



**Securities Industry Association**

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June 24, 2002

Mr. Jonathan G. Katz, Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: Proposed Form 8-K Disclosure of Certain Management  
Transactions (File No. S7-09-02)

Dear Mr. Katz:

The Derivative Products Committee (the "Committee") of the Securities Industry Association<sup>1</sup> is writing in response to the release issued by the Securities and Exchange Commission (the "Commission" or "SEC") on April 12, 2002 (the "Release")<sup>2</sup> regarding the proposed amendments (the "Proposed Rules") to Form 8-K under the Securities Exchange Act of 1934 (the "Exchange Act") and related amendments to Rule 144 and Forms S-2, S-3 and S-8 under the Securities Act of 1933 (the "Securities Act"), which would require disclosure by a public issuer on current reports of certain transactions by its executive officers and directors.

The Committee appreciates the opportunity to provide its comments and suggestions to the Commission and its staff in connection with this important rulemaking. We applaud the Commission's ongoing efforts to promote greater transparency, investor awareness and public confidence in the securities markets. We agree that making relevant information regarding management transactions more readily available will help achieve these goals. Accordingly, we support adoption of a reporting regime along the lines of the Proposed Rules, subject to the modifications noted below.

<sup>1</sup> The SIA brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member-firms (including investment banks, brokers-dealers and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 93 million investors directly and indirectly through corporate, thrift and pension plans. In the year 2001, the industry generated \$198 billion in U.S. revenues and \$358 billion in global revenues. Securities firms employ approximately 750,000 individuals in the United States. (More information about the SIA is available on its home page: <http://www.sia.com>.)

<sup>2</sup> SEC Release No. 33-8090; 34-45742 (Apr. 12, 2002).

In the Committee's view, the specific disclosure requirements set forth in the Proposed Rules must be evaluated by reference to the primary purpose of the enhanced disclosure: to report on a timely basis transactions that may reveal management's views as to company prospects, in order to enable investors to make more informed decisions. Disclosure requirements that capture transactions not indicative of management's views may only serve to disguise information about those transactions in which investors are actually interested.

In the Committee's view, certain of the disclosures and the compressed time frames for filing required by the Proposed Rules unintentionally threaten to dilute significantly the quality of information reported to investors. If issuers are required to produce large volumes of less informative disclosure, their ability to prepare accurate and carefully considered disclosure about transactions important to the market may suffer.

The Committee's comments below are intended to assist the Commission in revising the Proposed Rules to more effectively provide useful information to the market on a timely basis and in an easily accessible form, while avoiding unnecessary distractions and potential confusion for investors and issuers.

## **I. Addition of New Form 8-K Item; General Comments**

Compliance with the proposed new Item 10 disclosure would place a new burden on corporate insiders, who already must comply with the reporting requirements of Section 16(a) of the Exchange Act and Rule 144 of the Securities Act for market transactions in company stock. It would also place a significant burden on issuers, many of whom already monitor transactions and prepare filings under Section 16(a) on behalf of their directors and executive officers. The Committee has set forth below a number of suggested modifications to the Proposed Rules to ensure that the new requirements will be no greater than necessary to achieve timely disclosure of the information that is relevant to investors.

### **A. Covered persons.**

The abusive practices with respect to management transactions in company equity securities that have been the focus of recent attention have involved senior executive officers. For this reason, the new disclosure requirements should specifically target transactions by these officers.

As noted above, outside directors are already required to file reports under Section 16(a) and Rule 144 in respect of their transactions in company equity securities. The Committee believes that layering additional disclosure rules on top of these existing requirements would provide few benefits relative to the additional administrative burden that the proposed rules would impose on outside directors. Outside directors generally hold relatively small amounts of company stock, and their transactions are of lesser interest to the

market. Furthermore, imposing additional disclosure requirements may make the recruitment of qualified independent directors more difficult, which could frustrate recent corporate governance proposals by the New York Stock Exchange and the Nasdaq Stock Market, Inc., to increase the role and responsibilities of independent directors on corporate boards.

Investors focus in particular on transactions involving senior executive officers of a company. The Committee therefore suggests that the new requirements apply only to transactions by a company's chief executive officer and its four other most highly compensated executive officers. By applying the disclosure requirements to the same group of senior executive officers covered by Rule 402 of Regulation S-K, the new rules would allow companies to concentrate their efforts on providing quality disclosure in respect of those officers for whom compliance procedures are already in place under the proxy disclosure requirements.

In the Release, the SEC asked whether it would be appropriate to require additional disclosure with respect to ten percent beneficial owners. Extending Item 10 disclosure requirements to such persons would, in the Committee's view, provide relatively little in the way of meaningful additional disclosure, since beneficial owners are already subject to reporting under Section 16(a) and Section 13(d) of the Exchange Act (including, in many cases, the requirement of Rule 13d-2 to file "promptly" amendments to schedule 13Ds in the event of material changes in beneficial ownership). Moreover, it would be difficult for issuers to obtain information from many ten percent beneficial owners, since such owners have no fiduciary duty to provide such information to the companies in which they invest, and in some circumstances may be hostile to management. Transaction disclosure by ten percent beneficial owners would not provide additional relevant information to shareholders because – as indicated by a study cited in the Release<sup>3</sup> – large shareholders are not generally involved in the day-to-day management of the company.

## **B. Reporting thresholds and deadlines.**

The compliance costs that would result from the Proposed Rules' dollar thresholds and reporting deadlines are not commensurate with their expected benefits. The proposed thresholds of \$10,000 for *de minimis* transactions and \$100,000 for two-business day reporting would pick up transactions that typically have not been the subject of abusive practices and are generally not the focus of the investor community. In addition, the proposed two business day reporting deadline would not allow sufficient time for an issuer to gather the required data, prepare an accurate filing and submit it electronically to the SEC.

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<sup>3</sup> See Josef Lakonishok & Inmoo Lee, *Are Insider Trades Informative*, 14 REV. FIN. STUD. 93 (2001) ("In the last 10 years, information from large shareholders' trades would have been counterproductive in timing the market. The weaker predictive power of large shareholders is probably a result of large shareholders being removed from the decision-making process of the firm.").

Many issuers have internal policies that prohibit executive officers and directors from trading in issuer equity securities other than in prescribed “window periods” during which they are unlikely to possess material nonpublic information. During these brief window periods, many executive officer and director transactions may occur with respect to a particular issuer’s equity securities. As a result of the requirement in the Proposed Rules to report all transactions in excess of \$100,000 within two business days and all transactions in excess of \$10,000 by the second business day of the following week, companies will in many cases be required to file multiple Form 8-K reports on a rapid basis during window periods, resulting in a large amount of potentially immaterial disclosure and a high likelihood of inaccurate reporting due to inadvertent errors.<sup>4</sup>

The Committee recommends the elimination of Form 5, which would accelerate the time frames for reporting certain transactions that may currently be reported annually on Form 5 such that they would instead be reported monthly on Form 4. While Section 16(a) of the Exchange Act establishes a deadline of ten calendar days into the next month for management transaction disclosure generally, the Commission has full authority to modify or eliminate the Form 5 disclosure rules that were created by the Commission itself under its exemptive authority. By making Form 4 the standard disclosure for all officer and director transactions, the SEC could accelerate disclosure of a whole range of management transactions currently eligible for deferred annual reporting with relatively little additional burden on companies. This simple modification to the Section 16(a) rules would also avoid potential duplication and confusion with respect to Item 10 disclosure that would be required for larger transactions.

Additionally, in place of the two-tiered approach under the Proposed Rules, the Committee suggests a simpler regime focusing on the information that is most important to the investor community. The Committee respectfully proposes (i) a single higher threshold of \$1,000,000 for triggering reporting under Item 10, (ii) simple aggregation rules that would require an issuer to report all transactions once the threshold is reached or exceeded within a calendar month (at the end of which any unreported transactions would be disclosed in a Form 4 filing), and (iii) a filing deadline in all cases of the second business day of the week following the date such threshold is reached or exceeded. This combination of rules would require disclosure of those transactions that are most likely to reflect an executive officer’s beliefs about the company’s prospects in a timeframe sufficient to allow investors to make informed investment decisions, but would avoid the devotion of resources to the disclosure of transactions less likely to convey such beliefs. It would also capture

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<sup>4</sup> The SEC asks in the Release whether transactions or loans that occur within the same two business day period should be considered together for purposes of calculating the dollar thresholds. Although this approach may have some theoretical appeal, in practice the uncertainty created by such a rule would in many cases lead to further confusion as companies rush to comply with already tight filing deadlines. Companies would likely respond to this requirement by automatically aggregating all transactions that occur in any two-day period, regardless of whether aggregation is actually required.

the types of transactions, such as those in respect of Enron, that have been the focus of so much recent attention.

### **C. Safe Harbor**

The Committee supports the safe harbor included in the Proposed Rules, under which an issuer would be shielded from sanctions for violations of the Proposed Rules where (i) at the time of the violation, it had designed procedures and a system for applying such procedures sufficient to provide reasonable assurances that Item 10 events are timely reported, (ii) at the time of the violation, the company followed those procedures, and (iii) as promptly as reasonably practicable, the company made a filing to correct any violation. The proposed safe harbor would further the policies underlying Item 10 by affording protection to issuers that take appropriate steps to ensure full and prompt disclosure.

## **II. Application to Specific Transactions**

### **A. Exempt transactions.**

The Committee supports the proposed list of transactions exempt from Item 10 disclosure, and proposes adding to that list gifts of company securities. A decision to dispose of equity securities by gift does not reflect a view of the company's prospects, and disclosure of gifts therefore would not help further the policies underlying the Proposed Rules. This rationale is especially true where gifts are made to immediate family members, since executive officers and directors should be presumed to have an interest in the economic welfare of their family members. In fact, disclosing gift information as possibly suggestive of the company's prospects could mislead investors.

In addition, although the Proposed Rules contain many of the same exemptions as the rules providing exemptions from the requirements to report transactions pursuant to Section 16(a), the Proposed Rules do not expressly adopt the large existing body of interpretive guidance regarding Section 16(a) reporting. This interpretive guidance has been developed by the SEC and its staff over many years based on the SEC's consideration of investor concerns. The failure to adopt this body of guidance would lead to inconsistencies between the two types of reporting that could lead to confusion among company compliance personnel and result in inaccurate reporting. We are unaware of any policy basis for concluding that this body of precedent is inapposite to the exemptions from Item 10 reporting. The final rules or their adopting release should therefore explicitly clarify that the body of interpretive guidance developed under Section 16(a) would also apply to Item 10 Form 8-K reporting.

### **B. Derivative transactions.**

#### **1. Reporting deadlines**

Derivative transactions may present additional unique considerations that bear on the timing of mandated disclosure regarding the execution of a particular transaction. By reference to “the date on which the parties enter into an agreement” as the date triggering a filing requirement, the Release leaves some uncertainty as to what date should be used to determine the disclosure deadline for a derivative transaction.

Derivative transactions may be executed under terms providing for the establishment of the “fixed price” by reference to a weighted average of closing prices or other market references or price sources for the underlying security over a period of days following the date on which the transaction is agreed. This practice results from recognition of the need of the dealer counterparty, for prudential market risk management purposes, to establish a hedging position for the market risks assumed by it as part of the transaction. The period of days selected for a specific transaction generally reflects the parties’ judgment as to the amount of hedging activity that may be prudently undertaken on a given day, in light of the security’s daily trading volume, without unduly impacting the market for the stock and/or potentially increasing the cost of executing the transaction.

The disclosure of the transaction to third party market participants prior to the end of this pricing period could have a significant adverse impact on the pricing of the relevant transaction. The Committee does not regard the potential benefits to be derived from expediting, by a matter of days, the disclosure of such transactions to be in any way commensurate with the inherent unfairness and potential costs to the transacting shareholder by such disclosure. The Committee therefore recommends that the Commission clarify that the relevant reporting date for such transactions be deemed to be the date as of which the fixed price for the transaction has been established.

## *2. Determination of aggregate value of derivative transactions*

The Proposed Rules indicate that for a physically-settled derivative security, the aggregate value would be computed by reference to the market value of the underlying securities on the date of the transaction, while for a cash-settled derivative security, the aggregate value would be computed based on the transaction’s notional value. It is not clear from the Release why the SEC has chosen to distinguish derivative securities based on their method of settlement. The Committee proposes that, where determinable, the value of both cash-settled and physically-settled derivatives should be determined based on the market value of the underlying securities on the date of the transaction. Since investors are interested in the extent to which management holds real economic exposure to the company’s equity securities, they are more likely to gain useful information based on the market value of the underlying securities to which a derivative security relates. In those cases where the market value of the

underlying shares is indeterminable, then the determination of value could be based on the notional value of the transaction as proposed.<sup>5</sup>

As a related matter, the Release states that where net settlement procedures are used in the exercise, conversion or other settlement of a derivative security, the aggregate value would be computed on a gross basis. The Committee assumes that this language is intended to apply to, among other things, cashless exercises of employee stock options. If this assumption is correct, the Committee recommends that the Commission confirm this interpretation in the release adopting the final rules.

### *3. Items to be disclosed*

The disclosure example given in the Release involving the reporting of a derivative transaction includes disclosure of the identity of the broker-dealer counterparty on derivative trades as well as the fee paid, suggesting that such information would be deemed a material term of a transaction requiring disclosure. Disclosure of the identity of the broker-dealer and the fee paid is unrelated to the purpose of the rules, and would merely serve to expose sensitive and confidential competitive information. Disclosure of this type of information may also give rise to front-running and market manipulation in advance of transactions by the applicable broker-dealer, providing a disproportionate advantage to some market participants that is not outweighed by the policy goals of the Proposed Rules. The Committee strongly recommends that the final rules adopted by the Commission exclude such information, which would be consistent with the Section 16(a) reporting requirements.

The Proposed Rules also require disclosure of “any other material information” regarding a derivatives transaction. This standard is too broad given the short time frame in which reports would be required, even under the Committee’s proposed modifications. In the interests of consistency and ease of compliance, the disclosure requirements for Item 10 should be conformed to the Section 16(a) requirements. If the Commission deems other specific information to be relevant, a list of required disclosure should be enumerated.

### *4. Exemption from disclosure for derivative security expirations and corporate events*

The Proposed Rules include the expiration of a derivative security as a reportable event. In the Committee’s view, such disclosure is not warranted for two reasons. First, the expiration date of a derivative security would have already been reported when the transaction was entered into. Second, the expiration of a derivative security in accordance with its terms does not involve

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<sup>5</sup> Some derivative securities transactions (such as variable forward contracts) require the delivery of a variable number of underlying securities, subject to both a minimum and a maximum delivery obligation. In such cases, the Committee believes the value of the transaction should be based on the market value on the date of the transaction of the maximum number of securities deliverable under the contract.

any volitional act on the part of the executive officer or director, and accordingly provides no signal to the market as to the prospects of the company or its stock. Reporting the expiration of a previously-reported derivative security as a management “transaction” would only lead to duplicative filings and potential investor confusion as to the significance of the event.

In addition, the Committee requests that the Commission confirm that the conversion of a derivative security pursuant to the terms of a merger or a similar corporate transaction would not have to be reported. In such situations, the effect of the corporate transaction on the underlying derivative securities would already be reported in connection with the corporate transaction.

### **III. Application to Exchange Act Rule 10b5-1 Arrangements**

The Rule 10b5-1 regime has proven successful and has won broad acceptance by the market as a method by which executive officers and directors can transact in company securities without raising concerns that such transactions are indicative of a change in the company’s prospects. The Release proposes disclosure not only of transactions engaged in pursuant to the terms of Rule 10b5-1 arrangements, but also of the arrangements themselves. This disclosure would prove contrary to the principles underlying Rule 10b5-1 and the Proposed Rules.

Simply initiating a Rule 10b5-1 plan does not actually reflect the executive officer’s or director’s views of his or her company’s prospects, and such arrangements are often initiated as a matter of course by insiders of large issuers in connection with long-term estate and financial planning. In fact, by their very design, these plans are established to avoid any link between the insider’s transactions and information held by the insider about the company. Furthermore, while the proposed Item 10 disclosure seeks to report on a timely basis transactions that have recently occurred, requiring the reporting of Rule 10b5-1 arrangements would amount to pre-transaction disclosure that could lead to duplicative and speculative reporting. Just as limit orders are not reportable by broker-dealers or insiders until an actual transaction occurs, disclosure should be required only when an executive officer or director has actually purchased or sold securities in a particular transaction. If a particular transaction was completed pursuant to a 10b5-1 arrangement, that fact should be indicated through a code in the Form 8-K report in order to avoid any investor confusion as to management’s intentions.

Similarly, a director’s or executive officer’s termination or modification of a Rule 10b5-1 arrangement would not be indicative of a change of view of the company’s prospects. If, however, the termination of a plan must be disclosed, plans that lapse in accordance with their terms should not be subject to such disclosure, as lapsing involves no volitional act on the part of the director or executive officer and so provides no signal to the market as to the prospects of the company or its securities.

With respect to the particular disclosure requirements applicable to Rule 10b5-1 arrangements, the example provided in the Release includes disclosure of the identity of the agent or counterparty with respect to a Rule 10b5-1 plan. As in the case of derivative transactions discussed above, disclosure of this information is unnecessary and could be harmful to the competitive position of the agent or counterparty. Public release of such information also raises the risk of front-running in advance of transactions. As a result, the Committee recommends that this information be excluded from the reporting requirements.

In addition, the Release notes that the Commission has not proposed to require that the disclosure of Rule 10b5-1 arrangements involve disclosure of "the prices and intervals at which transactions would occur, or the number of securities to be purchased or sold per interval," and further notes that modifications to such terms should be disclosed "in general terms, ... without requiring disclosure of the specific price, number of securities, or duration of interval." The Committee supports this position, as this information is confidential and again raises the risk of front-running and market manipulation.

#### **IV. Application to Company Loans**

The Proposed Rules require disclosure of loans or guarantees of loans made by companies to management. The Committee generally supports disclosure of this information, but believes that the following suggestions would best achieve the aims of the Release while keeping disclosure requirements manageable for both investors and issuers. First, because the Proposed Rules would cover loans and loan guarantees from affiliates of the issuer, they should be modified to carve out loans made in the ordinary course of business (such as margin loans) by affiliates of an issuer on terms that are offered to customers or employees generally. These transactions do not merit the attention of investors because they do not invoke the rationale provided by the SEC in the Release for requiring loan disclosure ("the use of company assets for arrangements that are not available to shareholders generally"). If the SEC is concerned that large loans from the company should be disclosed to investors, even if made in the ordinary course of business on generally available terms, the Committee proposes applying to such ordinary course loans the same reporting threshold of \$1,000,000 discussed above with respect to transactions in securities.

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The Committee appreciates having had this opportunity to provide the Commission with its comments and suggestions regarding this important proposal and looks forward to working with the Commission on future proposals.

If you have any questions or would like further information regarding this letter, please feel free to contact Gerard J. Quinn of the Securities Industry Association at 212-618-0507, Luke Farber of Merrill Lynch & Co. Inc. at 212-449-6128, or Edward Rosen, Robert Cook or Jeffrey Karpf of Cleary,

Gottlieb, Steen & Hamilton, special counsel to the Committee in this matter, at 212-225-2820, 202-974-1538 or 212-225-2864, respectively.

Very truly yours,

Luke Farber,  
Derivative Products Committee

cc: The Honorable Harvey L. Pitt, Chairman  
The Honorable Isaac C. Hunt, Jr., Commissioner  
The Honorable Cynthia A. Glassman, Commissioner  
Alan L. Beller, Director, Division of Corporation Finance