

American Bar Association

Technical Session Between the SEC Staff and the Joint Committee on Employee Benefits

Questions and Answers

May 1997

The following questions and answers are based on informal discussions between private sector representatives of the JCEB and SEC staff members. The questions were submitted by ABA members and the responses were given at a meeting of JCEB and government representatives. The responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy. This report on the discussions was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meeting, and has not been reviewed by SEC staff members. The questions were submitted in advance to the agency, and it was understood that this report would be made available to the public.

JCEB Questions for SEC - 1997

Securities Act of 1933

1. **Registration of deferred compensation.** (a) What is the current status of the SEC position regarding 1933 Act registration of deferred compensation plans?

ANSWER: The staff sees deferred compensation plans as involving securities which need to be registered unless an exemption is available. The event which triggers the registration obligation is the election to defer rather than the subsequent deferral of compensation pursuant to that election.

- (b) What is the status of the ABA letter on the topic?

ANSWER: The hold-up which has delayed issuance of a response to the ABA letter is the issue of how to treat interest-only, "plain vanilla" plans. The staff has concluded that there is no legal or policy reason to say that interests in these plans are not securities. The staff intends to issue a response to the ABA letter this year. The response will likely state that registration of (non-exempt) deferred compensation obligations will be required for all deferral elections made after a specified date. The staff recognizes that people have relied on the earlier no-action letters and will need time to adjust to the current position. They are willing to provide for a reasonable transition period, and solicited suggestions for such a transition period.

The staff has not addressed, and would need to consider, how to treat elections to further defer the payout date of amounts which were initially deferred before issuance of the current staff position. Input from the ABA on this issue would be welcome.

- (c) What is the status of the ABA letter suggesting a new Rule 701-type exemption for deferred compensation plans?

ANSWER: The staff has been considering whether to adopt a rule raising the Rule 701 limits and making other changes in Rule 701. No conclusion has been reached yet, but that project will take into account the needs of non-public companies that have deferred compensation plans. Unfortunately, due to the time needed for rulemaking, the "fix" to Rule 701 is expected to come after the effective date of the deferred compensation registration position.

- (d) Would the SEC consider using its new general exemptive authority to exempt from the registration requirement (i) plain vanilla deferred compensation plans, and/or (ii) deferred

compensation plans covering a somewhat broader group of employees than would constitute a private placement?

ANSWER: No. Any exemption would come only in the form of changes to Rule 701.

1A. Additional Question -- Deferred Compensation Plans of Subsidiaries. If the deferred compensation obligation is issued by a non-public subsidiary of a public company and the parent company does not guaranty the obligations, can the obligations be registered on an S-8 filed by the parent company?

ANSWER: If it's an obligation of the subsidiary, the subsidiary needs its own exemption, and could not use the parent's S-8. The staff would welcome an ABA letter on this point.

1B. Additional Question -- Rule 701 Limit for Deferred Compensation. Assume a situation where deferral elections with respect to 1999 compensation are made in December 1998. This could be viewed as an "offer" of deferred compensation obligations which is outstanding in December 1998. However, the "sale" of deferred compensation obligations with respect to 1998 compensation could be viewed as having been made in December 1997 when that deferral election was made, (i.e. within the 12 months preceding the current "offer"). Under a literal reading of Rule 701, because the prior year's sale and the current year's offer occur within the same 12-month period, the \$5 million limit of Rule 701 would have to be spread over two years of deferrals rather than a single year. Would the staff consider providing relief in this area?

ANSWER: The staff sees this question as raising an interpretive issue as to how to count the dollar limit under the rule, and invited the ABA to add this question to its interpretive request letter.

- 2. S-8 for transferable options.** What is the current status of the proposal for amending Form S-8 to permit its use for the exercise of stock options which have been transferred to family members or family trusts?

ANSWER: The staff is interested in taking care of this problem, but will only do so in a rulemaking procedure which also deals with the current abuses of S-8 (primarily involving utilization of the Form for stock issuances to consultants and advisers). Therefore, it may be some time before the staff is prepared to release a proposal dealing with transferable options.

- 3. Definition of affiliate.** The Commission has proposed to amend the definition of affiliate for purposes of Rule 144 to establish a bright line test of affiliate status. Is there any contemplation of extending the proposed new definition for 1933 Act purposes generally? If not, could there be a situation where, for example, a 9% shareholder is deemed to be an affiliate for Section 5 purposes, but is not entitled to the safe harbor of Rule 144? Or is there an unspoken assumption that anyone who is not an affiliate for purposes of Rule 144 is not an affiliate for any other purposes?

ANSWER: The safe harbor definition of affiliate was intended to be limited to Rule 144, and not to persons selling under Section 4(1).

- 4. Sale of shares in a rabbi trust.** What are the registration requirements for the sale of shares of the issuer from a rabbi trust? If the trustee is independent from the issuer, will sales by the trustee be treated as sales by an unrelated third party, or will the sales be deemed to be sales by the issuer? Can sales be registered on Form S-3 as secondary offerings? If the sales are pursuant to employee investment directions in the underlying plan, can the sales by the trustee be made pursuant to an S-8 for the plan?

ANSWER: A rabbi trust is not viewed as a separate issuer. This approach avoids having plan interests and Investment Company Act problems under deferred compensation plans. Thus, to be consistent, sales by the trustee of the rabbi trust will be treated as sales by the employer. Employers who are eligible to use Form S-3 for primary offerings (those having a public float of \$75 million) can use S-3 for sales by the rabbi trust. But sales by a rabbi trust cannot be made as

secondary offerings under Form S-3 or on Form S-8. This is the case even if the trustee is independent from the issuer and has discretion over what to sell.

5. **Exemption for large non-US issuers.** Now that the SEC has general exemptive powers, would the SEC be receptive to considering creation of an exemption from 1933 Act registration for benefit plans of large public non-US companies that are not 1934 Act reporting companies but that exceed the Rule 701 limits? (An ABA subcommittee several years ago proposed a variation of this idea which was stymied by the then need to subject issuer financial statements to 1933 Act standards.)

ANSWER: The staff would consider increasing the Rule 701 limits rather than adopting a specific exemption.

6. **Form S-8.** A company has an outstanding S-8 registration statement covering shares issuable under a particular stock option plan. Can the company amend the S-8 to cover shares issuable under a different plan (or under non-plan employee stock options) if the number of shares being registered is not increased? What are the mechanics of such an amendment?

ANSWER: The staff noted that the answer to this question is addressed in the S-8 section of their telephone interpretations manual, which is available on the SEC's Web Page. A company can file a post-effective amendment to an existing S-8 to "transfer" unused shares to a newly filed S-8 relating to a new plan. This saves the registration fee with respect to the shares being transferred to the new S-8.

7. **Participation interests in 401(k) plan; rescission rights.** Assume that a 401(k) plan allows employees to invest their contributions in employer stock, thereby creating "participation interests" in the plan. Would a failure to register plan interests under the 1933 Act (absent an applicable exemption from the registration requirements) give rise to rescission rights on behalf of all participants or only those who invested in employer stock?

ANSWER: The staff has never been asked this question. It would seem that all participants would have rescission rights in this situation.

8. **Form 11-K.** (a) If a plan which is subject to the 11-K reporting requirements is terminated, and the S-8 is deregistered in the middle of a fiscal year, is there a requirement to file a final 11-K for the portion of the year before such termination?

ANSWER: If the S-8 is deregistered mid-year and a Form 15 is filed, there is no need to file an 11-K for that year, assuming it's not the first year of the plan.

(b) Is the result different if the plan continues, but the employee's ability to invest new money in employer stock is eliminated?

ANSWER: A Form 15 should be filed in this case too, to terminate the filing obligation. See Wisconsin Energy Corp. (March 19, 1991) regarding termination of 11-K filing obligations.

(c) Is a Form 15 required to be filed to indicate the end of the obligation to file Form 11-K?

ANSWER: See above.

9. **Rule 701.** Does the staff continue to hold the position taken in *Devon Energy Corp.* (May 12, 1989), that options subject to Rule 701 can be assumed in a merger and will continue to be subject to Rule 701 even if the acquiring company is a 1934 Act reporting company? There was a report in the March-April 1991 issue of *The Corporate Counsel* that the staff no longer holds that position, and would require the acquiring company to register the assumed option plan on Form S-8.

ANSWER: Yes. If a private company goes public, it can continue to rely on Rule 701. The same reasoning applies if the company "goes public" by means of an acquisition. The staff does not know where the reported change of position originated.

Proxy Disclosure

10. **S-K Item 405.** (a) Does Item 405 of Reg. S-K require a company to disclose a failure to file Form 5 in the following situation: The company has a plan that provides for automatic stock option grants to outside directors. A director failed to report his grant, but sent the company a certification that no Form 5 filing was due.

ANSWER: The staff has never stated that there is an independent duty for a company to investigate whether a Form 5 is correct, but on these facts the company would have the information and the Item 405 disclosure should be made.

(b) Is the answer the same if the director filed a Form 5 but omitted the option grant?

ANSWER: Same answer.

11. **S-K Item 404.** (a) If an outside director purchases more than \$60,000 of stock direct from the issuer, is this a transaction which must be disclosed under Item 404 of Reg. S K? Does such a transaction disqualify the director from being a "non-employee director" for purposes of Rule 16b-3?

ANSWER: Item 404 refers to payment for property or services, which is broad enough to include a director's purchase of stock from the company. As a result, a director who bought stock from the company (other than through a compensatory plan for directors) would no longer qualify as a "non-employee director."

(b) Is the answer different if the purchase was pursuant to a director compensation plan (e.g. upon the exercise of director stock options)?

ANSWER: If the purchase is pursuant to a director compensation plan, the disclosure is pursuant to S-K Item 402, not 404, so the director would continue to qualify as a "non-employee director."

12. **S-K Item 404.** If the issuer reimburses its outside directors for corporate expenses incurred by them, is the reimbursement a transaction that is required to be disclosed under Item 404 of Reg. S-K?

ANSWER: The staff would want to respond to this question on a case by case basis before giving a definitive answer, but generally reimbursement for a legitimate corporate expense, such as travel to a board meeting, need not be disclosed.

13. **Item 10 of Schedule 14A.** (a) How detailed a description of the tax consequences of stock options must be included in the proxy statement? Is it sufficient to disclose whether the spread on exercise is taxable or non-taxable and whether the issuer gets or doesn't get a deduction? (Any additional details, such as a description of ordinary income versus capital gain or the timing of income recognition seem more appropriate for the prospectus than for shareholders.)

ANSWER: The staff did not want to discuss the specific aspects of this question, but said only that the proxy statement should describe all material tax consequences. For this purpose, materiality is determined by what is material to shareholders.

(b) Please confirm that Item 10 does not require the proxy statement to discuss tax consequences for awards other than stock options (e.g. stock appreciation rights or restricted stock).

ANSWER: That is correct.

14. **Option grant disclosure.** Is the transferability of an option to family members or family trusts a "material term" of the option that needs to be disclosed in a footnote to the Option/SAR Grants table?

ANSWER: Yes.

15. **Summary compensation table.** Are commissions reportable in the table under "Other Annual Compensation" or "All Other Compensation?"

ANSWER: Commissions should generally be reported as salary.

16. **Compensation committee report.** Assume that a company's Initial Public Offering ("IPO") occurred during the middle of its fiscal year. Before the IPO, all compensation decisions were made by the entire board of directors. After the IPO, such decisions were made by a compensation committee. Should the compensation committee report for the fiscal year in which the IPO occurred be under the names of both the members of the compensation committee and the full board of directors? Is there any basis for limiting the report to the post-IPO period?

ANSWER: Compensation decisions made before an IPO need not be discussed in the compensation committee report. The theory is that there are no good comparative performance measures for private companies. This position is also included in the telephone interpretations manual.

17. **S-K Item 402 proposed amendments.** What is the status of the June 1995 proposal to amend Item 402 of Reg. S-K?

ANSWER: The June 1995 proposal was to shift some of the executive compensation information to the 10-K and to require tabular disclosure of director compensation. Until recently it was being considered as an active project, but was deleted from the most recent regulatory agenda. However, since that action, the SEC has been receiving numerous copies of a form letter asking for more disclosure of director compensation.

Section 16

18. **Rule 16b-3 and deferred compensation plans.** Assume a deferred compensation plan which has multiple phantom investment funds, including phantom company stock. Participants can transfer their account balances among the funds. The plan provides for lump sum distribution upon termination of employment.

(a) Please confirm that the board of directors' initial approval of the plan is sufficient to exempt the distribution upon termination of employment. (Item 4(c) of the 12/20/96 staff response to the ABA interpretive request letter seems to provide that board approval of the plan is insufficient only with respect to payouts on a fixed date chosen by the participant, but is sufficient approval of distributions upon termination of employment.)

ANSWER: Yes, initial board approval is sufficient to exempt automatic distribution at termination of employment.

(b) Does the result change if the participant has the right to elect, at some point prior to termination of employment, for the distribution to be made in installments rather than in a lump sum? In this scenario, the first installment would be made at termination of employment.

ANSWER: If the employee can change to an installment election, specific approval of the installment election would be required to exempt the distribution. See Item 4(b) of the December 1996 staff response to the ABA no-action letter.

(c) Item 4(c) of the staff response to the ABA letter states that "[i]n cases where the payout is neither a Discretionary Transaction nor exempted pursuant to initial plan approval as provided above, approval of the individual payout transaction will be necessary to satisfy the standards of Rule 16b-3(e) and Note 3 to Rule 16b-3." Under what circumstances would this occur? How specific does the subsequent approval have to be?

ANSWER: Transactions that would need specific approval would include fund-switching transactions that are outside the scope of discretionary transactions, such as fund-switching transactions made in connection with termination of employment. The board (or committee) cannot make a blanket approval, but could approve all transactions set forth on a list presented to the board (or committee); the key is that the list must identify the specific transaction election elected by the individual. (Note: While not discussed by the staff in this context, another example is the election described in Question 18(b).)

The board (or committee) may act to approve the transaction any time after the election is made, as long as it is before the transaction occurs. The election need not be contingent on approval. Thus the executive could elect a particular transaction and the board (or committee) can decide not whether to permit the transaction, but whether the transaction will be exempt under rule 16b-3.

19. **Rule 16b-3 and deferred compensation plans.** Assume a deferred compensation plan which has multiple phantom investment funds, including phantom company stock. Participants can transfer their account balances among the funds. The plan allows participants to elect payout at termination of employment or at an earlier fixed date. In December 1997, at the time of making his initial deferral election with respect to salary to be earned in 1998, a participant elects to have all of such amounts and related earnings paid to him on March 1, 2003.

(a) Assume the participant is an executive officer both in December 1997 and March 2003. Is the March 2003 distribution a discretionary transaction within the meaning of Rule 16b-3? If so, since the election to make the distribution was made in December 1997, does the exemption of the transaction depend on whether there was a transfer into the company stock fund or phantom fund during the six month period before or after December 1997? This result seems anomalous given the length of time between these elections and the ultimate transaction.

ANSWER: The March 2003 distribution would not be a discretionary transaction.

(b) Assume the above facts and that in January 1998 the same participant elected to transfer funds into the company stock fund. Would the December 1997 election of a fixed date for the deferred payout make the January 1998 transfer a "purchase"? This result also seems anomalous since the December election did not result in a current transaction.

ANSWER: The election of a fixed date for the deferred payout (made at the same time the election to defer is made) is not an election for a discretionary transaction. Thus, the January 1998 election to transfer funds into the company stock fund is the first (not the second) election for a discretionary transaction, and (assuming no other transactions) would not be a "purchase".

[THESE ANSWERS SUPERSEDED BY 3/99 PHONE INTERP MANUAL]

20. **Rabbi trust.** A company has a deferred compensation plan which has multiple phantom investment funds, including phantom company stock. Participants can transfer their account balances among the funds. The company's obligations under the plan are "funded" with a rabbi trust. As employees elect fund switches in the underlying plan, the company directs the trustee of the rabbi trust to make corresponding transactions in the company stock and mutual funds held in the trust. Who is the beneficial owner (for both 10% ownership and pecuniary interest purposes) of the shares of company stock held in the rabbi trust -- the company, the trustee, or the plan participant?

ANSWER: The staff referred to Questions 3 and 4 of the Thacher Profitt no-action letter (December 20, 1991) for the position that if the plan benefit is not defined as the specific assets in the participant's account in the rabbi trust, the participant is not deemed to have a beneficial ownership interest in the rabbi trust. The company which established the rabbi trust is like the general partner

in the Plum Creek no-action letter (March 1994); if the trust is irrevocable, the company is like a settlor who cannot revoke the trust, so Rule 16a-8(b)(4) does not make the company the beneficial owner. However, once the company becomes insolvent, the company becomes the beneficial owner. By contrast, the company would be the beneficial owner if it has the right to revoke the rabbi trust. In a situation where neither the company nor the participant is the beneficial owner, the trustee of the rabbi trust would be treated as the beneficial owner.

21. **Discretionary transaction definition -- "required to be made available."** Code Section 401(a)(28) requires an ESOP to offer a diversification election to any participant who has attained both age 55 and ten years of plan participation. Would a diversification election be treated as "required to be made available" under the Code, and thus not a discretionary transaction, if the plan offered the election to all participants who met either of these two requirements (e.g. to participants age 55 with only 5 years of participation)?

ANSWER: No, this goes beyond the scope of the carve-out discussed in Question 7 of the American Society of Corporate Secretaries letter (December 11, 1996). Because this example involves expanding the class of who can get the benefit beyond the group defined in the Code, the staff does not view this election as one which is "required to be made available."

22. **Short-swing period.** Section 16(b) imposes short-swing profits liability if an insider engages in any purchase and sale (or sale and purchase) "within any period of less than six months." In *Stella v. Graham-Paige Motors Corp.*, 132 F.Supp. 100 (S.D.N.Y. 1955), remanded on other grounds, 232 F.2d 299 (2d Cir.), cert. denied, 352 U.S. 831 (1956), the court said that a period of exactly six months would not be "less than" six months, so for there to be liability under Section 16(b), the transactions must have occurred within one day less than six months. This holding has been followed by various other courts. However, the following language is contained in Release 34-28869 (1991):

"For example, if an insider executes a transaction on April 28 and terminates officer or director status on April 30, any transaction executed on or before October 28 must be reported since it occurred within six months following the last transaction prior to termination of officer or director status."

Was this an intentional rejection of the holding in *Stella*? Note that Rule 16b-2(b) provides that a transaction following cessation of insider status is subject to Section 16 only if executed "within a period of less than six months" of an opposite transaction.

ANSWER: No.

23. **Beneficial ownership definition.** Does an insider have an "indirect pecuniary interest" in shares held in a trust for the benefit of members of the insider's family, even if the insider is not a trustee of the trust?

ANSWER: The staff initially responded yes, because Rule 16a-1(a)(2) defines an indirect pecuniary interest to include shares held by immediate family members sharing the insider's household. In discussion of this answer, a JCEB representative pointed out that such an interpretation would lead to the anomalous result that an insider who does not have any investment control with respect to trust transactions would not be deemed to have a pecuniary interest in shares held in the trust for the insider's own account, but would be deemed to have a pecuniary interest in shares held in the trust for the account of members of his immediate family who shared his household. The staff appeared sympathetic to this argument and said they would give further consideration to this point. (In a subsequent telephone conversation with a JCEB representative, a staff member said the staff would look at such a situation on a "facts and circumstances" basis to determine whether the insider in fact exercises or shares investment control, and only in that case would the insider be deemed to have a pecuniary interest in the shares held for the benefit of immediate family members in the same household.)

24. **Schedule 13D/G interplay.** Does an ESOP which has been a Schedule 13G filer and then exceeds the 13D filing threshold need to file a final amendment to its Schedule 13G to report the transaction which triggered the 13D filing? For example, assume that an ESOP goes from 6% stock ownership to 16% stock ownership on November 12. That change is required to be reported by December 10 pursuant to Rule 13d-1(b)(2). Does the ESOP also have to file an amendment to its Schedule 13G pursuant to Rule 13d-2(b)? Rule 13d-2(b) requires an amendment to Schedule 13G to be filed within 45 days after the end of the calendar year, and does not seem to give any relief for reports previously filed under Rule 13d-1(b)(2).

ANSWER: A Schedule 13G filer who triggers a Schedule 13D filing requirement does not have to amend his Schedule 13G to say he has become a Schedule 13D filer. There is a box on the Schedule 13D that if checked will treat the 13D as an amendment of the 13G.

25. **ESOP shares.** An ESOP provides for "pass-through voting" (i.e. that the trustee must solicit and follow participant direction in voting the shares held by the ESOP), as to both allocated and unallocated shares. The Department of Labor has, in a September 28, 1995 letter to Ian Lanoff, indicated that in general where a plan has such a provision, (1) the trustee should follow participant directions with respect to allocated shares in the absence of coercion or unfair procedures, and (2) the trustee should follow participant directions with respect to unallocated shares in accordance with the plan unless the trustee determines this would lead to an imprudent result. Based on the above, who is the beneficial owner of (1) the allocated shares and (2) the unallocated shares for purposes of Section 13(d)?

ANSWER: The DOL has told the SEC staff that the Lanoff letter isn't really a change of DOL position, but that they don't want to say more publicly at this time because the issue is in litigation. Based on this information from the DOL, the SEC staff believes the ESOP trustee would have beneficial ownership of the unallocated and non-directed ESOP shares even though the plan provides for "mirror voting". The staff is unwilling to change the position taken in the Rio Grande letter until it gets comfortable that the DOL agrees with the position that the trustee's rights to override participant instructions with respect to unallocated and non-directed shares are the same as for allocated shares.