**AMERICAN BAR ASSOCIATION**
**Section of Business Law**
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November 12, 2002

**By Hand Delivery and E-Mail**

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609
Attn: Jonathan G. Katz, Secretary

**Re: File No. S7-31-02**

Ladies and Gentlemen:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities of the American Bar Association's Business Law Section (the "Committee")* in response to the Commission's request for comments in Release No. 34-46421 (August 27, 2002) regarding the application of Sections 16(a) and 16(b) to stock options.

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and therefore do not represent the official position of the Association. In addition, this letter does not represent the official position of the ABA Section of Business Law, nor does it necessarily reflect the views of all members of the Committee.

## Request for Comment

On August 27, 2002, the Commission adopted amendments to the rules and forms under Section 16(a) of the Securities Exchange Act of 1934 to implement Section 403 of the Sarbanes-Oxley Act of 2002, which accelerated the deadline for filing beneficial ownership reports under Section 16(a). In the adopting release (Release No. 34-46421), the Commission

* References in this letter to "we" and "our" mean the Committee.

solicited comment regarding "whether any changes are required in the treatment of stock options under Sections 16(a) and 16(b)." The Commission did not propose any changes to the treatment of options, but did invite comment on how to calculate the six-month short-swing profit recovery period of Section 16(b) in connection with an acquisition and exercise of a stock option and subsequent sale of the stock received upon the exercise of the option. In addition, the Commission asked whether the issuer's grant of a stock option to an officer or director should be exempt under Rule 16b-3 only if the optionee satisfies the six-month holding period specified in Rule 16b-3(d)(3). (Currently, Rule 16b-3(d)(3) is only one of four alternative bases for exempting an option grant under Rule 16b-3(d); the other three require approval of the option grant by either the board of directors, a committee comprised solely of two or more non-employee directors, or the issuer's shareholders.)

**Discussion**

As the Committee has indicated in recent letters to the Staff, the Committee believes that the Commission should revise the Section 16 rules to clarify their application to certain types of derivative securities. The Committee does not believe, however, that the Commission should consider fundamental changes to the application of Sections 16(a) and 16(b) to stock options or other derivative securities, particularly a change to the determination of the dates of "purchase" and "sale" in connection with transactions involving stock options.

**The 1991 Amendments to the Section 16 Rules**

The Section 16 regulatory framework applicable to stock options and other derivative securities was adopted in 1991, as part of the Commission's comprehensive revision of its Section 16 rules. *See* Release No. 34-28869 (February 8, 1991). The treatment of derivative securities adopted in 1991 was based on the fundamental economic principle that a derivative security represents indirect beneficial ownership of the underlying equity securities. *See, e.g.*, Release No. 34-26333, § IV (December 2, 1988). Application of this fundamental principle led to the conclusion, for purposes of Section 16(a), that an insider's acquisition of a derivative security is reportable as of the date of acquisition (not, as the pre-1991 rules required, as of the date on which the option becomes exercisable). *See* Rule 16a-4(a). The principle also led to the conclusion, for purposes of Section 16(b), that the date of an insider's acquisition of an option, not the date of the insider's exercise of that option, is the date of "purchase" for purposes of Section 16(b). A corollary of this conclusion is that generally the exercise of an option involves a mere change in form of beneficial ownership of the underlying securities, from indirect to direct, and therefore does not involve a "purchase" that may be matched with a non-

exempt sale under Section 16(b). *See* Rule 16b-6(b). (Prior to the Commission's adoption of Rule 16b-6(b), many courts treated an insider's acquisition of an option as a non-event for purposes of Section 16(b), and treated the insider's exercise of the option as a non-exempt "purchase" that could be matched with the insider's sale of securities of the same class within less than six months. *See, e.g., Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970).)

While the Commission's 1991 rule changes had the effect of making every grant of an option to a Section 16 insider a "purchase" of the underlying stock by the insider, the rule changes also provided that an issuer's grant of a stock option to a director or officer may be exempted from Section 16(b) under Rule 16b-3. Currently, to qualify for exemption, the grant must satisfy the requirements of one of the four alternative bases for exemption set forth in Rule 16b-3(d), discussed above.

**Rationale for Current Treatment of Stock Options**

The Commission's decision in 1991 to revise the treatment of derivative securities under Section 16 was based on a careful analysis of the economics of derivative securities, together with an examination of the policies underlying Section 16(b). *See* Release Nos. 34-26333 and 34-27148 (August 18, 1989). To achieve the purposes of Section 16(b), the Commission said, the determination whether a transaction should be subject to short-swing profit recovery should be based on "profit potential and the opportunity for abuse of inside information, which in the option context means the date of acquisition of the option, not the date of exercise." *See* Release No. 34-26333, § IV. The Commission cited (and endorsed) the views of economists that an insider's profit potential under an option arises upon acquisition of the option, and that the insider "realizes no profit at the time of exercise, has not significantly altered the potential for profit, and has acquired no greater percentage of beneficial ownership." *See* Release No. 34-27148, § IV.

In adopting the new derivative securities rules in 1991, the Commission acknowledged that the new regulatory structure represented a significant departure from the prior treatment of options and other derivative securities by the Commission and the courts. See Release No. 34-28869, § III. The Commission noted, however, that "after 30 years of study and experience with trading in derivative securities, the Commission's rules today recognize . . . that derivative securities are functionally equivalent to underlying equity securities for purposes of Section 16." See *id*., § III.A. The Commission also said that treating the acquisition of an option, not its exercise, as the relevant "purchase" date "is essential to the efficacy of the Section 16 regulatory scheme." *See* Release 34-27148, § IV.

## Recommendations

### Date of "Purchase"

We believe that the economic and policy analyses underlying the current treatment of stock options for purposes of Sections 16(a) and 16(b) are as valid and persuasive today as they were in 1991. Treating the date of acquisition of an option as the relevant purchase date for purposes of calculating the six-month short-swing profit recovery period, and exempting from Section 16(b) the exercise of the option, is consistent with the purpose of Section 16(b), which is to prevent insiders from profiting from stock price movements occurring within a period of less than six months. We are aware of no "new thinking" or abusive practices that warrant revisiting the conclusions reached in 1991.

### Availability of Rule 16b-3 Exemption for Option Grants

We also see no reason to impose a six-month holding period as a condition to exempting an option grant under Rule 16b-3. Because an option represents beneficial ownership of the underlying securities, we see no basis for treating options differently from bonus stock, restricted stock or any other form of equity security for purposes of Rule 16b-3(d). No purpose would be served, for example, by exempting a grant of bonus stock, restricted stock or other form of stock award under Rule 16b-3(d)(1) or (2) even where the insider sells the stock less than six months after the grant date, but not exempting an option grant under similar circumstances solely because the insider exercised the option and sold the underlying stock within less than six months of the grant date.

We believe that, instead, the insider's acquisition of the option in a transaction that meets the approval requirements of Rule 16b-3(d)(1) or (2) should be exempt from Section 16(b), on the same terms as any other grant of an equity security, and that the exemption provided by Rule 16b-3(d)(3) should remain a separate, alternative basis for exempting an option grant. As the Commission noted when it proposed the current version of Rule 16b-3(d), grant and award transactions generally are intended to provide a benefit or compensation to reward or incentivize performance by the grantee, and do not present the possibility of abuse of insider information. *See* Release No. 34-36356, § II (October 11, 1995). The alternative approval requirements of the rule, particularly the alternatives requiring advance approval of an award by either the full board of directors or a committee comprised solely of two or more non-employee directors, involve the exercise of fiduciary duties and therefore "ensure that appropriate company gate-keeping procedures are in place to monitor any grants or awards and to ensure acknowledgement and accountability on the part of the company when it makes such grants or

awards." *Id*., § II.B. The Commission's reliance on these safeguards is even more justified today, in view of the enhanced role of independent directors mandated by the Sarbanes-Oxley Act of 2002 and the proposed new listing requirements of the New York Stock Exchange and Nasdaq.

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We appreciate the opportunity to submit our comments to the Commission. Should the Staff wish to discuss our comments, we and other members of the Committee's Subcommittee on Employee Benefits, Executive Compensation and Section 16 are available at the Staff's convenience.

Respectfully submitted,

/s/ Stanley Keller
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