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The alchemists of old have returned in the guise of the Securities and Exchange Commission, performing wondrous transmutation through the effective creation of an "equity security" out of a form of executive compensation known generically as "stock appreciation rights" (SARs). As described in greater detail below,[1] a stock appreciation rights program is a form of deferred incentive compensation. Grantees are awarded SAR-units representing an equal number of the grantor's equity shares currently being traded in public markets. Upon eventual exercise of the rights accompanying such units, grantees receive an amount equal to the appreciation in market value of a like number of shares of the grantor's publicly traded stock between date of grant and date of exercise. This amount may be payable in cash, stock, or a combination of the two. SARs thus provide grantees the benefit of stock ownership without equity interest, investment, or risk of loss.

Publicly held companies used SARs for a number of years[2] without SEC comment as to potential exposure to the provisions of either the Securities Act of 1933 (1933 Act)[3] or the Securities Exchange Act of 1934 (1934 Act).[4] SAR programs offer many advantages over other forms of executive compensation and hence have grown rapidly in number. These advantages include the availability of benefits without the requirement of monetary payments (unlike stock option programs), the utilization of SARs as an interest-free form of financing the purchase of stock under tandem stock option programs, the job performance incentive created by the correlation of earnings and market appreciation, and the ability to structure SAR plans so that market appreciation is measured over a longer time span than is generally used for stock option plans, thus better serving the corporate purpose of retained employment.[5] The elimination of the preferential tax

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1. *See* text accompanying notes 19-26 *infra*.

2. The stock appreciation rights plan of the Pittsburgh Consolidation Coal Co. (the "Management Units Plan") was adopted in 1946. The well-known and oft-copied plan of Koppers Co., Inc. (its "Deferred Compensation Unit Plan") was initially approved by stockholders in 1956. For discussion of these plans, see respectively Berkwitz v. Humphrey, 163 F. Supp. 78, 83-85 (N.D. Ohio 1958), and Lieberman v. Koppers Co., 38 Del. Ch. 239, 240-42, 149 A.2d 756, 757-59, *aff'd sub nom.* Lieberman v. Becker, 38 Del. Ch. 540, 155 A.2d 956 (S. Ct. 1959). *See also* Perham, *Phantom Stock: Better Than Options?*, DUN'S, Sept. 1970, at 32 (noting du Pont, General Motors, Union Carbide, Koppers, Bethlehem Steel, and Eastman Kodak as "long-term users" of plans); Shelmerdine, *Shadow Stock Deferred Compensation Arrangements,* 17 N.Y.U. INST. FED. TAX 933, 933 (1959) (adoption of plans "by a number of corporations"); Note, *Phantom Stock Plans,* 76 HARV. L. REV. 619 (1963).

3. 15 U.S.C. §§ 77a-77aa (1976).

4. 15 U.S.C. §§ 78a-78kk (1976).

5. Stock options seeking "qualified" treatment for tax purposes cannot be exercisable more than five years from the date of grant. I.R.C. § 422(b)(3). Five years is often a maximum exercise date for nonqualified options as well, since companies prefer to avoid the build-up of a substantial overhang of options on the existing market.

treatment of qualified stock options in the Tax Reform Act of 1976[6] also has increased the popularity of SARs.

Despite the attractiveness of SAR programs, recently adopted amendments to the Commission's rule 16b-3 have substantially chilled their continued growth by giving notice of the Commission's current view that SARs may not be immune from regulation by the federal securities laws.[7] Limiting

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6. Pub. L. No. 94-455, § 603, 90 Stat. 1520 (1976) (amending I.R.C. § 422). *See* note 93 *infra.*

7. *See* 17 C.F.R. § 240.16b-3 (1978). Rule 16b-3, initially adopted in 1935 and amended numerous times thereafter, sets forth conditions for § 16(b) exemptions applicable to the acquisition of stock options and the acquisition of stock pursuant to stock bonus, retirement, incentive, thrift, savings, and similar plans. SEC Exchange Act Release No. 34-13,097, 42 Fed. Reg. 754 (Dec. 22, 1976) added stock appreciation rights to the list of transactions covered by the rule and added a subsection (e) setting forth "safe harbor" guidelines for cash settlements of SARs. As amended, rule 16b-3(e) reads as follows:

> *Cash Settlements of Stock Appreciation Rights.* Any transaction involving the exercise and cancellation of a stock appreciation right issued pursuant to a plan (whether or not the transaction also involves the related surrender and cancellation of a stock option), and the receipt of cash in complete or partial settlement of that right, shall be exempt from the operation of section 16(b) of the Act, as not comprehended within the purpose of that section, if all the following conditions are met:
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> (1) *Information about the issuer.* (i) The issuer of the stock appreciation right has been subject to the reporting requirements of section 13 of the Act for at least a year prior to the transaction and has filed all reports and statements required to be filed pursuant to that section during that year.
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> (ii) The issuer of the stock appreciation right on a regular basis does release for publication quarterly and annual summary statements of sales and earnings. This condition shall be deemed satisfied if the specified financial data appears (A) on a wire service, (B) in a financial news service, (C) in a newspaper of general circulation, or (D) is otherwise made publicly available.
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> (2) *Limitation on the right and any related option.* Neither the stock appreciation right nor any related stock option shall have been exercised during the first six months of their respective terms, except that this limitation shall not apply in the event death or disability of the grantee occurs prior to the expiration of the six-month period.
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> (3) *Administration of the plan.* (i) The plan shall be administered by either the board of directors, a majority of which are disinterested persons and a majority of the directors acting on plan matters are disinterested persons, or by a committee of three or more persons, all of whom are disinterested persons;
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> (ii) The board or committee shall have sole discretion either; [*sic*]
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> (A) To determine the form in which payment of the right will be made (i.e., cash, securities, or any combination thereof), or
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> (B) To consent to or disapprove the election of the participant to receive cash in full or partial settlement of the right. Such consent or disapproval may be given at any time after the election to which it relates.
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> (iii) Any election by the participant to receive cash in full or partial settlement of the stock appreciation right, as well as any exercise by him of his stock appreciation right for such cash, shall be made during the period beginning on the third business day following the date of release of the financial data specified in paragraph (e)(1)(ii) of this section and ending on the twelfth business day following such date. This paragraph (e)(3)(iii), however, shall not apply to any exercise by the participant of a stock appreciation right for cash where the date of exercise:
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> (A) Is automatic or fixed in advance under the plan;
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> (B) Is at least six months beyond the date of grant of the stock appreciation right; and
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> (C) Is outside the control of the participant.
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> (4) *Compliance with other conditions of Rule 16b-3 § 240.16b-3.* The plan under which the stock appreciation rights and any related options are granted shall meet the conditions specified above in Rule 16b-3 (a), (b), (c) and (d) (§ 240.16b-3 (a), (b), (c) and (d)).
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> (5) *Limit of the exemption.* Nothing in this paragraph (e) provides an exemption from section 16(b) for the acquisition of stock upon the exercise of a stock appreciation right or a stock option.

its concerns to the short-swing profit provisions of section 16(b) of the 1934 Act,[8] the Commission recognized (although it explicitly refrained from adopting) the argument for the recovery of SAR "profits" under section 16(b) on the theory that SARs are a form of equity security, and that their exercise is equivalent to a simultaneous purchase and sale of the underlying common stock on which the SAR value is based. The expansive view of "securities" implicit in the Commission's action might have been shielded from criticism had the Supreme Court affirmed the equally expansive views of the Seventh Circuit [9] in *International Brotherhood of Teamsters v. Daniel.*[10] The Court's reversal in *Daniel,* however, was a rejection of the Commission's broad interpretative position.[11] Although the *Daniel* Court limited its holding to the particular form of pension plan participation at issue, the decision casts further doubt on the Court's willingness to approve the SEC's efforts to stretch statutory language beyond its literal or clearly intended bounds.[12]

The policy argument for section 16(b)'s application to SARs is based on the fear that insiders, if free from the restraints of the securities laws, will manipulate the granting and exercise of SARs as a form of shadow stock to achieve the same financial gains obtainable through legally impermissible transactions in actual securities. Thus, for example, materially favorable, soon-to-be disclosed news may cause insiders to issue themselves SARs that will bear immediate gain following the public release. Near term exercise of the SAR for cash would thus be an expedient means of obtaining profits while avoiding section 16(b)'s proscription of short-swing trading in "equity securit[ies]." [13] Alternatively, where materially adverse information is about to be disclosed, insiders who exercise previously granted SARs may gain the advantage of the currently high market, leaving the public shareholders to suffer alone through the forthcoming market decline. Grants of SARs may conceivably involve manipulative "trading" if coordinated with market sales of the underlying securities, thus permitting insiders to sell securities on the market at inflated prices and, following a market drop due to disclosure of previously confidential adverse information, "buy back" the securities at lower prices through obtaining an equivalent number of SAR-units. The probability that any of the foregoing abuses may occur is speculative at best, however, in light of internal program safeguards and the

8. 15 U.S.C. § 78p(b) (1976). Section 16(b) provides for recovery by a corporation of "profits" realized by insiders from short-swing transactions (purchase and sale, or sale and purchase, within a six-month period) in the corporation's "equity securities." The term "profits" has been broadly defined as a matching of the lowest priced purchases against the highest priced sales within the six-month period, disregarding notions of FIFO (first in, first out) accounting, identity of certificates, and other criteria that may in fact be more reflective of actual economic consequences. Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943). Section 16(b) provides only for private enforcement, either through direct or derivative actions.

9. *See* text accompanying note 45 *infra.*

10. 99 S. Ct. 790 (1979), *rev'g* 561 F.2d 1223 (7th Cir. 1977).

11. A similarly broad interpretation advanced by the Commission was rejected in United Hous. Foundation Inc. v. Forman, 421 U.S. 837 (1975).

12. *See* text accompanying notes 41-45 *infra* for further discussion of the *Daniel* decision.

13. 15 U.S.C. § 78p(b) (1976).

inhibiting influence of state statutory and common-law corporate norms. To date there has not been a single instance cited by the SEC or raised in federal or state litigation of an SAR program which was designed or administered to achieve, or which has resulted in, any manner of manipulation which section 16(b) is intended to prevent.[14]

Without providing any analysis of the argument for application of section 16(b) or discussion of the likelihood that SARs actually lead to the kind of speculative abuse for which statutory recovery of profits was intended, the Commission raised the imposing specter of section 16(b) liability. By amending rule 16b-3, however, it provided a "safe harbor" of immunization from such liability for participants in SAR plans if the plans conformed to a panoply of Commission standards. Although safe harbor provisions often imply that transactions outside the harbor's parameters are subject to civil or criminal penalties or other form of regulatory control,[15] the Commission stopped short of adopting an express position on SARs. In fact, it disclaimed any intent on its part to subject nonconforming plans to potential application of section 16(b).[16] The disclaimer, unfortunately, borders on the disingenuous, as the *in terrorem* effect created by the implied potential of section 16(b) liability produces a result which differs little from the adoption of a fixed rule of application allowing neither latitude nor deviation.[17]

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14. In Matas v. Siess, [Current] FED. SEC. L. REP. (CCH) ¶ 96,749 (S.D.N.Y. Jan. 19, 1979), the court regarded the SAR program of Apco Oil Corporation as inherently capable of speculative abuse, since "[t]he officer or director is in a position . . . to reap a profit which he speculates may not be realizable a few months hence, based on inside information." *Id.* at 94,924. The court's statement was in the context of denying a motion to dismiss, however, and no facts had as yet been developed regarding the particular SAR plan and the grants and exercises thereunder. *See* note 138 *infra.* Moreover, the court treated as immaterial the lapse of time between dates of grant and exercise, a position that may well be contrary to the statutory standard of § 16(b). *See* text accompanying note 74 *infra.*

15. For example, the Commission Release regarding proposed safe harbor guidelines for the disclosure of financial projections provides that such projections will not be deemed false or misleading if there is a reasonable basis for them and if they are disclosed in good faith. SEC Exchange Act Release No. 34-15,306, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,757 (Nov. 7, 1978). A finding of liability under rule 10b-5 or other provisions may therefore be expected in the absence of a reasonable basis for and good faith disclosure of financial projections.

16. The Commission's action in revising Rule 16b-3 in order to provide a "safe harbor" for certain transactions in stock appreciation rights should not be construed as a statement by it that SAR transactions which do not satisfy the conditions of the rule necessarily are subject to section 16(b). In this regard, the Commission wishes to emphasize that because of the unsettled legal status of stock appreciation rights under section 16, it is expressing no view as to the applicability of that section to transactions in stock appreciation rights that are outside the scope of Rule 16b-3, and that no inference in that connection should be drawn from the Commission's actions today.

SEC Exchange Act Release No. 34-13,097, *supra* note 7, at 755.

17. Conformity to the safe harbor provisions is characterized as "essential" by Herzel & Perlman, *Stock Appreciation Rights*, 33 BUS. LAW. 749, 768 (1978). Those authors, as practicing attorneys, reflect the understandably conservative response of the bar to the safe harbor provisions and accompanying SEC statements. Thus, in a recent request for a staff interpretation, counsel wrote: "We recognize that Rule 16b-3 is intended to be no more than a 'safe harbor'. However, as a matter of prudence, stock option plans and exercises of rights thereunder are normally structured and planned to comply with the Rule and the interpretations of the Commission and the Staff." Houdaille Indus., Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,635, at 80,561 (footnote omitted).

The SEC's adoption of safe harbor guidelines, in the absence of any well-reasoned justification, raises important issues concerning responsible agency conduct in the formulation and adoption of administrative rules. Specifically, it is questionable whether the Commission's duty to provide guidance and "expertise" may be avoided by the shield of non-position and safe harbor declarations.[18] In the context of SARs and rule 16b-3, serious questions are also raised as to whether sufficient evidentiary and legal bases exist for the application of the rulemaking process, particularly where the rules (regardless of the seeming neutrality of disclaimers and safe harbor designations) have the inevitable effect of substantially hindering or preventing adoption of long established corporate incentive compensation programs. By avoiding analysis, the Commission has deferred judgment to whichever courts may become the forum for the issue of section 16(b)'s application. Pending judicial clarification, it remains unclear how far company plans may stray from the straight and narrow of rule 16b-3. And when challenge is made, to what extent should the safe harbor guidelines determine the potential for section 16(b) abuse?

This Article will discuss the issues raised by the Commission's adoption of the amendments to rule 16b-3. After briefly describing the most important features of SAR programs, it will consider the question which the Commission did not choose to answer—whether section 16(b) applies to transactions in SARs. The Article will then examine the basis and scope of the safe harbor provisions, particularly from the perspective of companies that may find themselves either deliberately or unwittingly outside the harbor's confines, and will consider to what extent such provisions are appropriate standards even if section 16(b) is applicable to SARs. Because of the Commission's particular concern with plans that provide participants the ability to obtain cash (in lieu of an equivalent value of stock) upon SAR exercise, this Article will focus principally upon these issues in relation to SAR cash settlements.

I. Stock Appreciation Rights

In its common form, a stock appreciation right is a variety of deferred, nontransferable, incentive compensation. Upon exercise, the grantee of a

18. In Robinson v. UMW Health & Retirement Funds, 435 F. Supp. 245, 247 n.3 (D.D.C. 1977), the court noted that,

> [u]ntil *Daniel* [v. International Bhd. of Teamsters, 561 F.2d 1223 (7th Cir. 1977), *rev'd*, 99 S. Ct. 790 (1979),] the SEC consistently maintained the view that non-contributory pension plans were not covered by the federal securities laws. . . . Having suddenly shifted its position in an *amicus* brief in that case, the SEC is no longer entitled on this issue to be accorded the special deference normally granted to an administrative agency interpreting its governing statute.

It is not argued here that, with regard to SARs, the SEC's years of silence preclude it from adopting particular rules or weaken the deference ordinarily accorded its positions. Rather, given the passage of time, the undisturbed growth in popularity of SAR plans, the lack of firm evidence of abuse in a § 16(b) context, and the weakness of the legal arguments for statutory application, the SEC should have confronted and commented upon the legal issues in a much more direct manner and should have avoided even the apparent (but clearly ephemeral) neutrality of a safe harbor provision in the absence of such analysis.

determined number of SAR-units is entitled to receive an amount equal to the appreciation in market price of a like number of shares of common stock of the grantor corporation between the date of SAR grant and the date of its exercise. As with stock options, consideration for SAR grants is generally based upon covenants not to compete, long-term employment undertakings, post-retirement consulting arrangements, and other non-monetary employment covenants entered into at the time of the grant.[19] Unlike stock options, however, the exercise of an SAR requires no payment by the grantee to obtain the value of the market spread. Rather, an amount equivalent to the appreciation is paid to the grantee in the form of cash, securities, or a combination of both. At no time is there a purchase or sale by the grantee (as such transactions are commonly regarded) of any of the underlying traded securities to which the SAR relates.

SARs are generally either "free-standing" or coupled with stock option grants.[20] "Free-standing" SARs are granted independently of other compensation arrangements. They may be subject to both minimum holding periods and requirements that they be exercised within a particular time frame (for example, within two years after retirement). When SARs are coupled with stock option grants, SAR units are generally granted in an amount equal to the number of shares subject to option. Exercise of any portion of either the stock option or the SARs causes a corresponding reduction in the number of shares or SAR units remaining subject to option, thus maintaining a balance between outstanding options and SAR units. Grantees may exercise solely the stock option portion of the grant, solely the SAR, or a portion of both, utilizing the cash obtained from the SAR exercise to purchase the option shares. Coupled with stock option grants, the SAR thus provides an interest-free means of financing the acquisition of option shares.[21]

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19. The Koppers plan requires grantees to agree to remain in Koppers' employ for five years from the date of grant, or until retirement, whichever is first, and to observe the terms of a restrictive covenant following severance of employment. *See* Lieberman v. Koppers Co., 38 Del. Ch. 239, 242, 149 A.2d 756, 758, *aff'd sub nom.* Lieberman v. Becker, 38 Del. Ch. 540, 155 A.2d 956 (Sup. Ct. 1959).

20. Although statistics are not available, it is probable that most SARs are coupled with stock option grants, with the SARs providing a method of financing the exercise of stock options. The Commission has noted that generally only plans calling for SARs issued in tandem with stock options have been brought to the Commission's attention. SEC Exchange Act Release No. 34-12,374, 41 Fed. Reg. 19,983, 19,983-84 (Apr. 23, 1976). In light of differing incentive considerations, some companies have adopted both "free-standing" and stock option SAR plans. *See, e.g.*, Interpretative letter to Columbia Pictures Indus., Inc. (Aug. 4, 1977) (avail. Sept. 6, 1977).

21. The following plan description, set forth in a request for a no-action letter by Towers, Perrin, Forster & Crosby, Inc., is typical:

> Briefly, the term "stock appreciation right" generally refers to an optionee's right to elect to receive the difference between the market value of optionable shares as of the exercise and option grant dates in cash or shares of stock, in lieu of exercising the stock option. For example, an optionee may have the right to exercise shares of stock at its fair market value of $100 per share as of the option grant date. If the value of such stock subsequently increases to $115, he may exercise the option to purchase shares of Company common stock at $100 or, alternatively, he can waive such purchase right in consideration of his receipt of $15 per optionable share of stock either in cash or the fair market equivalent in shares of Company

Variations among SAR plans abound, limited only by specific compensation considerations and the ingenuity of corporate executives, counsel, and consultants. Minimum holding periods range from six months to an indefinite date of retirement, depending upon whether goals are oriented to current compensation, long term incentives, or retirement. After expiration of minimum holding periods, time frames for SAR exercise range from periods relatively close to the date of grant if the SAR is regarded as part of a current compensation program to periods coinciding with or past retirement if SARs are awarded for retirement program purposes.[22] Valuation provisions for determining market appreciation include such variations as (i) average price during a fixed period (*e.g.*, twenty days) immediately preceding date of exercise and (ii) market price on a date selected by the grantee within a fixed period following retirement if the market price on the selected date does not exceed the highest market price of the company's stock during the period of the grantee's employment.[23] The determination of the form of payment, whether in cash, securities, or a combination of both, may be made by the grantee, by the committee administering the program, or by some form of joint decisionmaking.[24] Some plans provide for accrual of dividend credits equal to dividend payments made on the underlying stock to which the SAR applies, while others provide for interim cash payment of such "dividends" even prior to the actual exercise of the SAR.[25] Stockholder voting rights for SAR holders may even be incorporated through an agreement by the corporation's principal stockholders to vote their shares in the manner directed by SAR holders on a one-share-per-SAR-unit basis.[26]

> common stock. In some cases, the optionee may make a partial waiver of optionable shares so that he can receive his "stock appreciation rights" in cash which he then uses to exercise the balance of his option.

[1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,756, at 84,036-37 (1974).

22. SAR exercises are frequently limited to maximum stated percentages over a period of time, such as 20% per year (often cumulative as to prior non-exercised portions) over a five-year period, commencing upon expiration of the minimum holding period.

23. The retirement-oriented Koppers plan provides for an alternative valuation date (referred to as the "Selected Value Date") in lieu of the grantee's date of termination of employment, with the alternative valuation date being selected by the grantee during the three-year period immediately following termination of employment. A ceiling on market prices, equivalent to the highest prices at which the common stock traded on the New York Stock Exchange between the date of grant and date of termination of employment, is provided, however. If no alternative valuation date is selected, the grantee's valuation date is fixed, subject to the ceiling price, as the third anniversary of the date of termination of employment. *See* Lieberman v. Koppers Co., 38 Del. Ch. 239, 242, 149 A.2d 756, 758 *aff'd sub nom.* Lieberman v. Becker, 38 Del. Ch. 540, 155 A.2d 596 (Sup. Ct. 1959).

24. The Commission's response to SARs was particularly concerned with the discretionary election to receive cash upon SAR exercise. The "cashing-out" of SARs raises fears of abuse of inside information to a much greater extent than does the use of SARs to finance the exercise of stock options, for the stock so acquired continues to be subject to the six-month holding period of § 16(b). *See* 17 C.F.R. § 240.16b-3(e)(5) (1978). Reflecting this concern, the rule 16b-3 amendments principally involve provisions governing cash settlements of SARs. *See* SEC Exchange Act Release No. 34-13,659, 42 Fed. Reg. 33,283 (June 22, 1977); SEC Exchange Act Release No. 34-13,097, *supra* note 7.

25. See, *e.g.*, the description of Bell System Long Term Incentive Plan set forth in American Tel. Co., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,608 (Apr. 6, 1978) (avail. May 8, 1978).

26. *See, e.g.*, Austin Bridge Co., [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,672 (1973).

The above description, while not covering all variations of SAR plans, includes the principal elements of SAR plans tied to stock market appreciation.[27] The plans essentially enable executives and other grantees to profit, without ownership risk, from an increase in market price of their corporations' publicly traded securities.[28]

II. Application of Section 16(b) to SARs

Unlike the judicial challenges to the legality of SAR-type programs under state law,[29] the challenge under federal securities law is of recent vintage. Two elements comprise the argument for application of section 16(b) to cash settlements of SARs. The first is that an SAR is, or at least should be deemed to be, an "equity security," the *sine qua non* of section 16(b)'s applicability;[30] the second is that exercise of an SAR is equivalent to a simultaneous purchase from and sale to the issuer of the underlying stock on which the SAR's value is based. Neither of these arguments commands direct statutory or judicial support. Determining whether the statute applies requires both undertaking analysis of its language as well as the more difficult task of perceiving the particular transaction within the scope of legislative intent. The SEC failed to provide analysis in either of those areas. In light of the recent prominence, noted below, of a pragmatic interpretation of section 16(b), we might have at least expected some discussion regarding the potential for speculative abuse of SARs.

A. *SARs as "Equity Securities"*

1. *The Meaning of "Security."* Characterization of SARs as a type of "equity security" presumes the underlying existence of a "security." [31] Yet,

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27. Alternatives to market appreciation include plans tied to performance goals such as increases in book value or per share earnings. The SEC generally treats performance award plans as analogous to "stock bonus" or similar plans, rather than SARs, and therefore regards exemptions from § 16(b) as based upon the stock bonus plans provisions of rule 16b-3. 17 C.F.R. § 240.16b-3 (1978). *See* SEC no-action letter to Eli Lilly & Co. (avail. Sept. 30, 1976).

28. There have been two reported stockholder challenges to SAR-type plans under state law. In each instance the plaintiffs alleged that an increase in the market value of the corporation's shares is not an appropriate standard to determine employee compensation, citing the disparity that may exist between the value of employees' services and the price of the corporation's stock. Differing conclusions as to such relationships and effects led to opposing decisions on the issue. *Compare* Lieberman v. Koppers Co., 38 Del. Ch. 239, 149 A.2d 756 (upholding the plan), *aff'd sub nom.* Lieberman v. Becker, 38 Del. Ch. 540, 155 A.2d 596 (Sup. Ct. 1959), *noted in* 108 U. PA. L. REV. 1066 (1960), *with* Berkwitz v. Humphrey, 163 F. Supp. 78 (N.D. Ohio 1958) (upholding the stockholders' challenge), *noted in* 47 CALIF. L. REV. 190 (1959). *Lieberman* appears to be the prevailing opinion as to the validity of SAR plans, however, since the growth of such plans in recent years has not generated stockholder challenges.

29. *See* note 28 *supra.*

30. *See* 15 U.S.C. § 78p(b) (1976).

31. In Matas v. Siess, [Current] FED. SEC. L. REP. (CCH) ¶ 96,749 (S.D.N.Y. Jan. 19, 1979), the court failed to address the issue of the existence of a "security." Since the court equated the cash settlement of an SAR with a simultaneous purchase and sale of the underlying common stock, presumably the court's position would be that the "security" requirement is met by the equivalence of an SAR to an unquestioned security, the underlying common

the difficulties in applying statutory norms to SARs are no less evident for this initial inquiry. The problem of statutory application may indeed be even more difficult at the "security" than the "equity security" level, for the statutory definition of the former, unlike that of the latter, does not expressly delegate authority to the Commission to enlarge upon the listed forms of interest by further rules and regulations.[32] There is, to be sure, great latitude and breadth in the statutory definition of "security," and the reference to a "right to subscribe" to stock is particularly relevant to SARs. But fundamental differences between SARs and the statutory norm preclude facile inclusion of SARs within that norm.

The only listed forms of securities in section 3(a)(10) arguably analogous to SARs are "stock," "participation in any profit-sharing agreement," "investment contract," and a "right to subscribe to or purchase" stock.[33] In terms of investment risk, equity ownership, transferability of interest, rights against officers and directors, voting status, liquidation preferences, dividend rights, and other statutory and common-law attributes accorded to holders of stock, there is little ground for reasonably expanding the statutory reference to "stock" to SARs, a compensation program tied to the effect of trading in shares by persons other than plan participants.

"Participation in any profit-sharing agreement" involves no less a twisting of statutory language to cover SARs.[34] To the extent that there is an understanding as to what constitutes participation in a profit-sharing agreement, Professor Loss, after noting the breadth of interpretation, has concluded that "[t]he line is drawn . . . where neither the element of a common enterprise nor the element of reliance on the efforts of another is present."[35] While market appreciation is undeniably the result of the trading activities of others, it takes a considerable stretching of an SAR program to regard it as an "enterprise" or to regard the requirement of reliance upon efforts of others as satisfied by the independent, uncontrolled, and unforeseeable trad-

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stock. That approach would be a subtle sleight of hand that shifts the inquiry from whether the SAR is a security to whether the exercise of the SAR has an effect similar to the sale of a security. That form of interpretative approach is essentially a modification of the statutory reference to "equity security" by insertion of the phrase "or any kind of transaction that would be similar in effect to a purchase and sale, or sale and purchase, of an equity security." Such statutory elongation may sweep in far more than SARs, but in any event cannot be supported in the context of a punitive statutory provision and an actual definition of terms by Congress itself. *See* note 32 *infra*.

32. *Compare* 15 U.S.C. § 78c(a)(10) (1976) (defining "security") *with* 15 U.S.C. § 78c (a)(11) (1976) (defining "equity security").

33. *See* 15 U.S.C. § 78c(a)(10) (1976).

34. Profit-sharing plans commonly involve the annual distribution of a portion of corporate profits to a fund managed by administrators or trustees selected by the corporation. Vesting of interests in plan participants, forfeiture, and other plan provisions govern the rights of individual participants. The amount eventually paid from the fund to participants upon termination of employment, retirement, or other qualifying condition is the combined result of vesting and contribution provisions, corporate funding of the plan, and the success of investment decisions by plan managers.

35. 1 L. Loss, Securities Regulation 491 (2d ed. 1961). *Cf.* Hirk v. Agri-Research Council, Inc., 561 F.2d 96 (7th Cir. 1977) (lack of commonality in various discretionary trading accounts indicates no participation in a profit-sharing agreement in a form intended by the 1933 Act).

ing in securities by future unknown stockholders. Totally lacking from any analogy of SARs to profit-sharing plans is a common fund of corporate contributions maintained and invested by plan trustees on behalf of the undivided interests of all plan participants.

Broader application may be gained from the term "investment contracts," a phrase that contains no clear cross reference, and therefore is not limited by analogy, to particular forms of financial interest. Not surprisingly, therefore, this phrase has been the focus of efforts by private litigants and the Commission to expand the definition of "securities." Although earlier Supreme Court decisions finding "investment contracts" in a variety of forms gave broad scope to that term,[36] the Court has rejected expansive arguments in the two most recent cases before it.[37] In *United Housing Foundation, Inc. v. Forman*,[38] the Court held that "Congress intended the application of [the federal securities laws] to turn on the economic realities underlying a transaction, and not on the name appended thereto." [39] The economic realities of the cooperative apartment shares involved in *Forman* were not viewed by the Court as the equivalent of investment contracts. Rather, the Court was influenced by such factors as the inalienability of the shares, the lack of substantial risk confronting the invested capital, and, perhaps most importantly, the fundamental purpose of the shareholders who "were interested in acquiring housing rather than making an investment for profit." [40] Similar conclusions may apply to holders of SARs, which are also inalienable, lacking in substantial risk, and, fundamentally, are more likely to be regarded by holders as a method of incentive compensation than "an investment for profit."

In *International Brotherhood of Teamsters v. Daniel*,[41] the Court picked up a similar theme by referring to the pension plan at issue as being "a relatively insignificant part of an employee's total and indivisible compensation package." [42] SARs may carry the potential of substantial gains, but their inherent contingencies, coupled with the lack of meaningful control over value, would reasonably place them for most, if not all, employees considerably subordinate to current compensation and vested fringe benefit provisions. Although separate consideration beyond current services is generally required of SAR grantees,[43] neither post-retirement consulting obligations nor short-term restrictive covenants can be regarded as a significant additional

36. *See* Tcherepnin v. Knight, 389 U.S. 332 (1967) (capital shares in a savings and loan association); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (limited risk annuities); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959) (issuance of variable annuity contracts); SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (sale of citrus acreage accompanied by option to purchase service contracts to cultivate and market fruit).

37. International Bhd. of Teamsters v. Daniel, 99 S. Ct. 790 (1979); United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

38. 421 U.S. 837 (1975).

39. *Id.* at 849.

40. *Id.* at 860.

41. 99 S. Ct. 790 (1979).

42. *Id.* at 797.

43. *See* text accompanying note 19 *supra.*

element to an employee's current services. As noted by the Court in *Daniel*, "[l]ooking at the economic realities, it seems clear than an employee is selling his labor primarily to obtain a livelihood, not making an investment" for the future.[44]

The *Daniel* decision may be particularly relevant to SARs because the Court was faced with a form of deferred compensation that was noncontributory in nature and of uncertain value until date of vesting. The Court impliedly rejected the broad conclusion reached by the Seventh Circuit that "a right to receive benefits, received as a form of compensation and not subject to unilateral withdrawal by the . . . employer, is a sufficient interest to constitute a security, even though it will only mature upon the happening of certain events in the future."[45]

The remaining area of potential statutory applicability would be to regard SARs as a "right to subscribe to or purchase" stock. As noted below,[46] dependence on this criterion would preclude application to plans involving only cash settlements of SARs, a result contrary to the Commission's principal concern. For plans that offer a stock or cash settlement alternative, the SAR would be a strained form of "right to purchase" where exercise of an SAR is totally contingent on factors beyond the grantee's control, is defeated by an absence of market appreciation, and may result in the plan's administering committee requiring the payment of cash in lieu of stock.

2. *The Meaning of "Equity Security."* Assuming the substantial obstacles of the "securities" hurdle are cleared, the definitions of the term "equity security"[47] are sufficiently broad to provide arguable application to SARs in at least three alternative manners. SARs might be regarded as (i) participation in a profit sharing agreement, (ii) securities or rights

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44. 99 S. Ct. at 797.

45. Daniel v. International Bhd. of Teamsters, 561 F.2d 1223, 1233, (7th Cir. 1977), *rev'd*, 99 S. Ct. 790 (1979). Also important is the Court's "starting point," 99 S. Ct. at 795, the construction of the statutory language, and its reference to the omission of pension plans in both the 1933 and 1934 Acts "[i]n spite of the substantial use of employee pension plans at the time they were enacted." *Id.* Although SAR plans had not been devised when the 1933 and 1934 Acts were originally passed, there has been an ongoing omission of SARs in both statutes and regulations despite a considerable period of substantial use and numerous statutory and regulatory amendments.

46. *See* text accompanying note 52 *infra*.

47. 15 U.S.C. § 78c(a)(11)(1976) provides:

> The term "equity security" means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

17 C.F.R. § 240.3a11-1 (1978) provides:

> The term "equity security" is hereby defined to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.

convertible into the underlying common stock (followed by immediate resale to the issuer), or (iii) an option or privilege of "buying such a security from or selling such a security to another without being bound to do so." [48] As noted in the context of the 1933 Act,[49] the statutory terms have "been liberally construed by the courts to bring within the act many forms of transactions which, on their face, do not appear to be 'securities' in the commercial sense of the word." [50]

Despite the remedial purpose served by expansive regulatory language and judicial interpretation, an otherwise legitimate form of corporate compensation should not be implicitly subjected to the perils of section 16(b)'s application without fuller analysis than has been presented to support the need for protective measures. Such an analysis would reveal that none of the possible arguments for concluding that SARs are equity securities can be supported.

As noted,[51] the dissimilarities appear dominant in any attempt to analogize SARs to participation in a profit sharing agreement. The convertibility alternative appears more plausible, but it necessarily involves a fiction if SARs are exercisable only for cash settlements. Moreover, even when exercise for an equivalent value of stock is an offered alternative, the SARs themselves are not convertible. Rather, the grantee is given the right to apply the monetary value of the SARs to the purchase of an equivalent value of stock. Such a right to purchase is much closer to the third alternative—an option to buy stock—thus suggesting that SARs exercisable only for cash do not fall within the statutory or regulatory definitions, while SARs providing alternative modes of payment may be within these confines.[52] The logic of such a result, however, is contrary to the concerns of the Commission, which focus almost exclusively upon cash settlements.

Thus, despite the breadth of the definitions, there remains substantial doubt that a nontransferable SAR providing for cash settlement (or permitting the purchase of stock in lieu of cash) is an "equity security." There

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48. 17 C.F.R. § 240.3a11-1 (1978). Although the regulation is drafted in the disjunctive of buying or selling the underlying security, it would not be an unreasonable extension (once the greater leap has been taken of concluding that a purchase or sale had occurred) to apply the regulatory language to the deemed conjunctive SAR purchase *and* sale transactions.

49. *See* 15 U.S.C. § 77b(1) (1976).

50. Feldman & Rothschild, *Executive Compensation and Federal Securities Legislation*, 55 MICH. L. REV. 1115, 1117 (1957). Indeed, if the term "stock" were deemed to include all of its functional equivalents, SARs might be regarded simply as "stock." *Cf.* Note, *Put and Call Options Under Section 16 of the Securities Exchange Act*, 69 YALE L.J. 868, 873 (1960) (arguing that "puts" are functionally equivalent to stock).

51. *See* text accompanying notes 34-35 *supra.*

52. Cash settlements of SARs are arguably analogous to both a simultaneous exercise of a "call" at the market price as of the date of grant and a "put" at the then current market price, and a limited form of "put" establishing a ceiling on profits limited to the spread in the market between dates of grant and exercise of the SAR. The analogy would not lead to statutory application, however, for "puts" and "calls" involve contracts to purchase or sell the underlying securities and are therefore within the statutory references of "buying such a security [i.e. the underlying stock] from or selling such a security to another." 17 C.F.R. § 240.3a11-1 (1978). A cash settlement of an SAR at no time involves a contract to acquire or dispose of the underlying security—it is no more than a right to obtain the monetary value of the market spread.

is, after all, no investment in stock, no ownership or purchase of shares, and no acquisition of rights to purchase shares, except as an alternative form of payment which, if exercised, will itself set the section 16(b) clock running as to the stock so acquired. Nor do SARs generally authorize or provide equity investment attributes such as voting, dividend, and liquidation rights.[53] In light of the unique characteristics of SARs, this form of compensation should not be regarded as an "equity security" in the absence of clearer legislative authorization. Although it is true that section 16(b) "is not aimed solely at the actuality of evil . . . but also at potentiality,"[54] experience over time ought to provide an adequate means of judging whether that potentiality exists. SARs have been a form of corporate compensation for over twenty years without providing evidence of abuse of the letter or spirit of the securities laws. To raise the specter of statutory applicability at this point creates, without sufficient cause, serious problems as to SARs issued and exercised in the past as well as substantial uncertainties for companies considering current SAR plans.

B. *Cash Settlements as Simultaneous Purchases and Sales*

Even if SARs arguably fall within the broad definition of "equity security," there appears to be very little support for the second prong of section 16(b)'s application, the supposed equivalence of an SAR cash settlement to a simultaneous purchase of the underlying shares (at the date-of-grant price) and resale of those shares (at current market price) to the grantor corporation.[55] When SARs are coupled with stock option grants, the simultaneous purchase-sale argument emphasizes the concurrent surrender (likened to a "sale") of an equivalent number of stock options.[56]

Analogy, however, is the beginning, not the end, of legal analysis.

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53. If grantees are accorded dividend accruals, voting privileges, and other benefits prior to exercise, *see* text accompanying notes 25-26 *supra*, there may be justification for treating such SARs as a form of equity security, regardless of payment options. For example, the Commission has indicated, in response to an inquiry regarding the pass-through of voting rights for pension plan participants in the context of the rule 16a-8(g) exemption from reporting requirements, that "the mere pass-through of voting rights to participants . . . would not, in and of itself, destroy the exemption from the reporting requirements." The Commission pointed out, however, that if other elements are also present to suggest a direct rather than indirect interest in the portfolio's securities, the combined effect of a pass-through of voting rights and other elements may destroy the exemption. Pillsbury, Madison & Sutro, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,472, at 83,318 (1973).

54. Newmark v. RKO General, Inc., 425 F.2d 348, 350-51 (2d Cir. 1970).

55. "The concern in this area apparently is based on the possibility that the settlement of a stock appreciation right for cash may be deemed to involve a purchase of stock which is simultaneously sold to the issuer in a cash sale." SEC Exchange Act Release No. 34-13,097, *supra* note 7, at 755.

56. Alternative arguments, unsuccessfully raised by the plaintiff in Freedman v. Barrow, 427 F. Supp. 1129, 1151-52 (S.D.N.Y. 1976), were characterized by the court as either (i) that "the exercise of an SAR . . . is in reality two matched transactions, a *purchase* of *stock* equal to the aggregate amount of the spread and a simultaneous *sale* of the *stock option* back to the corporation" or (ii) that the net result is the same "as if he [the executive] had exercised a stock option, and then immediately sold enough shares to recover his out of pocket cost in exercising the option . . . . Those shares retained would then represent the *profit* realized on the transaction."

Despite the accepted doctrine that "commercial substance of the transaction rather than its form must be considered,"[57] equivalency in result does not transform every disparate form of transaction into the "commercial substance" with which section 16(b) is concerned. Such an argument was rejected by the Supreme Court in *Reliance Electric Co. v. Emerson Electric Co.*[58] In that case, Emerson Electric Co. had acquired 13.2% of the outstanding common stock of Dodge Manufacturing Co. in June, 1967. Emerson, however, found itself on the losing end of a defensive merger between Dodge and Reliance Electric Co. Rather than become a minority stockholder of Reliance (through the forced exchange of stock upon merger), Emerson chose to sell its Dodge shares in the pre-merger market. Recognizing the applicability of section 16(b) to ten percent stockholders, Emerson sold a sufficient number of shares in August to reduce its remaining holdings to 9.96%. This balance was then sold within two weeks. Conceding its section 16(b) liability for the first transaction, Emerson argued that the second and much larger transaction was not within the scope of section 16(b), since it was no longer a ten percent stockholder. Despite the obvious integration of the sales, the Court adopted a literal, "objective" reading of the statute and refused to regard the two sales as linked for section 16(b) purposes. In a suggestion applicable a fortiori to SARs, the *Reliance* Court indicated that congressional intent as to the transaction in question would be better determined by statutory amendment since "[l]iability cannot be imposed simply because the investor structured his transaction with the intent of avoiding liability under Section 16(b)."[59]

The more recent trend to a pragmatic approach to interpretation of section 16(b),[60] which focuses upon the effect and nature of the particular transaction, also appears to require rejection of a formalistic "simultaneous purchase-sale" analogy. Such an analogy was rejected by a district court as a ground for section 16(b)'s application in *Rosen v. Drisler*,[61] which involved the surrender of stock options in return for payment of the spread between the option exercise price and the then current market price.[62] To plaintiff's argument that the surrender and payment were equivalent to the simul-

57. Bershad v. McDonough, 428 F.2d 693, 697 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971).

58. 404 U.S. 418 (1972).

59. *Id.* at 422. The competing "objective" and "pragmatic" approaches to 16(b) applicability are discussed in Note, Reliance Electric *and 16(b) Litigation: A Return to the Objective Approach?*, 58 VA. L. REV. 907 (1972). The Court in its subsequent decision in Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973), discussed the alternative approaches to statutory interpretation of 16(b), indicating its acceptance of the "pragmatic" approach for "unorthodox" transactions. *Id.* at 594 n.26.

60. *See* text accompanying notes 81-90 *infra*.

61. 421 F. Supp. 1282 (S.D.N.Y. 1976).

62. "The fact that an alternative manner of carrying out a transaction which would violate 16(b) is available does not render another method of completing the transaction violative of the section." *Id.* at 1286.

taneous exercise of the stock options followed by the sale of the stock back to the company, the court replied:

> In the instant case, accepting, *arguendo*, plaintiff's characterization of the transaction as a "purchase" and subsequent "sale," there was no span of time between the "purchase" and "sale" in which the market could fluctuate and which could be exploited by any of the defendant insiders in the form of short-swing profits. Such transactions thus do not create an opportunity for "the realization of short-swing profits based upon access to [inside] information," the evil to which 16(b) was attuned.[63]

Similarly, in *Freedman v. Barrow*,[64] plaintiff's arguments by analogy for section 16(b)'s application to SARs were rejected by a district court that found that "[m]erely because the net result to the employee is the same as if some other transaction had taken place does not mean that other transactions have in fact occurred." [65] Noting that the section 16(b) rules "reflect a practical and balanced approach to the problem which recognizes the importance of these employee incentive plans," [66] the court rejected "this strained attempt to carve up the single SAR transaction by calling it something which it is not. The exercise of a stock appreciation right does not involve the *sale* of an equity security by the officer-director . . . ." [67] Thus, the simultaneous purchase-sale argument for section 16(b) applicability is not supported by either "objective" or "pragmatic" approaches to statutory interpretation.

Matas v. Seiss[68] is the sole decision to the contrary. The court there found an SAR cash settlement to be "a wholly voluntary simultaneous purchase and sale." [69] Analogizing SARs to stock options, the court concluded that "[s]ince an option is a purchase only when it is exercised, not when it is granted, there was a purchase here." [70]

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63. *Id.* at 1287 (quoting Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594-95 (1973)). *See also* Del Noce v. Jomarco, Inc., [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,954, at 93,805-06 (S.D.N.Y. 1973).

64. 427 F. Supp. 1129 (S.D.N.Y. 1976).

65. *Id.* at 1152.

66. *Id.* at 1152-53.

67. *Id.* at 1152.

The arguments in *Freedman* were raised in the context of stock rather than cash settlements of SARs, and the court's rejection of the "equivalency" theories is therefore limited to that context. Indeed, the court observed in dictum that "if an SAR was settled entirely for cash, this would constitute a sale, as to the net proceeds received, some or all of which would be subject to § 16(b)," *id.* at 1153, but provided no citation or reasoning in support of this dictum. It appears that the court was addressing itself only to the form of the plan before it, which was a tandem SAR-stock option plan and which provided only for the receipt of stock upon SAR exercise. Although there was no cash election alternative, the plan permitted the corporation, at its sole discretion, to settle its stock obligation by payment of an equivalent amount of cash. In that context a decision to pay cash in lieu of stock is more closely analogous to a "sale" of the underlying stock, as the grantee expects and is entitled to receive only the underlying stock.

68. [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,749 (S.D.N.Y. Jan. 19, 1979).

69. *Id.* at 94,925.

70. *Id.* (footnote omitted).

The court's analogy to stock options is inapt. The issue with stock options is whether the exchange of one form of security (the stock option) for another (the purchased stock) permits the tacking of the former holding period to the latter. Similar considerations are not applicable to the cash settlement of an SAR, where the right itself is a questionable security and its exercise clearly does not result in the acquisition of any security.[71] Analogy to other forms of securities may be a useful tool for interpretative purposes, but the *Matas* court failed to note or discuss the substantive differences between SARs and stock options that should at least give pause to one who relies upon such an analogy.

With equal ease and the barest of discussion, the *Matas* court found that the receipt in cash of the appreciated value of the underlying stock was "plainly a sale." [72] No reference is made regarding a sale of "what" or "to whom." In light of the court's minimal effort to examine the statutory language of section 16(b) (the "starting point" of inquiry as noted in *Daniel*),[73] its failure to recognize the elements of SARs that distinguish them from stock options and other securities, and its complete rejection of the relevance of the statutory holding period,[74] it is understandable how the court so readily concluded, contrary to prior case law and the SEC's expressed doubts, "that no stretching of the statute is necessary to find a purchase and sale here within the contemplation of § 16(b)." [75]

If SARs were disguised stock options or some other form of equity security, or a sham form of stock issued to evade restrictions applicable to the stock itself, there would be just cause for elevating substance over form. But SARs are neither disguises nor shams; they enjoy their own substance as an alternative form of corporate compensation. SARs are not simply a means of financing tandem stock options. Cash settlements of SARs, for example, avoid problems of equity dilution of the issuer's securities that may be created by stock option and stock bonus plans. For younger executives and other employees, SARs offer a means of sharing in the growth of their company without having to purchase equity interests. For all grantees, SARs avoid the problem of being tied financially into illiquid, restricted securities obtained upon exercise of stock options, shares that may substantially decrease in value prior to any permissible sale. Even if the stock so obtained is registered on a Form S-8, the amount and timing of the sale of shares may be hindered by market factors. From the corporation's standpoint an SAR program may be preferable to an option program because SAR incentives and benefits, unlike stock options, may be more readily controlled by the company until retirement. In addition to time limitations imposed by the Internal Revenue Code for the exercise of "qualified" stock

71. A more appropriate analogy would be to the holding period of the options, not the stock acquired thereunder. *See* note 80 *infra*.

72. [Current] FED. SEC. L. REP. (CCH) ¶ 96,749, at 94,925.

73. *See* note 45 *supra*.

74. "[T]he fact that an optionee may have held the rights for more than six months is simply irrelevant." [Current] FED. SEC. L. REP. (CCH) ¶ 96,749, at 94,925.

75. *Id.*

options,[76] there is little inclination for shareholders to approve stock option plans that may result in large blocks of unexercised options hanging over the public markets for extensive periods of time. On the other hand, there may be no legal or practical grounds to preclude deferring cash settlements of SARs for as many as twenty or more years, particularly in a retirement-oriented program. Indeed, shareholders may well prefer this. Moreover, once exercised, the terms of SAR cash payments are much more controllable for continuing incentive purposes than the more limited restrictions that may apply to the sale of stock received upon the exercise of stock options. While not exhaustive, this list indicates some of the advantages of timing, financing, and flexibility offered by SARs and not available with stock options or other forms of incentive or retirement compensation. SARs are formed with an independent and legitimate "commercial substance," and courts which consider the applicability of section 16(b) to SARs ought not yield to a simplistic "substance over form" argument.

The infirmities of the argument by analogy are further exposed by examining one element of the supposed transaction—the "purchase." The argument that the cash settlement "purchase" (as well as "sale") occurs upon date of exercise is contrary to current judicial interpretations. The recent decision in *Prager v. Sylvestri*[77] is illustrative. Plaintiff's section 16(b) claim was based upon an alleged short-swing transaction involving defendant's receipt in 1975 of shares obtained under the earn-out provisions of a 1972 merger agreement, followed by their sale within six weeks.[78] The issue raised was the date of defendant's "purchase" of the shares. Citing Supreme Court and Second Circuit authority, the district court held that the date of the merger agreement should be the date of assumed "purchase." At that point, the court concluded,

> the investor becomes irrevocably committed to the transaction and, in addition, no longer has control over the transaction in any way that could be turned to speculative advantage by the investor. It is at that moment that the decision to invest is made and the power to manipulate the transaction is lost.[79]

Thus, the six-month clock began upon execution of the earn-out agreement, not the subsequent "technicalities" of stock transfers or the passing of title.

Similar considerations would apply to SARs, even if it were accepted arguendo that a "purchase" for section 16(b) purposes in fact occurs. At the date of grant the participant obligates himself to whatever consideration

76. *See* note 5 *supra.*

77. 449 F. Supp. 425 (S.D.N.Y. 1978).

78. The merger agreement provided that if the continuing earnings of the merged corporation exceeded specified levels in each of the following four fiscal years, the defendant (who had been the sole shareholder of the acquired corporation) would receive additional stock equal in value to a multiple of the excess earnings.

79. 449 F. Supp. at 432-33 (citing Foremost-McKesson v. Provident Securities Co., 423 U.S. 232 (1976), and Blau v. Ogsbury, 210 F.2d 426 (2d Cir. 1954)). *Accord,* Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978).

is required and his investment is made. In return he receives a specified number of units, or the right to receive such upon application of a specified formula, the "purchase" price of which is equal to the then market value of an equivalent number of shares of stock. Later SAR exercise does not alter the fundamentals of the earlier "purchase." Thus any potential application of section 16(b) should depend upon the hiatus between the date of grant and the date of exercise.[80]

C. *Policy Considerations*

The critical element in determining section 16(b)'s application, one not sufficiently examined by the Commission, is whether SARs pose the possibility of abuse of inside information to which section 16(b) is addressed.[81] Even accepting arguendo that SARs are "equity securities," they cannot be regarded as other than within the "unorthodox" group of transactions [82] for which courts have invoked the pragmatic approach of examining "whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information." [83]

From a pragmatic viewpoint, application of section 16(b) to SARs is supported only by conjecture and somewhat remote potentialities. Except when considerable volatility in the market price is occurring or expected,

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80. Treating an SAR as having been purchased as of date of grant appears contrary at first glance to the treatment of stock options. "For § 16(b) purposes an option is a purchase only when it is exercised, not when it is granted." Levy v. Seaton, 358 F. Supp. 1, 4 (S.D.N.Y. 1973). That rule, however, is applied, as in *Levy*, to determine the holding period of the stock acquired upon exercise of the stock option, not the holding period of the option itself. If focus were placed upon the stock option, for example in situations that might involve trading in options or, as in Rosen v. Drisler, 421 F. Supp. 1282 (S.D.N.Y. 1976), *discussed in* text accompanying notes 61-63 *supra*, where stock options were being cancelled in consideration for their current value, the statutory holding period would commence on the date of grant. As noted in Silverman v. Landa, 306 F.2d 422, 424 (2d Cir. 1962),

> if . . . each option (as distinguished from the stock covered by the option) itself is viewed as an "equity security," as the plaintiff contends, he still has no case. For the call was never exercised and the put was exercised not until after the six months' period. Thus there was no sale and purchase of either option within the statutory period.

81. In Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959), the court considered whether the profits from a conversion of preferred stock into common followed by a sale of the common within six months was subject to recovery under § 16(b). The court rejected an equivalency approach in favor of an inquiry as to whether the particular transaction facilitated speculative abuse of inside information. Finding a valid, independent basis for the conversion (to avoid redemption at a price substantially lower than the market price of the common stock), the court determined that the conversion did not result or arise from speculative advantage accruing to the defendant director. *Accord*, Petteys v. Butler, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967). *Contra*, Heli-Coil Corp. v. Webster, 352 F.2d 156 (3d Cir. 1965). Convertibility questions under § 16(b) were substantially resolved by the exemption provisions of rule 16b-9. *See* 17 C.F.R. § 240.16b-9 (1978).

82. In Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973), the Court noted that "options, rights, and warrants" are among the "unorthodox" transactions appropriate for a pragmatic application of § 16(b). *Id.* at 593 n.24. The ambiguities in the *Kern* decision regarding which elements present in that case were necessary or sufficient to take the transaction outside the scope of § 16(b) are discussed in Note, *Exceptions to Liability Under Section 16(b): A Systematic Approach*, 87 YALE L.J. 1430, 1434-40 (1978).

83. Kern County Land Co. v. Occidental Petroleum Corp. 411 U.S. 582, 594 (1973).

cash settlements of SARs are unlikely means for short-swing abuse of inside information. Unlike restricted stock options issued at less than fair market value, or stock bonus plans, where employees may sell stock allocated to them and obtain incentive compensation even in a relatively flat market, SARs are unproductive without upward price movement.[84] If such movement is anticipated, other forms of compensation that would not subject grantees (under plans requiring minimum holding periods from date of grant) to the risk of later market decline, such as salary increases, bonuses, and other fringe benefits, might be preferable to SARs. Moreover, exercise of SARs does not injure the integrity of the market place nor does it disadvantage third parties trading without the benefit of undisclosed information, unlike what may potentially occur in transactions among the currently listed forms of "equity securities" to which section 16(b) applies.

The pragmatic emphasis upon the potentiality of speculative abuse should be tempered by considerations of probability, particularly when dealing with a form of unorthodox transaction that does not carry with it a history of misuse. Allegations of abuse regarding an insider's simultaneous writings of puts and calls, based on the "assumed" possibility that the insider could foresee the stability of dividends and earnings over the period of the options (and thus their non-exercise), were dismissed in *Silverman v. Landa*[85] as "underlying assumptions . . . which . . . seem to us remote, at best." [86] The court's opinion was based, appropriately for SARs, not on the absence of the potentiality of speculative abuse, but rather on its conclusion that section 16(b) does not apply to every form of transaction that could possibly involve speculative abuse. "Merely because the options may have been entered into for a speculative purpose," the court noted, "it does not follow that they constitute purchases and sales of the type which were penalized." [87]

Were short-swing problems more evident the Commission might have more appropriately responded to instances of actual abuse, but the Commission has not cited a single instance of short-term speculation involving SARs.[88] While it is neither necessary nor appropriate for the SEC to un-

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84. Moreover, since income upon exercise will be taxed at ordinary rates, *see* I.R.C. § 83, net gain is further minimized and, assuming 50% tax rates, may often not be significant nor create inducements for speculative abuse. Tax deferral may be achieved through installment payments, but regardless of method the absence of capital investment will result in ordinary income treatment of any gains. *See Phantom Stock Plans: An Increasingly Popular Form of Executive Compensation*, 22 J. TAX, 342, 343 (1965).

85. 306 F.2d 422 (2d Cir. 1962).

86. *Id.* at 425.

87. *Id.*

88. The only closely analogous cases to date, neither of which involved cash settlements of SARs, are Rosen v. Drisler, 421 F. Supp. 1282 (S.D.N.Y. 1976), and Freedman v. Barrow, 427 F. Supp. 1129 (S.D.N.Y. 1976). *Rosen* did not involve SARs, but the "simultaneous purchase-sale" argument in the context of a surrender of stock options in exchange for the spread between exercise price and the then current market price. *See* text accompanying note 63 *supra*. *Freedman* is the only case that has dealt with SARs, but it did so in the context of an exercise of an SAR to finance the tandem exercise of a stock option. *See* note 56 *supra*. Plaintiffs' actions were dismissed in both *Rosen* and *Freedman* but in dictum the *Freedman* court stated that it would have reached a different result if a cash settlement had

cover the smoking gun of SAR abuse prior to the issuance of guidelines, a pragmatic approach to the question of section 16(b)'s application seems to require either a hands-off approach pending more definitive evaluation or at least the avoidance of innuendo in view of the lack of evidence of abuse and the remote possibility that such abuse will occur. One commentator has noted that "[a]t the sacrifice of predictability of result, the new pragmatism represents a continued attempt to eliminate the potential for 'purposeless harshness' that in certain situations necessarily arises from the imposition of strict liability." [89] The SEC's action, disclaimers notwithstanding, may have created such "purposeless harshness." Moreover, since a major purpose of section 16(b) is to deter insider manipulation, it is relevant that in instances of high market volatility where abuse could potentially arise, state statutory and common-law safeguards are very likely to prevent or considerably reduce the risk of overreaching or otherwise improper SAR allocations or exercises by corporate directors and officers.[90]

III. Constructing the Safe Harbor

Reflecting its own uncertainties as to the applicability of the securities laws, the SEC has, through the expediency of a "safe harbor," neatly avoided firm conclusions concerning the status of SARs. Nonetheless, its position has created a substantial deterrent to the adoption of SAR programs, particularly those in which cash settlements would be the preferred method of reward. With only a passing footnote reference to the two decisions under section 16(b) then relevant to SARs,[91] the Commission volunteered that

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been involved. The decision in Matas v. Siess, [Current] FED. SEC. L. REP. (CCH) ¶ 96,749 (S.D.N.Y. Jan. 19, 1979), which did involve an SAR cash settlement, was a denial of a motion to dismiss. Since the case has not proceeded to trial, it is not possible to determine whether short-term speculation was involved.

89. Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C.L. REV. 1, 55 (1975).

90. Depending upon variables such as the amount of SARs granted, the timing of grant and exercise dates, and the nature of the intervening market rise, stockholders could challenge short-term SAR bonanzas on one or more of the following grounds: (1) breach of fiduciary duty through the abuse of inside information, *see* Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949); Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969); RESTATEMENT (SECOND) OF AGENCY § 388, Comment c (1958) ("An agent who acquires confidential information in the course of his employment . . . has a duty not to use it to the disadvantage of the principal . . . ."); (2) breach of fiduciary obligation by the board of directors, or perhaps controlling shareholders, through the adoption of a compensation program containing insufficient controls (although Lieberman v. Koppers Co., 38 Del. Ch. 239, 149 A.2d 756, *aff'd sub nom.* Lieberman v. Becker, 38 Del. Ch. 540, 155 A.2d 596 (S. Ct. 1959), upheld the per se validity of the SAR plan, the court noted the existence of substantial internal controls, including Koppers' unilateral right to *reduce* the award); (3) waste or misapplication of assets based upon compensation not bearing a reasonable relationship to the value of services rendered, *see* Rogers v. Hill, 289 U.S. 582 (1933), and its progeny; (4) conflict of interest and self-dealing, thus shifting the burden of proof and invoking statutory standards such as those found in MODEL BUSINESS CORPORATION ACT § 41 (1974). Other causes of action are possible depending upon relevant factors such as charter and bylaw provisions, state law notions of ultra vires, disclosure considerations, and express or implied limitations contained within the SAR plan provisions.

91. "It should be noted, however, that two recent court decisions suggest that Section 16(b) is not applicable to the exercise of a stock appreciation right, at least under the circum-

"there is a great deal of concern and uncertainty in the business community with respect to the status of stock appreciation rights under Section 16 of the Exchange Act." [92] What caused the Commission to act when it did, and on such a broad scale, is best left to speculation. It might reasonably be surmised, however, that the recent growth in popularity of SARs, spurred by the demise of qualified stock options as a favored form of corporate compensation,[93] created a need for a timely statement that would limit the growth of plans that the Commission might be unable to deal with on a retroactive basis, given its years of silence in this area.

A. *Development of the SEC Position*

If non-response could be said to constitute a position, it would not be unreasonable to regard the Commission's initial reaction to SARs as one of at least benign neutrality, if not implied acceptance of them as not inconsistent with the concerns and objectives of securities laws. Because SAR-type plans often involve stockholder approval (for the authorization of additional shares or other reasons) and consequent SEC review of proxy materials, it can scarcely be said that the Commission was unaware of the growing popularity of such plans during the past thirty years.[94] Yet there has not been a single ruling, release, enforcement action, or evidence of any other administrative concern that such plans may involve the issuance of equity securities and the possibility of short-swing abuse. In neither its regulation adopted in 1965 defining the term "equity security" under the 1934 Act nor in its broadening amendment adopted in 1973 [95] did the Commission refer to or describe SARs or similar "shadow stock" concepts. While prior nonreaction may not preclude the raising of current concerns, the historical perspective ought to create pause as to why such concerns have been raised at this time[96] and why a highly articulated safe harbor rather than continued neutrality should be a preferred position.

The change in official position was first reflected in a 1973 response to a request for a no-action letter. The Chief Counsel's office stated that the

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stances described in those cases." SEC Exchange Act Release No. 34-13,097, *supra* note 7, at 755 n.1.

92. *Id.* Prior to its December 1976 issuance of the proposed safe harbor conditions, it appears that only fourteen requests for no-action letters were submitted over a three-year period in connection with potential § 16(b) applicability to SAR programs.

93. Section 603 of the Tax Reform Act of 1976, Pub. L. No. 94-455, § 603, 90 Stat. 1520 (amending I.R.C. § 422), substantially eliminated the tax advantage of qualified stock option plans by subjecting the value of an option to ordinary income treatment when granted, unless the option does not have a readily ascertainable fair market value at such time, in which event the imposition of the tax is postponed to date of exercise when the spread between option price and current fair market value will be taxed as ordinary income. Capital gains provisions were retained for options granted after May 20, 1976 under written plans existing at such date if such options are exercised prior to May 21, 1981.

94. *See* note 2 *supra.*

95. *See* note 47 *supra.*

96. *Cf.* International Bhd. of Teamsters v. Daniel, 99 S. Ct. 790, 801 (1979) ("[A]t no time before this case arose did the SEC intimate that the antifraud provisions of the Securities Acts . . . applied to noncontributory pension plans.").

grant of an SAR constituted the "purchase" of an "equity security" for purposes of section 16(b).[97] This statement, however, was unaccompanied by supporting argument or justification. The immediately apparent and unhappy consequence of this conclusion was that tandem grants of SARs and stock options would be regarded as a section 16(b) "purchase" of the SARs on the date of grant but would not be a "purchase" of the corresponding stock option until date of their exercise. Two short-swing periods would therefore apply, the first commencing at date of tandem grant and the second upon exercise of either of the stock option or SAR portion. In addition to an anomalous treatment of the grants, the supposed SAR "purchase" placed the grantee in the uncomfortable position of instant section 16(b) liability should an awards committee act within six months after the grantee's otherwise innocent and unrelated sale of securities.

The wholly unsatisfactory results caused by the Commission's position compelled a petition for reversal. Upon reconsideration, the staff withdrew its prior statement and adopted a revised position that the grant of an SAR would not be considered a "purchase" of a security, although the exercise of an SAR to acquire stock under a tandem plan would be a purchase for section 16(b) purposes.[98] Concurrently the Commission's staff retreated from its earlier unequivocal statement that an SAR is an "equity security" to the more cautious position that an SAR is "assumed" to be an "equity security." This assumption was made "only for the purpose of enabling the Division to express the interpretations set forth above and the Division is not expressing any interpretative positions at this time on whether stock appreciation rights are equity securities within the meaning of Section 16 of the Act."[99]

This revised position created no short-swing problems for SARs exercised either to obtain funds for the purchase of stock under tandem SAR-stock options or where the appreciated value was paid in stock. In each of these instances the section 16(b) holding period rules would apply to the stock so acquired, thus protecting against abuse through short-term sales.[100]

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97. Interpretative letter from William E. Toomey, Assistant Chief Counsel, SEC, to Xerox Corp. (Apr. 6, 1973) (avail. May 6, 1973). "No-action letters" are SEC staff responses to inquiries from issuers requesting advice, interpretation, or assurance that, assuming particular circumstances and proposed conduct described in the inquiry, no enforcement action under the federal securities laws would be recommended by the staff to the Commission. Although such letters have no precedential or binding force, they often create a substantive body of rules for recipients and similarly situated issuers in the absence of case law or other more authoritative guidelines. For a critique of this informal rulemaking process, *see* Lowenfels, *SEC "No-Action" Letters: Some Problems and Suggested Approaches*, 71 COLUM. L. REV. 1256 (1971). References in this section to the "Commission's" position refer to interpretative or no-action letters issued by Division staff. The only action formally taken by the Commission was the adoption of rule 16b-3.

98. Mobil Oil Corp., [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,716 (1974).

99. *Id.* at 83,912. A summary of the Commission's initial position and reconsideration is set forth in Freedman v. Barrow, 427 F. Supp. 1129, 1146-47 (S.D.N.Y. 1976).

100. Acquisition of stock through the exercise of stock options is a "purchase" activating § 16(b)'s six-month holding period. 17 C.F.R. § 240.16b-3(e)5 (1978). *See* Brenner v. Career Academy, Inc., 467 F.2d 1080 (7th Cir. 1972).

The SEC position did not consider, however, whether and to what extent the exercise of an SAR in whole or part for cash could or should be subjected to section 16(b) scrutiny. In such a situation, the benefit of exercise was obtained immediately and could not thereafter be effectively controlled.

The Commission recognized its inability to issue regulations in this area unless it concluded that SARs were "equity securities," whose exercise constituted a short-swing transaction under the "purchase" and "sale" considerations of section 16(b). Unprepared to adopt such conclusions, the Commission opted for the evasive course of a "safe harbor," setting forth those standards under which cash settlements of SARs would not be regarded as short-swing transactions subject to section 16(b)'s recovery of profits. For plans not meeting the criteria, the Commission advised that the safe harbor provisions "should not be construed as a statement by it that SAR transactions which do not satisfy the conditions of the rule necessarily are subject to Section 16(b)." [101] There is the barest of "cold comfort" in this statement, as it contains a large dose of warning (*nota bene* the term "necessarily") to executives pondering nonconforming plans.

B. *The Dangers of the Safe Harbor*

Despite its reservations regarding section 16(b)'s applicability, the Commission did not tread lightly in constructing the safe harbor's perimeters. The restrictions upon SAR plans contain substantial limitations regarding the form and adoption of plans,[102] the nature of grants,[103] the conditions for governance,[104] and the timing and availability of cash settlements.[105] It is in the cash settlements context that the rule imposes its most extensive conditions, dealing with such matters as public release of financial information,[106] administrative discretion to approve or disapprove elections,[107] and "window periods" permitting elections only during short and specified time frames.[108] Further impetus for adhering to the safe harbor provisions was provided by the Commission's concurrent amendment of rule 16a-6(c),[109]

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101. SEC Exchange Act Release No. 34-13,097, *supra* note 7, at 755.

102. The plan must be in writing, describing the terms of eligibility and the method by which the amount of the award is to be determined, 17 C.F.R. § 240.16b-3(d)(1)(i) (1978), and must be approved by a majority vote of stockholders, *id.* § 240.16b-3(a). Stockholder approval of "material" plan amendments is also required. *Id.* § 240.16b-3(a)(2)(ii).

103. The plan must contain limitations (either on an annual basis or for the plan's duration) on the dollar amount or number of shares of stock "which may be subject to . . . stock appreciation rights." *Id.* § 240.16b-3(c). Limitations may be expressed for each participant or for the plan in the aggregate. It is not clear whether a plan will satisfy this requirement by containing nothing more than a gross, aggregate number, estimated on the high side, of SARs that may be granted.

104. Steerage into the safe harbor may be provided only by "disinterested administrators," unless the plan contains a sufficiently definite formula for the timing and amounts of SAR awards so that administrative discretion is substantially eliminated. *Id.* § 240.16b-3(b),(e)(3). *See* note 114 *infra.*

105. 17 C.F.R. § 240.16b-3(e)(2) (1978).

106. *Id.* § 240.16b-3(e)(1)(ii).

107. *Id.* § 240.16b-3(e) (3) (ii)(B).

108. *Id.* § 240.16b-3(e)(3)(iii).

109. *Id.* § 240.16a-6(c).

exempting the acquisition of an SAR from the reporting requirements of section 16(a),[110] only if granted under a plan conforming to rule 16b-3.[111] These distinct disclosure provisions again belie the Commission's expressed disavowal of opinion as to the legal status of nonconforming plans.[112]

The panoply of rule 16b-3 conditions and disclosure considerations cannot realistically be regarded as a safe harbor, but rather as a set of procedural limitations so extensive in scope and compelling in force that little room is left for corporate flexibility. One shudders to think what more the Commission might have included had it determined that SARs are in fact equity securities subject to section 16(b) rather than disclaiming any opinion on the question.

Numerous corporations may well be capable of adopting plans conforming to the safe harbor provisions, particularly those that have professional "outside" directors or consultants capable of making informed judgments.[113] For many companies, however, the substantial benefits of SARs as a form of compensation may be severely undercut by the procedural standards of rule 16b-3's safe harbor provisions, standards that may not be possible or practical to attain. The principal foreseeable problem areas from a corporate standpoint are now considered.

1. *Disinterested Administrators.* The safe harbor requires that the

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110. 15 U.S.C. § 78p(a) (1976). Form 3, 3 FED. SEC. L. REP. (CCH) ¶ 33,711 ("Initial Statement of Beneficial Ownership of Securities") and Form 4, 3 FED. SEC. L. REP. (CCH) ¶ 33,731 ("Statement of Changes in Beneficial Ownership of Securities"), both adopted in SEC Exchange Act Release No. 34-6487, [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,752 (Mar. 9, 1961), are the reporting forms promulgated by the Commission pursuant to § 16(a).

111. The rule 16a-6(c) exemption for conforming SAR plans is not equivalent to a rule or regulation imposing a reporting requirement upon nonconforming SARs, particularly in light of the Commission's disclaimer of opinion as to an SAR's legal status. *See* note 16 *supra.* Rule 16a-6(c) implies such a disclosure requirement, but query why the Commission avoided the simple expedient of also amending subsection (a) of rule 16a-6 to add SARs to the listed forms of securities for which § 16(a) filing is required. In light of the criminal and civil enforcement provisions of the 1934 Act, *see* 15 U.S.C. §§ 78ff,78u (1976), perhaps the Commission concluded, in a manner resembling its reasoning on the § 16(b) issue, that it could achieve its desired result through the exemption process without having to deal affirmatively with the substantive issues.

112. Subjecting SARs to the glare of public disclosure may well be an effective deterrent to speculative abuse, but the desirability of disclosure does not resolve the more difficult issues of statutory interpretation under §§ 16(a) and 16(b). A goal of disclosure may be achieved through other means, such as the reporting of remuneration of officers and directors in periodic reports due under §§ 13 and 15 of the 1934 Act, 15 U.S.C. §§ 78m, 78o (1976), as well as proxy statements and annual reports to stockholders. Item 4(b)(1) of Form S-K, 43 Fed. Reg. 34,407 (1978) (to be codified in 17 C.F.R. § 229.20.4(b)(1) (1978)), requires disclosure in Forms S-1 and S-11 of the 1933 Act, and Forms 10, 10-K, and Schedule 14A of the 1934 Act, of remuneration paid pursuant to SAR plans, but such amount may be combined with the amount received under other incentive compensation plans. Furthermore, disclosure is required only for each of the five highest paid officers and directors receiving remuneration in excess of $50,000 and for all officers and directors as a group. 43 Fed. Reg. 34,407 (1978) (to be codified in 17 C.F.R. § 229.20.4(a)(1)-(2)). If potential speculative abuse of SARs is a legitimate concern (a questionable premise in light of current evidence), there are no legal impediments to expanding the disclosure of remuneration to focus upon SARs and to increase the number of officials whose remuneration must be disclosed.

113. Also, a relatively small number of companies with salary scales sufficiently high (or SAR and other incentive programs so limited) that director-officers could readily exclude themselves from participation, could be capable of meeting rule 16b-3's standards, since the excluded "insiders" could qualify as "disinterested" plan administrators.

SAR program be administered by disinterested persons, that is persons who are not now eligible, nor were eligible within one year prior to any exercise of discretion, to receive an SAR or any stock or stock options under any plan of the company. Differing rules apply as to composition of the "disinterested" awards committee depending upon the class of the grantee.[114] Section 16(b) applies to the broad spectrum of corporations having securities registered under section 12 of the 1934 Act,[115] but unfortunately, not all of such companies are blessed either with altruistic senior management prepared to declare themselves ineligible for incentive compensation programs or with the ability to find and compensate outside directors (or consultants) who would become sufficiently knowledgeable about vast numbers of personnel to render the qualitative judgments inherent in incentive programs. To the extent that SARs are intended to reward extra effort and achievement, judgments as to grantees may, and in large companies probably do, involve not only numerous employees unknown to outside directors or consultants but also critical evaluations of performance that outsiders may not be capable of undertaking. By emphasizing and mandating dependence on outsider judgments, the Commission may often be creating nothing more than an ill-disguised lip service to such a goal at the corporate level through the appointment of nominally independent administrators who necessarily rely in varying degrees upon management for guidance and input.[116]

The problem of finding independent directors willing and able to involve themselves in numerous compensation considerations is exacerbated, particularly for small companies, by the increasing responsibilities and risks imposed upon such directors and the high cost, or indeed unavailability, of directors' liability insurance.[117] The movement towards independent audit

114. Subject to the provisions of rule 16b-3(e)(3)(i) discussed below, in lieu of a "disinterested" committee the rule permits selection by the board of directors if, with respect to awards to directors, a majority of the board and a majority of the directors acting on such awards are themselves "disinterested." 17 C.F.R. § 240.16b-3(b)(1)(i) (1978). The board or a board committee may act, irrespective of "disinterested" standards, in the granting of awards to officers (other than directors). *Id.* § 240.16b-3(b)(2)(i). Many corporations may prefer, however, not to engage their boards in determining individual compensation questions. The "disinterested" requirement may also be avoided, at least as to plans that do not provide the possibility of cash settlements, if the plan contains strict limitations upon the discretion of the awards committee. Such limitations may be either in the form of specified maximum number of SARs which directors and officers may acquire and the periods within which such rights may be acquired and exercised, *id.* § 240.16b-3(b)(1)(iii)(A), (2)(iii)(A), or "effective and determinable" limitations, set forth by formula or otherwise, such as earnings, dividends, or other factors governing the amount and manner of SAR awards, *id.* § 240.16b-3(b)(1)(iii)(B), (2)(iii)(B). If cash settlements are an alternative form of payment, rule 16b-3(e)(3)(i) requires administration by a board, the majority of whom are disinterested, or a totally disinterested committee, regardless of the specificity of plan provisions or lack of control of the grantee over the form of payment. *See* Compech Telecommunications Corp., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,658 (Apr. 13, 1978) (avail. May 15, 1978).

115. 15 U.S.C. § 78p(a) (1976). As of September 30, 1978, there were 9,263 companies with securities registered under the 1934 Act. OFFICE OF REPORTS AND INFORMATION SERVICES, SEC, DIRECTORY OF COMPANIES REQUIRED TO FILE ANNUAL REPORTS WITH THE SEC UNDER THE SECURITIES EXCHANGE ACT OF 1934 (1978).

116. *See* text accompanying notes 148-49 *infra*.

117. A major problem in getting outside directors to serve on corporate boards is the high cost and unavailability of directors' liability insurance. . . . An informal survey disclosed that only a few insurance firms are willing to offer such protection

committees has resulted in major new responsibilities for outside directors.[118] Requiring such directors to undertake the additional responsibilities of making numerous decisions regarding incentive compensation would impose a further substantial burden upon them. This burden may be an impossible one for many corporations, and its advantages are not apparent.[119]

2. *Window Period.* Rule 16b-3 requires that the exercise of the SAR and elections by participants as to the form of payment (cash, securities, or a combination of both) may be made only within a "window period" commencing on the third business day following the release of quarterly or annual financial data and ending on the twelfth business day following such release.[120] Unfortunately, cash needs cannot be so conveniently timed or controlled. The "window" for cash settlements opens for only ten days each quarter, and, for cautious grantees concerned about potential abuse of their fiduciary positions, it will not open even then if any form of questionably material information has not yet been released. In addition, if the window period happens to coincide with a period of a general market depression affecting the grantor's stock values, employees may be effectively locked in or forced to exercise during an unfavorable market period.[121]

3. *Disapproval of Cash Election.* For a plan to be within the safe harbor, its administering committee must have sole discretion either to (i) determine the form of payment or (ii) consent to or disapprove of the election of the participant to receive cash in full or partial settlement.[122] The Commission's reliance upon the sole discretion of third parties is unaccompanied, however, by any standards by which an employee may reason-

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and liability insurance is extremely difficult to obtain when the corporation has less than $10 million in assets.

Summary of comments of John Hodges, Senior Vice-President, National Association of Securities Dealers, *reported in* 464 SEC. REG. & L. REP. (BNA) A-13 (Aug. 2, 1978). Hodges indicated that 95% of the 1,400 OTC-listed firms responding to an NASD survey of 1,400 corporations traded on the NASDAQ system stated that they technically had "public" directors. A technically public director may include outside counsel, investment advisers, retired executives, and others who, although literally meeting rule 16b-3's standard of disinterestedness, do not generate confidence in their immunity from the substantial influence of non-disinterested management.

118. Effective June 30, 1978, the New York Stock Exchange has required the existence of an audit committee comprised solely of independent directors as a condition for new or continued listing. 2 NYSE GUIDE (CCH) ¶ 2495H. An informal request by the SEC to the American Stock Exchange that a similar requirement be adopted by that exchange is reportedly opposed by the Chairman of Amex, who has cited "the problems the proposal could cause for small companies." Wall St. J., Jan. 29, 1979, at 10, col. 2.

119. *See* text accompanying notes 148-55 *infra.*

120. 17 C.F.R. § 240.16b-3(e)(3)(iii) (1978).

121. The Commission did exempt certain cash settlements from the window period provisions. Plans that provide automatic or fixed dates of exercise at least six months subsequent to date of grant and outside the control of the participant qualify for this exemption. *Id.* The Commission accepted the argument that plans providing for automatic dates of exercise do not create the potential of speculative abuse. It is questionable whether the Commission's position is consistent with its considerable concern over the possibility of speculative abuse of SARs. If a sizeable number of plan participants have identical automatic exercise dates (a substantial likelihood given the periodic, uniform manner in which awards committees often operate), this may be a formidable deterrent to the otherwise timely release of materially adverse information prior to the exercise date.

122. *Id.* § 240.16b-3(e)(3)(ii).

ably anticipate how that discretion may be exercised.[123] The vesting of "sole discretion" in the administrators appears to preclude any attempt to control the arbitrary or unreasonable use of such discretion, regardless of the timing of the exercise, the amount involved, the length of the holding period, the employee's position within the company, the purpose of the exercise, and other factors that may be relevant to the question of whether the exercise could reasonably involve the potentiality of speculative abuse. No protection is afforded the grantee against a committee's decision influenced by a preference to retain the company's cash balances at current levels, by executive pressure regarding personnel matters, or by other factors not relevant to section 16(b) considerations. Nor is it clear that an arbitrary denial will give rise to contractual remedies, for the rule provides a facade of legitimacy to committee determinations as well as an arguable notice of unfettered discretion. Companies considering the adoption of SAR programs for incentive compensation purposes may prefer to avoid the chilling effect created by the rule's imposition of discretionary power.

Similar concerns as to the use of discretionary authority apply to SAR plans providing alternative payment choices of cash or stock (or a combination thereof), for the administering committee's power of consent may force the election of stock in lieu of cash. The receipt of stock may have several disadvantages to grantees of SARs, including the risk of market decline, the possible unavailability of funds to pay the income tax upon the "spread" between exercise price and fair market value, and the eventual payment of brokers' commissions upon sale. These risks and added costs contain elements that compare unfavorably for incentive plan purposes to programs substantially if not entirely based upon the anticipation of cash payments.

4. *Interpretative Problems.* In addition to substantive areas [124] inadequately justified and in many cases beyond the practical capabilities of both small and large corporations, the burdens imposed by the safe harbor provisions of rule 16b-3 are intensified by substantial questions of internal interpretation. What is meant, for example, by the requirement that the plan describe "the method by which the . . . amount of the award is to be determined"? [125] If the requirement simply refers to an operational description of the award process there is little to gain from such mechanistic disclosure. If more is required, presumably it includes a description of the subjective

123. The Commission had initially gone further than the current rule by proposing that not only the election for cash but also the exercise of the SAR itself be subject to the plan administrators' approval. SEC Exchange Act Release No. 34-13,385, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,014 (1977). In response to adverse comments the Commission withdrew this proposal, concluding that the additional burdens of decisionmaking and uncertainty imposed on administrators and participants exceeded the proposal's potential benefits. SEC Exchange Act Release No. 34-13,659, *supra* note 24. It appears therefore that grantees seeking cash settlements may unilaterally determine to exercise their SARs, thereby protecting themselves against subsquent market decline, but must await administrative consent to the cash election indefinitely, with no assurance of ultimate approval.

124. Additional substantive limitations, discussed in text accompanying notes 162-65 *infra,* include stockholder approval of SAR plans, 17 C.F.R. § 240.16b-3(a) (1978), and the public release of quarterly and annual summaries of sales and earnings, *id.* § 240.16b-3(e)(1).

125. *Id.* § 240.16b-3(d)(1)(i).

elements that go beyond whatever objective formulae may exist regarding salary levels, years of service, and other elements that can be meaningfully described. The factor of weighting, for example, may well defy an attempt at effective description. The predictable result is disclosure by generality, hardly a significant element for safe harbor purposes. More importantly, the condition that the disinterested board or committee have "sole discretion . . . to determine the form of payment"[126] (or, alternatively, a veto over any cash election) raises several interpretative questions. Would a plan conform, for example, if grantees were permitted to nullify their prior elections in the event the committee selects stock as the sole form of payment? (Avoidance may well be the choice of grantees who would not otherwise have ready cash to meet the current tax consequences of election.)[127] Is the "sole discretion" standard compromised by precatory or mildly encouraging language in a plan description favoring cash settlements for SARs held in excess of six months? Would moderate limitations on discretion be acceptable if limited to plan participants not subject to section 16(b)?[128] These and other interpretative issues[129] are perplexing, and no rationale upon which the Commission's interpretative responses might be based is apparent. The Commission, unfortunately, has provided neither clarity nor analysis, only limitations extensive in scope and chilling in effect.

Summary. The sanguine response to the concern over the scope of 16b-3 conditions is that the Commission has simply provided a safe harbor and has studiously avoided implications as to plans that do not meet its specifications. Such a response, however, fails to recognize the substantive implications created by the guidelines and supporting releases, the frame of reference that has been provided to the judiciary, and the clearly foreseeable response of corporate executives and counsel considering the adoption of SAR programs. The adoption of safe harbor guidelines is an invitation to potential section 16(b) litigants, an intimation of an attitude based on, yet failing to provide, Commission "expertise," and a substantial intrusion upon the flexibility of a corporate compensation program that has existed for years without provoking a securities-oriented response.[130] Moreover, however wide in theory may be the gulf between safe harbor guidelines and fixed rules of application, the distance may be perilously close in fact, Commission disclaimers notwithstanding.[131]

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126. *Id.* § 240.16b-3(e)(3)(ii).

127. *See* note 84 *supra.*

128. To date the Commission's staff has not been receptive to plans varying from the safe harbor mold, even where variations would not affect officers, directors, or others to whom § 16(b) applies. *See* text accompanying note 155 *infra.*

129. Interpretative problems existing in rule 16b-3 prior to adoption of SAR-oriented provisions are discussed in Lang & Katz, *Section 16(b) and "Extraordinary" Transactions: Corporate Reorganizations and Stock Options*, 49 NOTRE DAME LAW. 705 (1974). Several of the interpretative issues noted are applicable to the rule's treatment of SARs.

130. *See* note 88 *supra.*

131. Judicial transmutation of safe harbor standards into required standards of conduct underlies the recently reported comments of Irwin M. Borowski, Associate Director of the SEC's Enforcement Division. Noting several consent decrees under which the Commission has required companies to adopt independent audit committees, as well as the increased

IV. Appropriate Controls of Speculative Abuse

Little can be gained from surmising why the safe harbor has been so tightly constructed; much more might be achieved by examining whether rule 16b-3's controls are reasonable and appropriate to minimize the potential of speculative abuse posed by cash settlements of SARs. Viewed from this perspective, section 16(b)'s statutory standard of a six-month holding period appears completely sufficient for safeguarding against potential abuse. Moreover, the other, more burdensome features of rule 16b-3 are at best unsatisfactory methods of control and in some circumstances may even be inconsistent with anti-fraud purposes.

A. *The Sufficiency of a Six-Month Holding Period*

The possibility of speculative abuse through the issuance and exercise of SARs is most apparent in instances of foreseeable short-term increases in market value or, for SARs already outstanding, near-term market decline.[132] In a sufficiently egregious situation it would not be surprising in either of those instances to see a judicial extension of section 16(b) to SAR cash settlements despite the lack of clear statutory authority. The simplicity of the remedy and the attractiveness of analogy become a powerful combination. Thus, for example, if Texas Gulf Sulphur had issued SARs to its executives just prior to its April 16, 1964, press release,[133] when its stock was selling at 30, and the SARs were cashed in one month later at 58, the use of inside

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emphasis in other areas on such committees, Borowski is reported as predicting that "judges may begin ruling that the failure to have an audit committee constitutes a *prima facie* case of negligence" and indeed may even be regarded as "willful and wanton" conduct establishing scienter. 453 Sec. Reg. & L. Rep. (BNA) D-4 (May 17, 1978). However meritorious or effective independent audit committees may be (a matter hardly free from doubt), it may be hoped that courts will not accept Borowski's suggestions but will instead recognize that audit committees represent only one of several alternative measures for the accurate preparation of financial data, and that it is the totality of all measures, safeguards, controls, and procedures on which issues of negligence and scienter are judged, not the existence *vel non* of a single control device. The reported comments, however, reflect an attitude no less pronounced in the Commission's adoption of safe harbor guidelines and accounts for the extensive restrictions adopted as to cash settlements.

132. If SARs are to be treated as "equity securities" under § 16(b), it does not necessarily follow that the grant or exercise of SARs should be matched with non-SAR transactions. Thus, for example, the sale of 100 shares of common stock at $50 per share on July 1, followed on September 1 by the receipt of 100 SAR units, not exercisable for six months and issued at a time when the common stock was trading at $45 per share, may not create the kind of "in-and-out" abuse to which § 16(b) was directed. Questions of matching deserve closer study if SARs are to be subjected to application of § 16(b). A pragmatic evaluation as in *Kern* might consider of particular importance such factors as whether the SAR grants were part of a regular, periodic program, whether the selection of the grantee and the number of SAR units awarded were consistent with program objectives and administrative history, and to what extent, if at all, the recipients effectively controlled the award process. *See, e.g.*, Rosen v. Drisler, 421 F. Supp. 1282, 1287 (S.D.N.Y. 1976). These issues inevitably create the likelihood of litigation and are therefore subject to the charge raised against the pragmatic approach by Justice Douglas in *Kern,* that by fostering litigation, and holding out hopes to insiders, it "destroys much of [§ 16b's] prophylactic effect." Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 612 (1973) (Douglas, J., dissenting). It would not be unreasonable to anticipate, however, that in time a growing body of decisions would create guidelines that remove substantial areas of uncertainty.

133. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

information to capitalize on the inevitable market rise could have been regarded (assuming statutory impediments were overcome) as "speculative abuse" subject to recovery of profits under section 16(b). The aborted effort by Carter Hawley Hale Stores to take over Marshall Field & Co. provides a second hypothetical of potential abuse.[134] The proposed tender offer was strenuously fought by Marshall Field, culminating in eventual withdrawal by Carter Hawley. Upon the withdrawal announcement, Marshall Field stock dropped over $8 per share. If a Marshall Field insider with knowledge of Carter Hawley's imminent withdrawal had cashed out an SAR immediately prior to Carter Hawley's public announcement, there would similarly be little doubt of an abuse of insider information analogous to the insider's sale of stock on the market prior to a detrimental public announcement.[135]

The potentiality of short-term abuse would be remedied by the six-month holding period requirement of section 16(b). This "crude rule of thumb," [136] which was incorporated in rule 16b-3 as only one of its numerous limitations,[137] would nevertheless be a totally adequate standard to protect

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134. Carter Hawley's takeover efforts are well chronicled in a series of articles in *The Wall Street Journal,* extending from Carter Hawley's original announcement, Wall St. J., Dec. 13, 1977, at 2, col. 2, through withdrawal, *id.*, Feb. 23, 1978, at 2, col. 2.

135. This Article has not focused upon potential abuse in the granting of SARs, since the principal concern of the Commission (and the bulk of rule 16b-3 provisions) is directed at the cash settlement upon exercise. Abuse is possible, however, in the granting of SARs, regardless of payment option upon eventual exercise, as evidenced by the following hypothetical: *X*, a statutory insider of *ABC* Corporation, learns of his company's pending disclosure of unexpectedly lower earnings and sells 1,000 shares of common stock at $60 per share. The market price drops to $50 the next day upon the announcement of earnings. One week later, while the stock is still at $50, *X* is granted 1,000 SAR units. The net effect to *X* is equivalent to a sell-high-buy-low coordinated transaction, making advantageous use of undisclosed information. The SAR units have effectively replaced the shares that were sold. Indeed the SARs are even better than buying back the stock at $50. *X*'s "profit" of $10,000 may be augmented if the market price increases prior to SAR exercise and, unlike a stock purchase, will in no way be affected by any further market decline. If *ABC*'s SAR program provides for dividend payments or accruals upon the SAR units, *X* will not have lost even the dividend value of his prior shares. There have been no publicly reported instances of such manipulative abuse, however. The hypothetical, of course, raises the question of matching SAR grants with underlying securities transactions for § 16(b) purposes. As previously noted, *see* note 132 *supra,* a pragmatic approach to such matching may involve operational and administrative considerations regarding the SAR program and grants thereunder. In the above circumstances the minimum holding period for the SARs may be of little relevance, as the "profit" has been effectively locked in upon the grant of the SAR, regardless of the date or fact of eventual exercise. All of this discussion presumes a preliminary finding that SARs are "equity securities" for § 16(b) purposes, a presumption accepted arguendo but of questionable statutory support.

136. You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

Stock Exchange Practices: Hearings on S.R. 84 and S.R. 56 Before the Senate Comm. on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934) (statement of Sen. Thomas Corcoran).

137. 17 C.F.R. § 240.16b-3(e)(2) (1978). Exceptions to the six-month holding period are provided in the event of the grantee's death or disability. Even though § 16(b) explicitly requires a six-month holding period, rule 16b-3's holding period provision is not superfluous. The rule addresses the issue of when the period commences for purely cash settlements as well as exercises of tandem stock options. In the absence of the rule a plausible argument could be made that a short-term exercise of an SAR for cash in order to effect a concurrent exercise of a tandem stock option would not be a short-swing transaction since the clock

against potential near-term speculative abuse. Both of the above examples would result in section 16(b) liability if exercise of the SAR had occurred within six months from dates of grant. Once the six-month holding period is satisfied, there would be no further basis for concluding that a subsequent cash settlement created a speculative abuse to which section 16(b) applies. The possibility of market appreciation existing at date of grant would have been subject to all other vicissitudes affecting market price during the holding period, and the favorable developments presumably would have been fully disclosed and digested.[138] As we have been judicially reminded in a section 16(b) context, "*cessante ratione legis, cessat et ipsa lex.*" [139]

If, as it appears,[140] the Commission's principal concern with SARs is that a cash settlement provides financial benefits equivalent to a sale-purchase or purchase-sale tandem transaction in the underlying security, imposition of a six-month holding period may substantially minimize the impact of any misuse of inside information as of the date of grant[141] and would place

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would only begin to run upon receipt of the stock so purchased, and any possibility of speculative abuse would be dissipated by the subsequent six-month holding period. If only a cash settlement is involved, the provision equates date of grant to the statutory references to purchase or sale, thus establishing a definitional framework.

138. Matas v. Siess, [Current] FED. SEC. L. REP. (CCH) ¶ 96,749 (S.D.N.Y. Jan. 19, 1979), may offer an interesting illustration of the use of SARs if and when facts are developed upon trial. Based on information contained in footnote 3 of the court's opinion, *id* at 94,921 n.3, it appears that SARs were granted in tandem with stock options to the individually named defendants prior to 1975 at times when the price of the common stock of Apco varied from $12.75 to slightly over $16 per share. Cash settlements during 1975 and 1976 occurred while the market price was between $22.50 and $24.75 per share. The holding periods in each instance exceeded six months, and the increase in market price was created by a bidding war between tender offerors that began in July 1975. *See* Alaska Interstate Co. v. McMillian, 402 F. Supp. 532, 539 (D. Del. 1975). If the defendants knew of the as yet undisclosed tender offers at the date of grant of the SARs, there may well be cause for a derivative action based upon accepted fiduciary concepts. *See* note 90 *supra*. From a § 16(b) standpoint, however, even if such inside information existed (unlikely in view of the secrecy generally preceding the launching of tender offers), cash settlements of the SARs occurring more than six months later would be functionally equivalent to an insider's purchase of stock based on confidential information followed by sale over six months later, an abuse of position and information that is unquestionably beyond the intended or actual reach of § 16(b). Alternatively, if the facts reveal that the SARs were granted absent any knowledge of pending tender offers, the SAR holders would have enjoyed the benefits of the increased market price in the same manner and to the same extent as the public stockholders. Here too, application of the statutory policy of § 16(b) would be inappropriate. When the SAR grants and exercises are thus viewed in the light of their actual settings, rather than conjecture as to the potentiality of abuse, the court may regret its initial, sweeping conclusion that "[v]aluable rights to acquire Apco stock were instantly converted to cash profits. A better case of short-swing trading can scarcely be imagined." [Current] FED. SEC. L. REP. ¶ 96,749 at 94,926.

139. Blau v. Lamb, 363 F.2d 507, 519 (2d Cir. 1966), *cert denied*, 385 U.S. 1002 (1967) ("the reason of the law ceasing, the law itself ceases"). In *Blau* the court held that conversion of securities was not itself a purchase of the security or a sale of the converted security.

140. *See* note 55 *supra*.

141. Discussions of market vicissitudes that might occur during the statutory holding period often presume or suggest a lessening over time of the impact on market price of the particular information on which the insider's transaction was based. Such lessening would not of course occur where no other equally material information comes to light during the holding period (absent other market factors). Profitable use of inside information may therefore only be delayed, not avoided, in such circumstances. Other common-law and statutory remedies for the misuse of confidential information may be available. *See* note 90 *supra*. Indeed, it may not be inconceivable in the SAR context to formulate a rule 10b-5, 17 C.F.R. 240.10b-5 (1978), claim against the grantee, treating the grantor corporation as

grantee at risk of market decline for a period likely to include additional reports of material information. Conversely, where potential abuse may be as of the date of exercise (anticipating the near-term release of unfavorable information), the statutory holding period would have provided a time frame during which the SAR would have become of value only if market appreciation occurred subsequent to date of grant and was maintained during the holding period. Under such circumstances it is fairly implausible that grantees would be able to foresee and orchestrate a six-month plan to acquire low and dispose high.[142]

B. *Questionable Validity of the Remaining Safe Harbor Conditions*

1. *The Commission's Rulemaking Authority.* Although section 16(b) does not purport to extend to abuses that occur beyond the statutory holding period,[143] rule 16b-3 conditions continue to be effective and may nullify safe harbor immunity even after the holding period has expired. It may seriously be questioned, however, whether the Commission may by rule (even as a safe harbor) impose limitations beyond expiration of the statutory period. By totally discounting the passage of time between date of grant and date of exercise, the Commission's position goes well beyond the underlying purpose of section 16(b), which is to prevent coordinated two-part speculation on short-term market activity. As one court has noted:

> Although the statute is intended to curb the use of advance knowledge of privileged information by insiders in their market transactions, it is not concerned with *all* forms of such insider abuse . . ., such as simply selling or buying on the basis of advance information. Rather, the particular abuse at which § 16(b) takes aim is an investment decision by an insider, based on inside

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the defrauded seller. Statutory interpretation of § 10 of the 1934 Act, 15 U.S.C. § 78j (1976), may not be subject to the same infirmities with regard to SARs as § 16(b), for there would be neither the "equity securities" concern nor the problem of a linked purchase-sale transaction. Under a rule 10b-5 theory, SARs may arguably be deemed an "instrumentality of interstate commerce." Alternatively they may be deemed to involve the indirect use of a "national securities exchange." A withholding of material adverse information known to the grantee may be a "fraud or deceit" upon the corporation, even if such information is known to the awards committee or the corporation's management. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971); Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969). The requirement that the fraud be "in connection with the purchase or sale of any security" leads back to the § 16(b) questions of whether cash settlements involve the purchase or sale of a security. Perhaps such questions may be avoided in the § 10(b) context by regarding "in connection with" as sufficiently broad to encompass schemes in which SAR values are dependent on the trading activities of third parties.

142. Had the safe harbor provisions required no more than a minimum six-month holding period commencing upon the date of grant, there would have been little intrusion upon SAR programs, nearly all of which provide minimum holding periods no less than § 16(b)'s statutory standard. Concerns expressed at the corporate level in response to the Commission's original position equating SAR grants with "purchases," *see* text accompanying notes 81-82 *supra*, might well have been resolved through additional interpretative responses consistent with the date of grant approach.

143. "It must be recalled that § 16(b) does not strip the insider of all advantage.... It is only the short-swing transaction which must yield profits to the company alone." Roberts v. Eaton, 212 F.2d 82, 85 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954).

> information, to engage in "in-and-out" or "out-and-in" trading, with the goal of reaping a profit because of advance knowledge of events. "Congress had in mind [only] a specific type of two-part transaction": a purchase and sale, or sale and purchase, which are but two parts of a single plan to gain advantage of knowledge of information of a limited circulation.[144]

For purposes of section 16(b)'s application, both parts of the single plan must be effected within a six-month period. The "crude rule of thumb" that applies to such transactions regardless of the innocence of intent precludes application of the section to transactions falling beyond the statutory period. This is not true under the safe harbor provisions of rule 16b-3, for the SAR may have been granted several years prior to exercise but the Commission nevertheless requires additional conditions for safe harbor purposes. The conditions suggest, however, that the statute may be equally applicable to the single transaction at the end (the exercise of the SAR) as well as to the dual transaction commencing with the grant. While interpretation of section 16(b) on this point may be open to some question,[145] the stronger argument based on both literal reading and legislative history limits application to the linkage of two transactions within a single speculative scheme.[146] In dealing with SARs, just as in the more common area of stock trading, there ought to be no linkage where the elapse of time between the date of grant and the date of exercise exceeds the statutory standard.[147]

2. *Alleged Anti-Fraud Safeguards.* Viewed from the anti-fraud perspective, the safe harbor conditions other than the six-month holding period from the date of grant appear extraneous. In addition to the practical problems previously discussed, in some instances the safe harbor provisions may be inconsistent with anti-fraud objectives:

a. *Disinterested Administrators.* It is difficult to conceive of an ad-

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144. Prager v. Sylvestri, 449 F. Supp. 425, 430 (S.D.N.Y. 1978) (citing Allis-Chalmers Mfg. Co. v. Gulf & Western Indus. Co., 527 F.2d 335, 346 (7th Cir. 1975), *cert. denied,* 423 U.S. 1078 (1976); other citations and footnotes omitted).

145. The *Prager* court noted that its unitary transaction approach to § 16(b) appeared inconsistent with the Second Circuit's decision in Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959), that § 16(b) applied to a purchase and sale by a person who became a director after the purchase but before the sale. The court suggested that, if given the opportunity, the Second Circuit may overrule its *Adler* opinion in light of the legislative history of § 16(b) and recent emphasis upon examining the function and purpose of the six-month rule. 449 F. Supp. at 432 n.13. *See also* Rothenberg v. United Brands Co., [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,045, at 91,694 (S.D.N.Y.), *aff'd mem.*, 573 F.2d 1295 (2d Cir. 1977) (section 16(b) "seeks to curb not all speculation and sharp dealing, but only that which is based on in-and-out trading by insiders. This kind of speculation seeks to profit from short swings in the market value of the securities.").

146. *See* Note, *Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach,* 72 MICH. L. REV. 592 (1974).

147. Arguably, the Commission has not extended the statutory holding period, if one is willing to accept the "equivalency" notion that a cash settlement may be deemed a *simultaneous* purchase and sale of the underlying securities. Such an argument justifies both commencement and conclusion of the holding period on the date of SAR exercise, regardless of elapse of time from date of grant, thus effectively eliminating any holding period concept. But the equivalency argument is too thin a reed for such broad-scale transmutation of the statutory scheme. *See* text accompanying notes 55-76 *supra.*

ministering committee that will not seek input from senior officers (eligible for grants) to assure informed and meritorious judgments. Such communication would be essential to avoid both arbitrariness and sensitive personnel problems. Reliance upon information obtained from "interested" sources is hardly a secret or condemned practice. In a case involving a stock option-SAR plan administered by three disinterested directors of a corporation, the court noted that "[t]o the extent that the committee based the awards upon the management recommendations which in turn were based upon the recommendations of the heads of departments, this was a proper exercise of discretionary business judgment." [148] Nor was it surprising to learn that the Salary and Supplemental Compensation Committee of Sears, Roebuck & Co., composed entirely of non-Sears employees, not only received recommendations from management for stock option grants, but "always approved them without change." [149]

Rather than rely on the "disinterestedness" of administering committees as a protection against speculative abuse, it is more appropriate to consider whether the committee has acted fairly under the circumstances and has avoided creating undue advantages.[150] This standard does not preclude decisionmaking by "interested" officers or directors. Rather, such decisionmaking may be subject to judicial standards of strict scrutiny, a shifting of the burden of proof, and, in some instances, statutory safeguards against the abuse of discretion.[151] Rule 16b-3's reliance on disinterested administrators stems from a myopic vision that such administrators will not be influenced by "interested" insiders.[152] Moreover, the rule fails to recognize that actions taken by administrative committees composed in whole or part of "interested" administrators are nonetheless subject to challenge under established statutory and fiduciary principles.[153] However laudable independent committees may be, evidence of a nexus between nonindependent committees and the risk of speculative abuse is lacking. Indeed, from the standpoint of avoiding the advantageous use of inside information, a committee consisting solely of

148. Ash v. Brunswick Corp., 405 F. Supp. 234, 243 (D. Del. 1975).

149. *See* Cohen v. Ayers, 449 F. Supp. 298, 305 (N.D. Ill. 1978). The court noted elsewhere in its opinion that although the Compensation Committee lacked personal knowledge of the abilities and potentials of the approximately 15,000 employees for whom management recommendations were followed, the Committee "was keenly familiar with the experience and ability of the twelve directors who received options as employees." *Id.* at 313. Such knowledge and independence of action cannot be uniformly presumed and are considerably more difficult to project for nondirector officers who may also be subject to § 16(b).

150. The court in Ash v. Brunswick Corp., 405 F. Supp. 234 (D. Del. 1975), recognized that this was the proper focus of its inquiry. *See id.* at 242-43.

151. See, for example, the alternative tests for validity of transactions involving potential conflicts of interest contained in DEL. CODE ANN. tit. 8, § 144 (1974). Similar standards are contained in MODEL BUSINESS CORPORATION ACT § 41 (1974).

152. At least one major study in the field of executive compensation has shown that outside directors are more generous than insiders in the setting of salaries. R. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 31 (1945). Maldonado v. Flynn, 448 F. Supp. 1032 (S.D.N.Y. 1978), *aff'd in part, rev'd in part,* [Current] FED. SEC. L. REP. (CCH) ¶96,805 (2d Cir. Mar. 15, 1979), provides a recent example of "outside" directors unanimously approving modifications of a stock option plan to the substantial benefit of corporate officers, an action that the court suggested (in dismissing federal securities law claims) "may be a breach of fiduciary duty . . . under state or common law." *Id.* at 1040.

153. *See* notes 90 & 151 *supra.*

"disinterested" members may create greater problems than it would allegedly solve. If material nondisclosed information exists at the time of consideration of grants, it is likely that the "disinterested" committee members, not privy to such information, may make awards that insiders would have hesitated to make at such time.[154]

To be sure, corporations may be well advised, quite apart from rule 16b-3 purposes, to rely upon disinterested directors or consultants to administer SAR programs. Compensation programs for key personnel are often regarded with suspicion by stockholders, creditors, and both participating and nonparticipating employees. If possible, these programs should not be within the exclusive or perhaps even substantial control of those who have the most to gain. Too few examples of benevolent subjectivity exist. However, for rule 16b-3 purposes, the issue is not whether disinterested committees are preferable, but whether the failure to achieve "disinterestedness" as defined by the SEC is evidence of the potentiality of speculative abuse to such an extent that the applicability of section 16(b) ought to be measured, in whole or in part, by adherence to such a standard. It is submitted that the evidence is lacking to support the conclusion that nonadherence to rule 16b-3's standards requiring disinterested administrators should be an influencing factor in the existence *vel non* of such potentiality.

The Commission has not only failed to provide any basis to support its insistence upon "disinterested" administrators, but it has also reacted adversely to a proposed program designed both to satisfy corporate requirements for well-informed judgments and to prevent the abuse of awards to those to whom section 16(b) applies. A recent interpretative request by Exxon Corporation set forth a proposed SAR program under which grants to directors, officers, and ten-percent stockholders would be made by a Board Compensation Committee conforming to the "disinterested" provisions of rule 16b-3(b)(3), while grants to all other employees would be made by employee-directors (some of whom may be eligible for SARs granted by the disinterested Board Committee and therefore not technically "disinterested"). All potential cash settlements of SARs, however, would be subject to the approval of the Board Compensation Committee. Thus, the only function of the "interested" administrators would be the selection of non-insider grantees. Nevertheless, the SEC staff was unwilling to agree with Exxon's opinion that the proposed program met the safe harbor requirements of rule 16b-3, stating that the Board Compensation Committee would not have *complete* power over all aspects of the SAR program.[155] It is indeed difficult to recon-

154. An analogous problem for stock option grants was presented in *Texas Gulf Sulphur,* which suggests a duty of potential recipients of stock options to disclose material information if they have reason to believe that the awards committee does not know of such information. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 856 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). While the same reasoning is applicable to SARs, some, perhaps all, of the recipients may also be unaware of the undisclosed information. Since it would be preferable to avoid all grants during the pendency of nondisclosure, including grants to employees other than directors and officers, prophylactic measures could be best achieved if the awards process included those having access to inside information.

155. 436 Sec. Reg. & L. Rep. (BNA) C-2 (1978).

cile the staff's position with rational controls for the avoidance of speculative abuse by insiders.

b. *Window Period.* The restriction upon exercise of an SAR except during the ten-day "window period"[156] is an important element in the Commission's response to the potentiality of speculative abuse. The window period concept is not original, as corporate counsel and stock exchanges have long been advising that insiders minimize their legal risks by confining their purchases or sales to periods just after publication of quarterly or annual statements. Nevertheless, the window period of rule 16b-3 should be regarded simply as a guideline, for speculative abuse is equally possible within or without the window period, particularly in light of the justifiable grounds that may exist for the withholding of material information.[157] Indeed, it may reasonably be argued that the window period concept facilitates market manipulation or encourages dilatory or only partial disclosure where fixed time periods govern the exercise of SARs or other transactions. In the absence of compelling evidence (of which none appears to have surfaced to date) that speculative abuse is endemic to the non-window period, application of section 16(b) for failure to conform to this safe harbor provision would be without justification.

If courts are prepared to regard SARs as equity securities, the consequent reporting requirements of section 16(a)[158] would further reduce any necessity for reliance on the window period limitations. Thus, disclosure of cash settlement exercises may alert potential plaintiffs to examine the concurrence, if any, of SAR transactions with corporate developments and announcements. If such a concurrence suggests a misuse of inside information, a cash settlement beyond the statutory holding period would not immunize the grantee from challenge.[159]

c. *Approval of Cash Election.* Quite apart from the absence of any standards limiting committee discretion, the provision requiring the committee's consent to any cash settlement appears motivated by the as yet unsubstantiated assumption that SARs generate uncontrollable short-term abuse of inside information. Even if the potentiality of such abuse exists, the safe harbor cure is a considerable overreaction. If the SAR has been held for six months, section 16(b) should not apply regardless of the form of pay-

156. *See* note 120 and accompanying text *supra.*

157. THE NEW YORK STOCK EXCHANGE COMPANY MANUAL A-18 (1968) lists several examples of information that may be withheld from announcement "where the risk of untimely and inadvertent disclosure of corporate plans is not likely to occur." Included among such examples are negotiations leading to acquisitions and mergers and the making of preparatory arrangements for exchanges or tender offers, calls for redemption, new contracts, products, or discoveries. In the *Texas Gulf Sulphur* case, the court noted: "We do not suggest that material facts must be disclosed immediately . . . . Here, a valuable corporate purpose was served by delaying the publication . . . ." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1976).

158. *See* note 110 *supra.*

159. *See* notes 90 & 141 *supra. See also* note 112 *supra* for discussion regarding the disclosure of SAR transactions outside the context of § 16(a).

ment.[160] If it has been held for a shorter period (which is very unlikely since SAR programs are generally adopted to provide long-term incentive compensation), speculative abuse will be present only in those infrequent instances when an awards committee is able to act in the often brief interim between a favorable development and market reaction,[161] or when a substantial short-term increase in market value is followed by an anticipated decline due to undisclosed adverse information known to the SAR holder. Cash elections in such circumstances may well subject the recipient to liability under state law, but the remoteness and infrequency of the potential abuse fail to support the rule's requirement of an uncontrolled grant of discretion to administering committees.

d. *Stockholder Approval.* Conditioning section 16(b) immunity upon plan approval by stockholders [162] is similarly an attempt to impose form over substance. It is difficult to perceive a discernible correlation between stockholder approval of an SAR program and the absence of potential abuse in that program. Although stockholder approval may play a legitimate role for plans such as stock options that may result in a dilution of equity, stockholders are not required sources of authority in determining or approving monetary compensation.[163] This is not to suggest that submission of SAR plans to stockholders is not appropriate. Indeed, submission may be well in keeping with principles of corporate democracy and disclosure, particularly in view of the potentially large costs an SAR program may generate in the event of substantial market rise. The issue for section 16(b) purposes, however, is the potentiality for speculative abuse. In this context, solicitation of stockholder approval for SAR programs is not an adequate measuring rod for determining the potential for abuse in the eventual grants and exercises under such programs.

e. *Publication of Financial Information.* The requirement that both annual and quarterly reports be released for publication [164] would be superfluous in view of the periodic reporting requirements of the 1934 Act [165] except for the element of release to the public of the figures contained in such filings, added by rule 16b-3. While public release of material information may be a possible means of safeguarding against, or at least discovering, speculative abuse through nondisclosure of information, this argument is

160. *See* Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied,* 348 U.S. 827 (1954).

161. It may be reasonably presumed that the consequences of potential rule 10b-5 liability for nondisclosure of material developments far outweigh whatever individual gains may be achieved by withholding announcement until SAR grants have been effected (since such grants are also evidence of the materiality of the pending disclosure). Moreover, favorable internal developments are often reflected in the market even prior to public announcement. The common stock of Texas Gulf Sulphur Co., for example, nearly doubled (from 17 to 30) from the time of initial exploration to public announcement. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 840 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

162. 17 C.F.R. § 240.16b-3(a) (1978).

163. O'Neal, *Shareholder Attacks on Corporate Pension Systems,* 2 Vand. L. Rev. 351 (1949).

164. 17 C.F.R. § 240.16b-3(e)(1) (1978).

165. 15 U.S.C. §§ 78m, 78o (1976).

equally applicable to all instances of insider trading. Yet, section 16(b) does not require the public release of information as a precondition to exemption from its provisions for any other form of transaction. Moreover, since public release of financial information is the norm for listed and other large corporations, the safe harbor requirement principally burdens those corporations whose public releases are not picked up or broadly disseminated. While failure to release financial information may in some instances be an effort to mask internal mismanagement or wrongdoing, this must be regarded as the exception rather than the norm. For companies filing financial statements with the SEC on a periodic basis, the occasional or even frequent failure to disseminate the public release of such information further could scarcely be determinative of the potential for speculative abuse of cash settlements.

CONCLUSION

For companies capable of adhering to the safe harbor requirements of rule 16b-3, cash settlements of SARs may continue to be an important part of the corporate compensation program. It may be reasonably expected, however, that a considerable number of corporations are either not capable of conforming to the safe harbor provisions for internal administrative reasons or not willing to undertake the loss of flexibility that conformity requires. In such circumstances SAR programs will most likely not be adopted by cautious management. Because this chilling effect was clearly foreseeable, the Commission has abrogated an important administrative obligation to provide guidance and clarity in the application of statutory standards.[166] Instead of guidance we are served with non-position, restrictive conditions and intimations.

Rule 16b-3 as it relates to cash settlements of SARs is much more than the safe harbor it purports to be—it is a call to arms for potential plaintiffs against nonconforming plans and an *in terrorem* warning to corporate counsel and officers considering the adoption of plans. The paucity of litigation to date may be due in part to the reluctance of corporations to go for-

166. "The function of filling in the interstices of the Act should be performed as much as possible through this quasi-legislative promulgation of rules to be applied in the future." SEC v. Chenery Corp., 332 U.S. 194, 202 (1947). The Commission's continuing abrogation of its interpretative responsibility is reflected in the staff reply to a recent AT&T request for no-action regarding its Long Term Incentive Plan. The proposed Plan involved the award of units to certain management personnel based upon the attainment of performance goals, each unit being eventually payable in a share of common stock or an equivalent amount of cash. Noting that a cash payment raises the issue of "whether such a distribution would constitute a simultaneous purchase and sale of stock within the meaning of that [16(b)] Section," the staff reply "expresses no view of this issue, since we believe it more appropriate for a court to make such determination." American Tel. Co., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,608, at 80,427 (Apr. 6, 1978) (avail. May 8, 1978). On what basis would a court be the "more appropriate" forum for such a decision? If the Commission's uncertainties of statutory interpretation are so pronounced as to avoid application of its expertise to this issue, it is appropriate to question the reasonableness of the scope, extent, and implications of the rule 16b-3 safe harbor provisions. The Commission is burning both ends of the candle, avoiding the hard questions of statutory application while imposing inflexible and substantial limitations for safe harbor purposes.

ward with nonconforming plans. What is not in doubt, however, is the substantial chilling effect created by the Commission, a result that belies the Commission's professed lack of position regarding nonconforming plans. Serious questions of statutory interpretation have thus been neatly avoided, and substantial restrictions have been effectively placed upon an otherwise legitimate form of corporate compensation without the barest of supporting evidence. Indeed, contrary conclusions as to section 16(b)'s applicability are suggested by statutory analysis and a review of judicial and regulatory standards.

At a minimum it appears that the Commission has painted with far too broad a brush in trying to eradicate a supposed abuse that cash settlements may create. Even if courts are prepared to regard SARs as a form of "equity security" subject to section 16(b), appropriate safeguards consistent with the statutory scheme would require no greater imposition of control than a six-month holding period from the date of grant. All the other rule 16b-3 conditions, from disinterested administrators to window periods, are of little value in determining whether speculative abuse exists or is likely. While the safe harbor approach is clearly the cautious and perhaps preferred course for companies capable of operating effective SAR programs within the guidelines, reason and flexibility ought to prevail as to section 16(b)'s applicability to companies in the SAR waters but outside the cramped confines of the safe harbor.