedging activities, only 15% banned all executives and directors, and 30% banned only executives. Therefore, what a company means by "banning" hedging transactions can vary significantly across firms. If not all hedging bans across issuers are uniform, how could an individual reading a short one sentence in a proxy statement hope to understand the implications?

The proposed requirement only adds to §229.402(b)(xiii) of Regulation S-K a broader disclosure requirement that encompasses smaller companies, as well as employees and directors who are were not otherwise named executive officers. Without anything more substantive, the limited requirement will not produce the fully desired effect and should be revised if the desired effects are to be achieved.

I've located two examples in order to illustrate the problem:

Company Name	Citation
Greatbatch, Inc.	Definitive Proxy Statement on Schedule 14A filed on April 13, 2015.
"The Company considers it improper and inappropriate for any director, executive officer or associate to engage in short-term or speculative transactions involving our Common Stock. We therefore prohibit directors, executive officers and other associates from engaging in pledging, short sales or other short-position transactions in our Common Stock. We also strongly discourage directors, executive officers and other associates from engaging in certain forms of hedging or monetization transactions, such as zero-cost collars and forward sale contracts, that allow a person to continue to own the covered securities but without the full risks and rewards of ownership. Any director or executive	

officer wishing to enter into such a hedging arrangement must first pre-clear the proposed transaction with the Company's Chief Financial Officer or General Counsel."	
Radian Group Inc.	Definitive Proxy Statement on Schedule 14A filed on April 10, 2015.
"Our Code of Conduct and Ethics specifically prohibits engaging in certain speculative transactions in Radian securities, including short sales and buying or selling puts or calls of Radian securities. In addition, we strongly discourage any other form of hedging or monetization transactions that would allow an employee or director to own securities without the full risks and rewards of ownership. Accordingly, any person wishing to enter into such an arrangement must first pre-clear the proposed transaction with both our General Counsel and Chief Financial Officer. No such transactions were pre-cleared during 2014."	

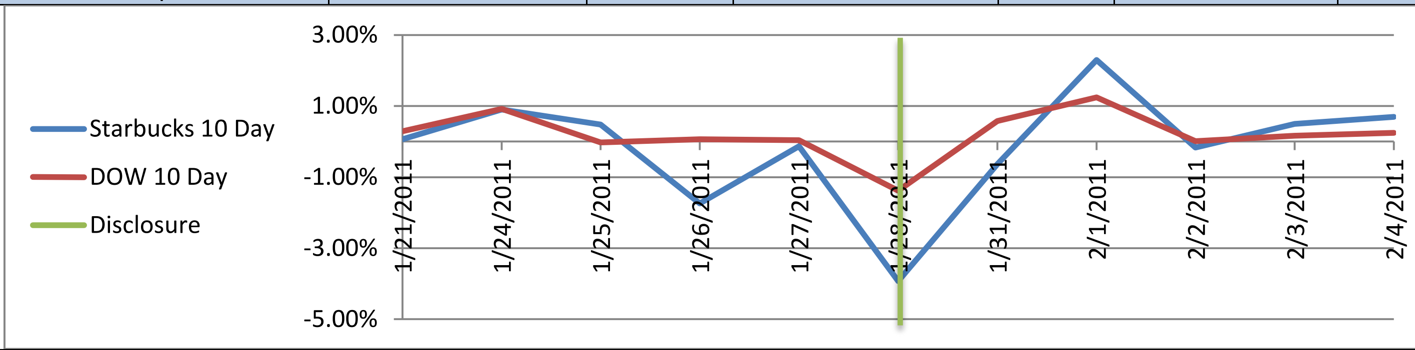
Both of the above policies are substantially similar in that they prohibit short sales of stock, while still allowing certain other types of hedging activities. While both issuers seemingly offer the same type of protection to shareholders, the last sentence of Radian Group's disclosure, "[n]o such transactions were pre-cleared during 2014," offers a distinct advantage in information to the shareholders and potential investors. To find out the same information about Greatbatch insiders, shareholders would have to review 72 Form 4s that were filed during Greatbatch's fiscal year 2014 alone. Even if the shareholder were to undertake this task, it is quite possible that they would overlook a hedging transaction because of the limited and often obscure disclosures on Form 4s. Radian Group's final sentence is substantially similar to what I am advocating in this paper, and I hope that this illustration helps to clarify the usefulness of that sentence. Instead of relying on the ambiguity of the issuer's hedging policy, requiring issuers to disclose what insiders ultimately did will help to better inform shareholders and potential investors of insider's hedging transactions.

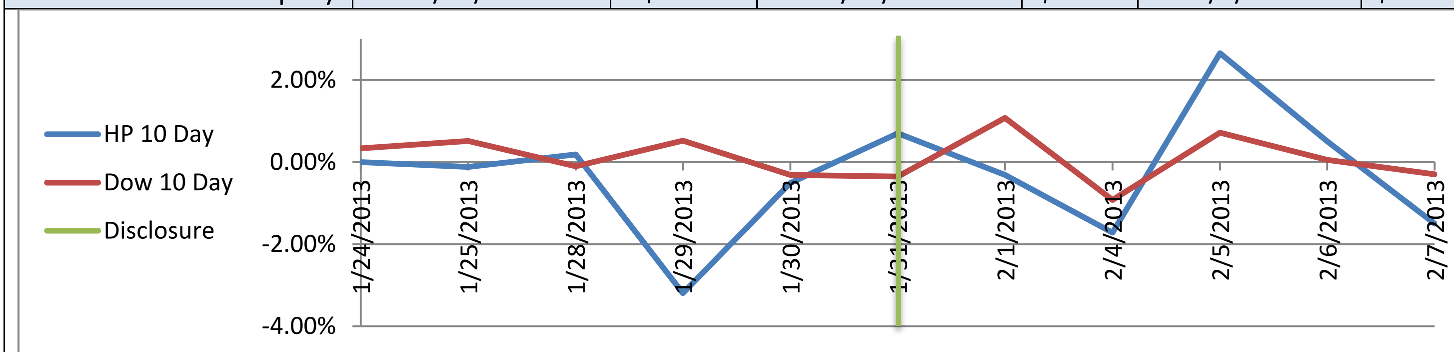
Reason #2: Limited Effect of Hedging Disclosures, as Illustrated by Issuer Share Price

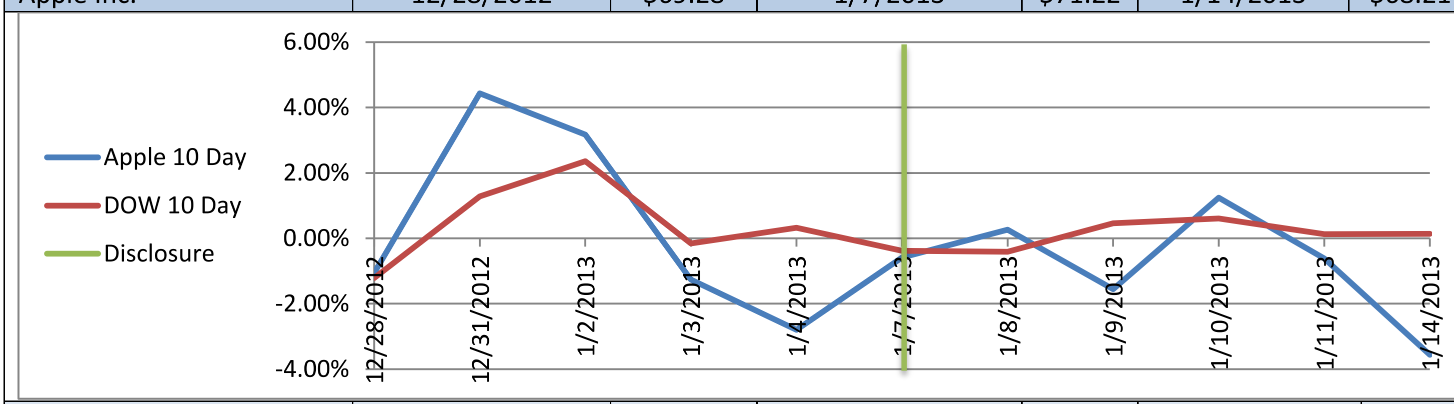
Because the regulatory requirement of disclosure under §229.402(b)(xii) of Reg. S-K is so limited, as discussed in the previous section, the disclosures have been limited as a result. One would expect that upon disclosure of the issuer's initial hedging restriction the stock price would react. However, as illustrated below, there is no predictable change in stock price value as a result of this first disclosure of the policy. This can be shown with empirical data represented by those companies currently required to report their hedging policies under §229.402(b)(xiii) of Regulation S-K and their common stock price five trading days before the issuer disclosed their policy on hedging and five trading days after they disclosed their policy. I have chosen to use these same four large-cap companies as in the previous section, because large-cap companies, in theory, have the largest number of potential investors and shareholders, and therefore most fully reflect the efficient market hypothesis. Due to the larger number of potential investors and shareholders analyzing disclosures of these issuers, the greatest number of individuals are available to recognize the additional disclosure and respond by buying or selling shares of the issuer's common stock, which will result in a shift in the price of the common stock, presuming there is enough trading activity. In addition, I have chosen to review share price information for common stock rather than other forms of equity securities, because common stock is likely to have the greatest liquidity across issuers. In addition, common stock is most likely to suffer from short term changes related to disclosures in the issuer's SEC filings.

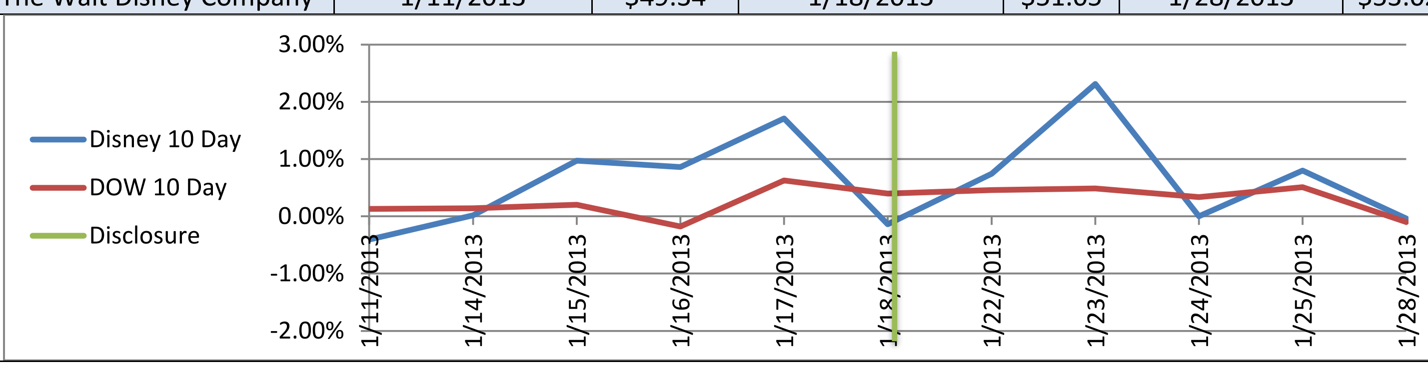
Graphs below show an illustration of change in share price data for the five trading days before the §229.402 disclosure that the EODs are not permitted to hedge, and 5 trading days after. The graphs plot the percent increase/decrease in share price per day during the period, as compared to the previous day. Each is graphed along with the DOW Industrial Average at the time of the disclosure in order to help visually discount share price changes as a result of overall market change. Because there are no large-cap companies that have self-reported that they allow their EODs to engage in hedging activities and then have a subsequent report that they *do not* allow their EODs to engage in those same hedging activities, an analysis of share prices before and after such change in policy is not available.

	5 Days Before Date	Price (1)	First DEF14A Disclosure Date	Price	5 Days After Date	Price
Starbucks Corporation	1/21/2011	$31.22	1/28/2011	$29.84	2/4/2011	$30.64
Hewlett-Packard Company	1/24/2013	$16.24	1/31/2013	$15.76	2/7/2013	$15.69
Apple Inc.	12/28/2012	$69.28	1/7/2013	$71.22	1/14/2013	$68.21
The Walt Disney Company	1/11/2013	$49.34	1/18/2013	$51.05	1/28/2013	$53.02









(1) All prices are based on closing price on selected date, adjusted for dividends and stock splits, provided by Yahoo finance

The graphs above are produced by measuring the difference in stock price from one day compared to the previous day as a percent increase or decrease in price. For example, Company A on day 1 had a stock price of $20. On day 2, Company A had a stock price of $21. This would result in a point of data located on day 2 of 5%. If Day 3's stock price is then $18.90, then it would result in a data point on day 3 of -10%, and so on. Note that an upward slope in the stock price does not indicate a rise in share price if both points of data are both below 0.00%, only those points of data above 0.00% reflect an increase in share price from the previous day.

After reviewing this data, I conclude that in large cap companies the additional disclosure that the EODs are restricted by the issuer from engaging in hedging activities does not produce a predictable rise in the share price of the issuer's common stock. However, I want to add a strong caveat that my graphs above are NOT an event study. I have taken no steps to neutralize external factors that may be causing a rise or fall in stock price. On a proxy statement, there are many things disclosed which indeed often produce a shift in stock price. However, I do believe that a rough sketch, as presented above, is still helpful in viewing the possible implications of past disclosures by companies on their proxy statement. I suggest that the lack of a predictable rise in share price as a result of first disclosure of a "no hedging" policy is due to one or more of three contributors:

1. That the potential investors or shareholders don't care whether the issuer's EODs are hedging;
    a. If this is the case, there is no reason to require the issuer to bear this additional cost to report on their current hedging policy. While this may be the case for some potential investors or shareholders, it is unlikely to be the sentiment of the majority of interested parties, and therefore I do not attempt to resolve this potential contributor.

2. That the potential investors or shareholders do not understand the implications of a restriction on hedging activities; or
    a. If this is the case, additional measures need to be taken to solve this issue beyond the currently proposed amendments. My proposed regulation, discussed in greater detail in part II, attempts to solve this issue by requiring issuers to specifically outline the hedging activities that officers and directors are currently, or have been in the past fiscal year, engaged in.

3. That the potential investors or shareholders already assumed that the EODs were not engaged in hedging activities.
    a. If this is the case, then shareholders should certainly have the information regarding recent insider hedging transactions made more greatly available to them through a regulation such as my own. Then, if insiders were engaged in hedging activities, the shareholders can pursue corporate remedies that they would not have otherwise pursued by assuming that the insiders were not engaged in hedging.

4. That there isn't enough information in the disclosure for investors to really take a vested interest in the issue.
    a. This will also be solved by my proposed regulation. With the added information of insiders actual hedging activities during the issuer's fiscal year, shareholders and potential investors are more likely to take an interest in the information, especially if it reveals that insiders have engaged in hedging transactions.

Reason #3: Limited Recourse for Shareholders

Assuming that shareholders have a private cause of action, either under state or federal law, the currently proposed regulation gives them a very limited circumstance in which this may occur. Because disclosures are so limited under the currently proposed regulation, there is only a small amount of information that could be classified as “false or misleading”, and it is difficult for shareholders to have anything substantive to file a claim about. Because issuers often do not have a copy of their code of ethics or their insider trading policy available to shareholders via EDGAR, shareholders cannot easily investigate the truth of the claimed hedging policy. Additionally, the SEC does not have the time or resources to investigate every disclosure relating to hedging on proxy statements. Therefore, there is relatively low risk for non-compliance with the proposed regulation (meaning that either issuers falsely report their own hedging policy, or that insiders ignore the hedging policy of the issuer and the issuer does nothing about it). With the addition of my proposed regulation, shareholders will more freely be able to locate the information pertaining to previous hedging. This benefits shareholders in two ways:

1. That they now are kept more easily abreast of previously engaged hedging activities by officers and directors;

2. That they have additional information regarding hedging disclosed in a proxy statement and/or annual report that they can declare is false or misleading, if reported incorrectly.

Additionally, the added information will allow shareholders to pursue other remedies afforded to them under general corporate law, such as voting rights and breach of fiduciary duty claims. In pursuing a fiduciary duty, there are even greater hurdles. Not only are the shareholders at a disadvantage due to ownership of far fewer details of the hedging transaction prior to litigation discovery, but shareholders also must jump through further hoops to bring a breach of fiduciary duty claim. This type of claim is necessarily derivative, and therefore would need to be submitted to the corporation (unless this was shown to be futile), and the validity of the claim judged by a special committee of the corporation. Courts usually defer to the decision of these special committees if they decide not to pursue the claim, as long as the committee is independent and considered the matter appropriately. An insider engaging in a hedging transaction may be declared by a court to be a breach of the fiduciary duty of loyalty. For example:

> A director has a large block of common stock that he directly owns and controls. This director, believing the corporation’s stock to be overvalued, decides to enter into a prepaid variable forward contract for a significant portion of his shares. He reports this on a Form 4 in table 2, as required, and gives substantial details of the transaction so that it is easily interpreted by shareholders. Several major shareholders see this, and believing that he is acting on inside information on the transaction, sell their shares of stock, flooding the market and reducing the share price of the issuer’s common stock. Harm results to the issuer in the reduced share price. The insider has engaged in a transaction that was inherently self-interested, and therefore a court may find that he breached his duty of loyalty to the shareholders.

While this may seem like an extreme example, it certainly is possible. Furthermore, the most unlikely part of this, in my opinion, is that the insider would disclose the details of his transaction so explicitly on a Form 4. Without the detailed information in the Form 4, insiders would be less aware of the terms of the contract, and may not have the information to recognize this as a self-dealing transaction and pursue a breach of fiduciary duty claim. While my proposed regulation does not go so far as requiring detailed information to be disclosed on the proxy statement of every hedging transaction, it does require that the issuer declares whether these transactions occurred. This spurs the conversation between shareholders and insiders, and may result in greater information availability and therefore the availability of corporate remedies to shareholders for insider injustice.

Part II: Proposal #1 – 'In Fact' Hedging Disclosure

As previously discussed, the solution that I am proposing is to require companies to disclose on their proxy statements and on Form 10-K whether officers and directors are in fact hedging, rather than simply requiring them to state whether they are allowed to hedge.

I note that the SEC has previously required reporting on derivative securities trading by insiders on Forms 3, 4 and 5 on table 2. *However*, research which studies the bulk of hedging transaction in the past decade reveals that this varies greatly across disclosures: from specific details to only generic references. Indeed, the reference is always included in table 2 of the form with the details, albeit usually limited, in the footnotes to the filings. [1]

The reasons that I propose this change are threefold:

1. That the requirement that the issuer disclose whether the EODs are in fact hedging builds on the already existing requirement to disclose hedging transactions on a Form 3, 4, or 5;

2. That the proposed disclosure will make the transactions more public, and will lead to less obfuscation by insiders because it will be seen and scrutinized by a larger audience of shareholders and potential investors; and

3. That 17 CFR 240.14a-9 provides the SEC a cause of action for false and misleading statements in proxy statements, as well as an implied cause of action for individual shareholders under *J.I. Case Co. v. Borak*[2]. Additionally, a large portion of states provide a private cause of action for false and misleading statements in filings with the Commission.

In order to best take advantage of the three above stated advantages, I propose that the issuer should restate the details of the hedging transaction with the associated insider within the proxy statement or 10-K.

Additionally, those issuers which have a policy against hedging will only have a very marginal burden on them by the necessity to place the extra sentence: "none of our officers or directors have engaged in any hedging activities as defined in [my proposed definition as discussed in Part III] during the previous fiscal year."

Bettis, Bizjak, and Kalpathy's 2013 study discussed earlier also reviews 2,042 unique derivative transactions between 1996 and 2006 by utilizing an aggregation of these disclosures created by Primark/Disclosure (now part of Thomson Reuters), in addition to their own results produced through keyword searches of Forms 3, 4, and 5. After analyzing the data, one of their primary conclusions is that because these instruments are less transparent than open market sales, and provide similar protection against downward trends in the stock price, these derivative instruments are more often used at firms where there is a greater risk of shareholder litigation and greater analyst coverage. The study suggests that this is because the insiders are attempting to hide the transaction from shareholders, and therefore avoid shareholder litigation. This could be explained in several ways:

1. That these issuers are inherently bad firms, and they are more likely to be engaged in wrongdoings at the officer and director level, resulting in increased hedging and higher chance of shareholder litigation;

[1] Insider' Use of Hedging Instruments – Bettis, Bizjak, Kalpathy 2013
[2] J. I. Case Co. v. Borak, 377 U.S. 426, 84 S. Ct. 1555, 12 L. Ed. 2d 423 (1964)

2. That the hedging is because of the impending shareholder litigation, as a result of the insiders attempted to reduce their personal risk associated with the lawsuit;

3. That hedging is simply a way to hide the transaction from shareholders, thereby reducing the likelihood that it is called to the attention of shareholders and reducing the overall likelihood of shareholder litigation.
   a. In my opinion, this is likely the most prevalent explanation, and the explanation that I am trying to fix in my proposal.

If my proposal was to be implemented, it would help to decrease the incentive to hide insider reductions in risk taking in two ways:

1. As previously mentioned, by requiring the disclosure to be present on 14A, 14C, and 10-Ks, it brings the disclosure to the attention of more potential investors, current shareholders, and analysts. Ideally, the disclosure would be revised to more directly explain the derivative transaction. However, I have not tackled how this would be accomplished through regulation in this paper, although I recognize that this would be a positive compliment to my proposal. By bringing this to the attention of these additional groups, it detracts from the incentive to engage in these derivative transactions as a viable alternative to open market sales, because they will be more present in disclosures to shareholders. By bringing the disclosure of hedging transactions that were effected in the issuer's previous fiscal year to a wider audience, it again increases the risk of derivative shareholder litigation.

2. By requiring the disclosure of hedging transactions in the issuer's previous fiscal year, it will bring these specific transactions to the attention of a greater number of sophisticated investors. As a result, it increases the likelihood that analysts will review the transactions and realize any correlations to downward trends in share price following the hedging transaction. If there is a trend, these sophisticated investors will be more likely to follow that issuer's ownership reports on Forms 3, 4, and 5, and when an insider engages in a hedging transaction at any time during the year the investor will be more likely to recognize the possibility of a downward trend and recommend sale of the stock, resulting in a more accurate stock price. While this will not directly degrade the incentive to engage in these transactions, it would potentially do so indirectly. By providing a more accurate downward trend in the share price after insiders engage in these transactions via increased coverage, it may also increase the risk of derivative shareholder litigation, and therefore incentivize insiders not to hedge their ownership as a result of the increased potential for liability to the corporation. This is because the downward trend in the stock price could more directly be linked to the insider's hedging of the issuer's stock, and therefore liability could more easily be assigned, and litigation more likely to succeed.

Potential Benefits to Issuers

In addition to providing benefits to current shareholders and prospective investors through the increased disclosure requirements, it could also bring potential benefits to a well-run issuer. As currently drafted, the proposed regulation is likely to produce a "status-quo" where issuers feel that they need to restrict hedging activities to some extent in order for their stock price to not be discounted accordingly. While this may result in some increase in hedging restrictions among all issuers, it produces an effect in the market that would not be present without regulation. I note that this market effect of making hedging restrictions almost compulsory may be an aim of the proposed regulation. However, I believe my proposed regulation provides the same protections to shareholders, without creating the unnatural force in the market (that is, to restrict hedging activities just because everyone else is doing it). In order to illustrate this, I would like to present two hypothetical companies, equivalent in every respect except for their policies on hedging:

1. Company 1 has an outright policy against all activities that could produce an effect of limiting the insider's risk due to possible downward shifts in the issuer's stock price. Any employee, officer, or director caught engaging in hedging activities will be subject to penalties imposed by the company. This is fully disclosed statement to shareholders.

2. Company 2 does not have a policy against hedging. In fact, it freely permits it. No board approval is required, and employees, officers, and directors are allowed to engage in any hedging activity that is permissible by law. This is fully disclosed to shareholders.

Now assume that both companies have been subject to my proposed regulation for several years. Both companies are required to report whether their officers and directors have engaged in any hedging activities, as defined in Part III. Both companies truthfully report in their proxy statement and annual report that there have been no hedging activities by officers and directors during the previous fiscal year. However, Company 2 has a distinct advantage over Company 1 to report. Their insiders did not engage in hedging *by choice*, not simply avoiding hedging due to the risk of penalties or going against the issuer's policy. Shareholders of Company 2 may infer, or the company may imply to them, that insiders are not hedging simply because they are not allowed to, but because they have chosen not to. This indicates that the insiders (assuming they have personal equity holdings, obviously), believe in the future of the company, and want to stand by it with their own personal investments. This type of reasoning may allow some companies to develop an internal culture of no hedging, without the pressure of outside regulation. It is quite possible that by requiring disclosure of hedging activities, rather than simply a limited hedging disclosure on the policy of the issuer, may spur this type of change. I concede that it is possible under the current regulation for companies to adopt the above strategy of Company 2, but without the extra push to require hedging transactions to openly be disclosed on proxy statements and annual reports, it is unlikely to be done, and this type of change is unlikely to occur.

Part III: Proposal #2 – Define "Hedging"

In this comment letter, I would also like to propose that "hedging" is defined to perform the following duties:

1. Keeping the definition of hedging broad, as suggested in the proposed regulation, but still listing several types of hedging that are commonly used, so there is no question that they are included in the definition and transactions that fall under these forms must be disclosed. If my proposed change in Part II is not adopted, pursuing the type of definition that I propose in this section still clearly enunciates that these types of transactions are certainly prohibited when a corporation discloses that EODs may not engage in hedging activities.

2. Exclude exchange funds from the definition of hedging. I'll describe my reasoning for this in detail below, beginning with a short introduction to what I mean by "exchange fund."

Defining "Exchange Fund"

An exchange fund (also called an exchange trust or swap fund), in the simplest sense, is a fund in which individuals may contribute a portion of their held shares into a fund. This fund then produces returns based on the aggregation of all shares put into the fund by other individuals. Here are some common characteristics among exchange funds:[3]

1. Exchange funds are made up of a group of individuals who all hold a concentrated position in a highly-appreciated stock.

These individuals are those that generally have a large concentration of their personal wealth resting on a single stock. Without engaging in an exchange fund, these individuals would likely seek to engage in another method of limiting the risk associated with holding so much of their personal wealth in a single source.

2. Exchange funds are not particularly customizable by any individual participating in the exchange fund by contributing their own shares.

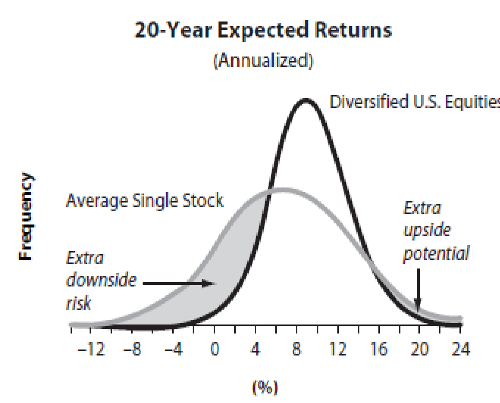
This is in contrast to prepaid variable forward contracts, equity swaps, and zero cost collars, where the individual engaged in the activity has sizable leverage to shape the transaction. In an exchange fund, the investment bank controlling the trust has significant control over the type of securities that go into the fund. Typically, the manager of the fund assembles a proposed portfolio, and distributes a report of the portfolio to the prospective investor. The investor has only a few days to pledge his securities to the fund or to pull out of the fund. Because of this short window of time provided to invest in the fund, these types of transactions are not typically engaged in in order to avoid a projected fall in stock price in the individual's insider holdings because the individuals do not have the flexibility to enter into these contracts spontaneously.

3. Exchange funds are created and managed by a third party, typically an investment bank.

Because investment banks may continuously market different exchange trusts, it is in their best interest to monitor the quality of the securities that the investment banker inserts into the fund. If an investment bank creates several underperforming exchange funds as a result of poor management by the bank, the reputation of the bank may suffer, and future business may be less likely. Therefore, investment banks who are concerned about the future performance of the fund are more likely to select firms in which the bank is familiar with the management, procedures, and prospects of the firm.

4. Exchange funds persist over a several year period, typically for seven years.

Because these funds exist over such a long period of time, it is unlikely that individuals engaged in the funds are doing so in order to avoid an anticipated reduction in the value of their individual stock that is known to them as a result of inside information. In fact, these funds are often used as estate planning devices[3]. While it may be true that by definition, some of the contributed securities to the exchange fund would have outperformed the fund as a whole during the given period, many studies show that a diversified portfolio over a long-term timeframe has a significantly better return and is more predictable than a single stock held for the same period. To the right is a graph generated by Bernstein Investment Research and Management[4] which displays a forecasted return for a single stock v. a diversified portfolio.



Based on Bernstein's estimates of the range of returns for the applicable capital markets over the next 20 years.

Because exchange funds are essentially diversified portfolios, I believe this a valuable illustration in this instance. Using

[3] "Exchange Funds: A Solution to Concentrated Wealth"
[4] "The Enviable Dilemma." *The Journal of Wealth Management*

the graph as an illustration, it is evident that a diversified portfolio can provide significant advantages over the time period that these exchange funds are active. While Bernstein's research is not in the context of exchange funds, the research seems to indicate that the peak time at which diversified investments outperform single stocks falls approximately at the same time as the traditional time span of an exchange fund.

5. The shares invested in the fund are illiquid during the period that they are invested in the fund.

Generally, these funds do not allow withdrawal of an individual's shares during the prescribed time period for the fund. Even if they do, the individual will trigger a taxable event, both for himself and potentially for other individuals involved in the fund. Because of this, there is a significant incentive not to divest an individual's own shares from the fund at any point during the prescribed period because if he does he is unlikely to be invited to participate in a similar fund in the future, in addition to the present tax consequences.

6. There is no secondary market for exchange fund investments.

Without a secondary market for an individual's stake in an exchange fund, individuals are essentially locked into the fund for the entire length of the contract, unless they wish to withdraw and incur the tax and reputational disadvantages described above. Therefore, an individual cannot engage in this type of fund simply to acquire a means to dispose of his holdings, potentially without disclosing the transaction to shareholders, further obfuscating the true nature of the insider's transaction. Because of this problem, I have included the requirement that the individual's stake in the exchange fund not be tradable/saleable in order to fit under the exception provided in my proposed definition of hedging.

7. At the end of the term, the investor receives a group of investments, generally a pro-rata share of all investments in the fund, rather than cash.[5]

Another reason why exchange funds are not a typical method to hedge securities is that individuals often do not receive cash upon the expiration of the term of the exchange fund. While the individual likely receives some portfolio of bonds that he may liquidate himself, this remains a much more complex transaction than a zero cost collar or prepaid variable contract, and therefore is less likely that the primary motivation for individuals engaging in exchange fund investments is to hedge against their holdings in the company on the basis of insider knowledge, and more likely that it is simply a wealth preservation tool.

[5] "Understanding Exchange Funds." *Financial Advisor Magazine*.

Effects of Insider Exchange Fund Participation on Issuer

I have chosen to rely again on Bettis, Bizjak, and Kalpathy's 2013 study (the "2013 Study") due to the extensive number of transactions studied in their analysis. The 2013 Study shows that participation in exchange funds by insiders does not result in a negative effect on stock prices over the aggregate. The 2013 Study does report negative abnormal stock returns after an insider has entered into a prepaid variable contract[6] or a zero cost collar[7]. This is consistent with the traditional use of a hedging transaction, and may indicate the use of negative inside information being used by those hedging individuals in the aggregate. However, the 2013 study finds *positive* abnormal stock returns following an insider's entrance into an exchange fund. The 2013 Study utilized share price data from 250 days prior to the hedging transaction to 250 days following the transaction. This was then compared to a control in three ways. The first is simply by comparing the issuer to another matching the size & industry, the second control also matches open market sales by insiders, and the third matches firm size, book-to-market value, and prior return of the issuer's stock. Please see the full study for more details. I have chosen to include the data table reflecting the findings on stock price fluctuation from the 2013 Study to the right.

Mean Cumulative Abnormal Return (%)

Panel A: Zero Cost Collars

	Matched Firm: Size & Industry	Matched Firm: Size, Industry, & Insider Sales	Matched Firm: Size, Btm, & Prior Return
[−250,0]	42.72	7.60	0.57
	(0.000)	(0.174)	(0.165)
[0,+250]	−18.83	−5.45	−11.51
	(0.000)	(0.210)	(0.011)

Panel B: Variable Forwards

	Matched Firm: Size & Industry	Matched Firm: Size, Industry, & Insider Sales	Matched Firm: Size, Btm, & Prior Return
[−250,0]	21.42	2.44	0.03
	(0.000)	(0.488)	(0.705)
[0,+250]	−6.77	−9.48	−13.50
	(0.024)	(0.003)	(0.000)

Panel C: Exchange Funds

	Matched Firm: Size & Industry	Matched Firm: Size, Industry, & Insider Sales	Matched Firm: Size, Btm, & Prior Return
[−250,0]	40.28	20.65	0.03
	(0.000)	(0.000)	(0.622)
[0,+250]	8.87	6.69	13.58
	(0.062)	(0.215)	(0.007)

Panel D: Equity Swaps

	Matched Firm: Size & Industry	Matched Firm: Size, Industry, & Insider Sales	Matched Firm: Size, Btm, & Prior Return
[−250,0]	30.62	6.52	1.10
	(0.031)	(0.698)	(0.434)
[0,+250]	−21.57	10.34	−4.52
	(0.163)	(0.520)	(0.664)

P-values are reported in parentheses.

While I cannot explicitly state the reason for an aggregate increase in stock price after an insider enters into an exchange fund, there does seem to be evidence of a correlation. The 2013 study hypothesizes that this may be a result of monitoring by investment banks on the type of securities allowed into these exchange funds. I agree. I also contend that it may be due in part to the individual actions of the insider who entered into the fund. He may have an increased incentive to maintain or increase the stock price for both reputational and planning reasons. If the insider wishes to engage in exchange funds in the future, he must have contributed a valuable stock to the portfolio, or he may not be invited to participate in the fund in the future. If the individual contributed shares to the fund simply as a hedging transaction, gaming on inside information that he possessed that the stock value was likely to decrease, he may have saved himself from a small percentage of the loss that he would have realized, but discharges himself of the potential for participation in the future.

[6] This finding is also reported by Jagolinzer, Matsunaga and Yeung (2007), which focused only on prepaid variable forward contracts.
[7] This is somewhat contrary to a previous finding by Bettis, Bizjack and Lemmon (2001) which reported normal performance of stock prices for six months following the hedge. Bettis et al did find significant positive abnormal performance of 19% relative to the market index over the 120 days prior to the hedge, which supports my hypothesis that zero cost collars are primarily used as flexible means to hedge one's ownership, or in this case ensure that an increase in equity is retained by the individual.

The 2013 study also provides summary statistics on the amount of the insider's ownership that is hedged on average using each of the instruments the study analyzes. The study reports that, on average, insiders engaging in zero cost collars, prepaid variable forward contracts, or equity swaps cover about 30% of their ownership. However, insiders engaging in exchange funds place only an average of 9% of their ownership into the fund. The 2013 Study suggests that this is primarily attributable to the limitations imposed by the investment bank managing the particular fund. Another likely reason is due to the lack of liquidity, control, and flexibility inherent in an exchange fund. As expected, this reduced usage results in a significantly lower dollar value invested in exchange funds. I have chosen to include the data table reflecting this from the 2013 Study below.

Panel A: Percentage of ownership and dollar amount covered by each derivative security.

	Percentage of Ownership Invested			Dollar Value Invested (millions)		
	Number of Observations	**Mean**	**Median**	**Number of Observations**	**Mean**	**Median**
Zero Cost Collars	227	31.47	21.62	255	$37.48	$5.25
Variable Forwards	441	28.37	18.07	452	$44.91	$7.65
Exchange Funds	363	9.00	4.44	364	$5.19	$2.17
Equity Swaps	31	32.58	14.89	26	$16.40	$3.78

Reason for Exclusion

Even after consideration of the stated components of an exchange fund and the potential for positive stock returns upon the issuer, which presumably would flow down to the stockholders, it still may be unclear why an exchange fund should be excluded from the definition of hedging in this proposed regulation. Research by Burns and Kedia (2006) indicates that the propensity of a firm to misreport its earnings may be increased as the CEO's wealth becomes increasingly related to the firm's stock price. Kim, Li, and Zhang (2011) find that firms in which insiders have higher levels of options are more likely to suffer a crash in stock price as a result of insider incentives to hoard bad news. Both of these results are logical. Just as incentives that are too low for insiders may result in a lack of alignment with the stockholders' objectives, when insiders have too much stake in the insider, it may result in perverse incentives. When the incentives are too low, boards can easily grant more equity awards to management and other insiders. However, when the insider has too great a stake in the issuer, boards can do little to correct this inequity.

As a result, it is wise to leave a process in which insiders can correct this problem and alleviate the inequities that could potentially befall themselves (personal wealth functionally tied to the stock price, which fluctuates according to factors outside of their own control) or the corporation (the possibility of perverse incentives if the individual takes measures to protect personal wealth rather than the stock price, such as hoarding bad news).

It is true that under the proposed regulation, issuers could simply state that they restrict all forms of hedging except for exchange fund participation. However, there are negatives associated with this:

1. It does not allow for the SEC to promulgate the definition of an "exchange fund"; and

2. Shareholders and potential investors may unreasonably discount the issuer's stock price unfairly due to a perceived loophole in the issuer's hedging policy.

I suggest that it is highly unlikely that most shareholders and potential investors, especially unsophisticated investors, view an insider's engagement in an exchange trust as anything other than a hedging transaction meant to reduce the risk of the engaged individual, and do not foresee any positive trend in the stock price as a result.

I note that leaving these types of transactions out of the definition of hedging may lead to abuse of the regulation by insiders attempting to "stretch" the definition of an exchange trust. However, I believe the benefit of allowing exchange trusts to freely operate will produce an overall benefit both to inside individuals and shareholders. I also point out that entrance into these exchange trust would still need to be reported on Forms 3, 4, or 5 as is currently the case. This fall back disclosure will help to keep exchange trust participation out of the dark and help to limit abuse of the exclusion that I am proposing.

Proposed Definition

Therefore, I propose to define hedging in the following way:

"For the purposes of this section 407 of Regulation S-K, 'hedging' includes the use by employees, officers, or directors of the issuer of zero cost collars, prepaid variable forward contracts, and equity swaps, as well as any instrument which produces the effect of limiting the insider's equity risk in the issuer without engaging in an outright sale. However, an issuer which allows employees, officers, and directors to pledge securities to an exchange fund, as defined below, may still disclose that those participating insiders have not engaged in hedging activities in the past fiscal year.

An exchange fund is an instrument created and managed by an independent third-party, such as an investment bank, into which insiders may pledge their personal shares for a term lasting several years, but in no instance fewer than 'X' years, and in exchange receive a return based on the overall performance of all the stock contributed to the fund. In order to qualify as an exchange fund under this section 407, the insider's stake in the exchange fund may not be tradable or saleable in any way until the expiration of the term initially established by the fund's managers."

In crafting the precise definition for an exchange fund, the SEC may also wish to consider additional factors such as:

- Who is qualified to establish and manage the fund? Will it be only investment banks or other individuals?
- Should there be a required minimum term for an exchange fund in order to qualify for this exception?
    - I believe that there should be, so that insiders do not engage in short term exchange funds that would mimic more traditional hedging transactions, but I have not considered the optimal number of years and have therefore left an 'X' in place of the number.
- Should there be a required number of participants in the fund in order to qualify?
- Listing factors that must be met (such as those I have listed above on pages 12 and 13) so that the definition of an exchange fund may be as precise and uniform as possible.

<u>Conclusion</u>

Agreeing with the overall spirit of the regulation, I write to suggest two changes:

1. To require issuers to disclose whether officers and directors have engaged in hedging transactions during the previous fiscal year on the annual report and on the proxy statement. I still suggest that the regulation regarding inside employees only require disclosure of the issuer's policy.

2. Define “hedging” by including common examples of derivative instruments and “of the same kind” definition language, while explicitly excluding exchange funds from the definition.

Through the adoption of these changes I believe it will result in a more effective display of information for shareholders and potential investors, and as a result keep them better informed of trading within the company and provide them a greater opportunity to exercise corporate remedies afforded to them.

I very much appreciate the opportunity to provide my thoughts on the proposed rule, and welcome any additional questions or comments you may have.

Sincerely,

Clinton Carlisle
J.D. Candidate 2016
University of Colorado Law School
[redacted]
cell: [redacted]

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