

**Joint Committee on Employee Benefits Q&A**  
**Technical Session with the SEC staff**  
**May 9, 2000**

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

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**Form S-8**

1. **Incorporation of Reports on Form 6-K.** Are Reports on Form 6-K filed by a foreign private issuer automatically incorporated by reference into the issuer's Form S-8 registration statement? The issue arises because such reports are deemed "furnished" but not "filed" with the Commission.

**Suggested Answer:** 6-K Reports are incorporated into an S-8 only to the extent specified by the issuer, as is the case under Form F-3. Form F-3 permits the issuer to designate in the F-3 and in subsequently-filed Reports on 6-K whether a particular 6-K Report is incorporated by reference into the F-3.

**SEC Answer:** Form S-8 doesn't actually have the same provision regarding 6-Ks that Form F-3 has. However, the Staff interprets Form S-8 in the same manner as Form F-3 on this point and lets the issuer choose which of its 6-Ks are incorporated.

2. **Financial Statements included on Form 6-K.** If a foreign private issuer incorporates by reference into an S-8 its quarterly financial statements filed under cover of Form 6-K, must those financial statements be reconciled to US GAAP?

**Suggested Answer:** No. Form S-8 does not require a foreign private issuer to include interim financial statements, except to the extent filed under a 6-K, and the 6-K does not require reconciliation to US GAAP.

**SEC Answer:** In the case of an S-8 for a foreign issuer, neither the requirements regarding age of financial statements nor reconciliation to GAAP apply.

3. **Distribution of Annual Report.** A foreign private issuer establishes a stock purchase plan under which employees have a one-time opportunity to purchase

company stock. As permitted by its home country laws, the company makes this purchase opportunity available after the close of its fiscal year, but before it is required to file its Form 20-F. The company intends to register the plan on Form S-8, and, pursuant to Rule 428 under the 1933 Act, will distribute last year's (1999) 20-F together with the S-8 prospectus for the plan. The current year's (2000) 20-F will not be available until after the purchases under the plan have been completed. (The company does not prepare an annual report satisfying Rule 14a-3, and uses its 20-F instead.) Rule 428 requires the current year's 20-F to be distributed, when it is available, to all employees who received the S-8 prospectus.

- a. Can the distribution of the 2000 20-F be dispensed with in this situation, since the purchase decision will have already been completed before the 20-F is available?

**Suggested Answer:** Distribution of the 2000 20-F is not necessary because it will not be the basis of a purchase decision; once the shares have been purchased, the employee will receive all materials sent to shareholders generally.

- b. If the 2000 20-F is required to be distributed, can the distribution be limited to those employees who elected to purchase the company stock?
- c. The company expects its annual financial statements (but not its reconciliation to US GAAP) to be available before the purchase decision is made. Can these financial statements be distributed to the US employees in lieu of the current year 20-F?

**SEC Answer:** There is no reason to deviate from the literal requirements of Rule 428 in this case. The foreign issuer would be treated the same as a US issuer and would be required to distribute the 2000 Form 20-F to all employees who received the prospectus. A foreign annual report that does not comply with Rule 14a-3 or does not contain audited financial statements reconciled to US GAAP is not an adequate substitute. The issuer may wish to consider the SEC releases regarding electronic distribution.

4. **S-8 Exhibits.** Is the text of either or both of the following types of plan required to be filed as an Exhibit to the S-8 for that plan:
  - a. a stock option plan (where the only security registered is common stock)?
  - b. a 401(k) plan (where both common stock and plan interests are registered)?

**SEC Answer:** In either case, the plan document is material to the registration statement, and it is better practice to file it. However Instruction 1 to Reg S-K Item 601(b)(4) says that there is no need to file documents that define a person's rights as a plan participant as opposed to as a security holder. This Instruction provides the basis on which some people have been omitting the plan document from their S-8. This Instruction is on the list of things the staff will be revisiting as part of a planned review of Reg S-K.

**Follow-up Question:** Must option grant letters be filed as exhibits to the S-8?

**SEC Answer:** No. Grant letters are picked up in Reg S-K Item 601(b)(10), which doesn't apply to S-8s.

5. **Option Repricing.** An issuer plans to give its employees an opportunity to surrender deeply underwater stock options and to receive a new grant 6 months later with an exercise price at the then market price. Does this employee election require S-8 registration?

**SEC Answer:** There are two questions embedded here. The first is whether surrender of the underwater option in exchange for a new grant is a sale of a security. The answer to this question is yes, because the optionee is giving up something of value in return for the new grant. The second question is whether registration is required. A transaction like this can be structured to come within the exemption provided by Section 3(a)(9) which exempts the exchange of one security of an issuer for another security of that issuer, provided no consideration is paid for soliciting the exchange.

**Follow-up Question:** If the plan which is registered on an S-8 permits repricing, would the existing S-8 cover the repricing (as an alternative to 3(a)(9))?

**SEC Answer:** The S-8 registers shares and here you're selling options, but you may be able to rely on the S-8 where the repriced options come from the same plan.

6. **Enrollment in 423 Plan Pre-IPO.** Can you let employees enroll in a Section 423 plan before an S-8 for the plan is filed as long as the S-8 is filed before the first payroll deduction? The purpose of this timing of the enrollment is to have the price for the first purchase period based on the IPO price.

**SEC Answer:** The staff has a problem with enrolling employees before the IPO is effective. They view the enrollment as an investment decision (i.e., an employee's offer to buy which is accepted by the company when it takes the payroll deduction); such an offer to buy can only occur after the applicable registration statement is on file. (See the current issues outline regarding electronic trading for

the staff's views regarding conditional offers.) This is the case even though there is no purchase or delivery of funds until the first payroll deduction. The staff's interpretive position that permits the filing of an S-8 after the grant of options has not been extended to 423 plans. The solution is to include the 423 plan shares on the S-1, and then file a post-effective amendment to the S-1 on Form S-8. The description of the plan can be on supplemental pages to the S-1 prospectus rather than included as part of the prospectus document delivered to non-plan investors. *[A request for interpretation was subsequently submitted to the staff seeking approval of a procedure by which employees can be automatically enrolled in the initial offering period of a 423 plan before the filing of an S-8. See ABA (July 25, 2000)]*

**Follow-up Question:** Can enrollments be taken before an S-8 is filed if the plan is a pre-existing plan?

**SEC Answer:** If you start a transaction on an exempt basis, it must be completed on an exempt basis. So if the plan starts under Rule 701, you must continue under Rule 701 for the offering period that spans the IPO date. You could not switch to an S-8 until you have a new offering after the company's 1934 Act registration, which in the case of a 423 plan, would mean a change in the price.

### **Rule 701**

7. **Financial Statements of Foreign Issuers.** Assuming the \$5 million threshold has been exceeded, Rule 701 requires financial statements to be delivered a reasonable time before the sale of stock (or the exercise of an option), and states that the financial statements cannot be as of a date more than 180 days earlier than the date of sale (or exercise). If this requirement is construed to apply to the GAAP reconciliation required for foreign issuers, it would create the anomalous situation in which foreign issuers that are not 1934 Act reporting companies are required to provide more detailed and more frequent financial statements under Rule 701 than foreign issuers that are 1934 Act reporting companies are required to provide (both to the market at large and for issuances under S-8). Specifically:
  - i. Foreign companies that are registered under the 1934 Act are required to provide annual financial statements that are reconciled to US GAAP, but are not required to reconcile their interim financials to US GAAP. By contrast, under Rule 701, both annual and six-month financials would be required to have a reconciliation to US GAAP.
  - ii. Foreign issuers registered under the 1934 Act are not required to file their annual financial statements (with reconciliation) until six months after year-end. However financials filed under this timetable would fail to

satisfy the Rule 701 requirement that the financials be no more than 180 days old.

Can a foreign issuer satisfy the financial statement requirements of Rule 701 by complying with the financial statement requirements applicable to foreign issuers that have registered under the 1934 Act?

**Suggested Answer:** Rule 701 was not intended to be more onerous than Form S-8 with respect to financial statements of foreign issuers. Therefore, a foreign private issuer should be able to comply with Rule 701 by providing (i) annual financial statements reconciled to US GAAP, plus (ii) any interim financial information required to be furnished on a Form 6-K (without reconciliation).

**SEC Answer:** Foreign issuers using Rule 701 that exceed the \$5 million threshold are required to maintain quarterly financial statements reconciled to US GAAP in order to comply with Rule 701. The Staff understands that this may be more onerous than the financial statement requirements for registered companies, but is concerned about large sales of securities to U.S. employees without GAAP financials. This issue was considered by the Commission as part of the process of adopting the Rule 701 amendments.

8. **Plan Interests.** Rule 701(c) uses the term "plan interests." Is that term synonymous with the term "participation interests" used in Releases 33-6188 and 33-6281?

**Suggested Answer:** Yes.

**SEC Answer:** Yes. Both terms refer to interests of a participating employee in the plan.

9. **Copy of Plan.** If a 401(k) plan or similar ERISA plan is offered under Rule 701, can the issuer comply with its obligation to deliver a copy of the plan by instead delivering a copy of the Summary Plan Description required by ERISA? Must a copy of the actual plan document also be made available upon request? Can the issuer charge a reasonable amount for copying costs, as permitted by ERISA, if a participant requests a copy of the plan?

**SEC Answer:** A 1988 interpretive letter issued to the ABA under old Rule 701 said you could deliver a copy of the Summary Plan Description instead of the actual plan. This interpretation is still valid. You shouldn't have to provide greater disclosure for the under \$5 million situation than for the over \$5 million situation, and in the latter case the Rule only requires delivery of the SPD. The staff was divided over whether the issuer could charge copying costs for the plan document.

10. **Compensation Paid by Shareholder.** A company has a compensatory plan under which the shares delivered to employees are delivered by a shareholder rather

than by the issuer. If, for tax purposes, the transaction is treated as if the shareholder made a capital contribution of the shares and the company then transferred the shares to the employees, will the same analysis be applied to treat the program as covered by Rule 701 (i.e., will the shares be treated as if they were delivered by the company)?

**SEC Answer:** This issue arises more frequently in the S-8 than the 701 context. There is a telephone interpretation under S-8 dealing with the situation where a majority shareholder proposes to fund the plan. The staff has taken the position that S-8 (and similarly 701) is not available for secondary offerings but only for compensatory offerings by the issuer. The staff is concerned that the majority shareholder could be getting an impermissible benefit (e.g., a way to sell his shares without registration) under this type of arrangement. The staff has made an exception to this position for certain foreign issuers where under their local law there are impediments to having the issuer fund the plan. For example, under Russian law there must be a special purpose subsidiary holding the shares. The staff has also issued a letter involving a Dutch company that used a foundation to fund its plan. Another example raised by the ABA participants was the funding of UK plans by offshore trusts, which the staff said would probably be OK. The staff will deal with these situations on a case by case basis.

**Follow-up Question:** What if the shareholder is giving his shares up as compensation and is not getting any cash for the shares?

**SEC Answer:** The staff would entertain this question on a case by case basis. You would have to demonstrate that the majority shareholder isn't getting a benefit from the transaction.

11. **Post-IPO Disclosure.** An issuer has outstanding stock options granted under Rule 701 at the time of its IPO. Please confirm that the issuer can satisfy its Rule 701 disclosure obligations by (i) delivery of a prospectus that contains the information required by Form S-8 *and* (ii) complying with the general 1934 Act reporting requirements.

**Suggested Answer:** Yes. This disclosure would be sufficient for shares registered on Form S-8. Greater disclosure should not be required just because the options were initially granted under Rule 701.

**SEC Answer:** Yes. The only thing that is lost in this situation is risk factor disclosure, so the staff wouldn't object once the information is available in the market. The staff suggested this as a topic for an interpretive letter.

**Follow-up Question:** Can you use an S-1 prospectus that is filed but not effective to fulfill the 701 disclosure obligation?

**SEC Answer:** Yes.

12. **Acquisition by 1934 Act Company.** A 1934 Act reporting company acquired a private company. In the acquisition, the stock and stock options of the private company, which were issued under Rule 701, were converted into stock and stock options of the public company. Please confirm that the converted stock and stock options continue to be governed by Rule 701 (with respect to both exercise of the options and resale of the stock).

**Suggested Answer:** Yes. This result would be consistent with the position taken by the staff in *Devon Energy Corporation* (May 12, 1989).

**SEC Answer:** Yes.

13. **Acquisition by Private Company.** Please confirm that a private company ("Acquirer") that acquires another private company ("Target") need not count against its Rule 701 limit securities issued by it upon conversion, pursuant to the acquisition, of Target stock and stock options which were issued under Rule 701.

**Suggested Answer:** Yes. For purposes of Rule 701, new grants by Acquirer need not take into account shares and stock options issued by Target under Rule 701 which were converted into Acquirer shares and/or options.

**SEC Answer:** Yes. Even if the combined grants of Acquirer and Target are over the limit, Acquirer can disregard Target's grants. If Acquirer still has room under the limits based on its pre-merger grants, it can continue to make grants. For example, if Target had granted up to its limit but Acquirer still had \$3 million left to get to its limit, after the merger Acquirer would still have \$3 million available for grant.

### **Other 1933 Act Issues**

14. **Holding Period for Restricted Stock Units.** A company has a benefit plan in which restricted stock units are credited to the accounts of officers or outside directors. At a specified time in the future, these units are settled by delivery of an equivalent number of shares of common stock.

a. Assuming that the shares have not been registered, does the holding period for Rule 144 purposes commence on the date of settlement of the units by distribution of such shares or on the date of crediting of the units to the officer's or director's account under the plan?

**Suggested Answer:** The holding period should start when the units are credited. Restricted stock units that can be settled only in stock have been treated as equivalent to actual shares of stock in other circumstances (e.g., Section 16

reporting, the beneficial ownership table in the proxy statement), and should get similar treatment here.

**SEC Answer:** The holding period starts on the date of the award. This is supported by the general precept that the holding period starts on the date of purchase and full payment, regardless of any delays in delivery of the share certificates. Release 33-6099 says that vesting subject to continued employment won't delay the start of the holding period.

**Follow-up Question:** Release 33-6099 refers to a plan. Is this still a requirement in order to disregard vesting requirements?

**SEC Answer:** Yes. If it's not pursuant to a plan, the securities are not deemed fully paid until all the consideration, including the vesting requirements, has been paid.

**b.** When does the holding period start if the units can be settled for either cash or stock? Is there a difference based on whether it is the company or the participant that chooses the settlement mode?

**Suggested Answer:** The holding period should start when the units are credited. Even though in this case the units may be settled in cash or stock, because the value of the unit is determined by the value of a share of stock, the participant has the same economic risk as if actual shares had been awarded.

**SEC Answer:** The answer to this would probably be the same as where the settlement is solely in stock, but there is no no-action or other authority addressing this question. It would seem to make no difference whether the company or the participant chooses the settlement mode.

15. **Conversion from LLC to Corporation.** An entity converts from an LLC to a corporation. Can the shareholders of the corporation tack their holding period for their LLC units for purposes of Rule 144?

**Suggested Answer:** Such a conversion should be treated as the equivalent of a reincorporation to another state, so tacking of holding periods should be permitted.

**SEC Answer:** A change in the form of business organization by means of a vote is a Rule 145 transaction because a change in form of business is viewed as an investment decision. The new holding period starts when the corporation is formed. The only exception to this is that if the members of an LLC or partners of a partnership cede to the founder the control over whether and when to convert to corporate form, then they can retain their original holding period. Recent letters on this include *Hygeia* (Feb. 13, 1986), *Peapod* (Nov. 17, 1997), and *Petersen Companies* (July 16, 1998).

16. **Regulation S Employee Plan Exemption.** A US company wishes to issue stock options to its non-US employees in a particular country under a plan or sub-plan designed to accommodate the laws and customary practices of that country. Can it use the employee plan provision of Rule 903(b)(1)(iv) of Regulation S if it satisfies the conditions of paragraphs (A) through (D) of that Rule, or is this provision unavailable on the ground that an option plan of a US company is not "established and administered in accordance with the law of a country other than the United States"?

**Suggested Answer:** The exemption is available if the terms of the awards reflect local laws and practices of the non-US country. The fact that the plan or sub-plan is adopted by a US issuer should not affect this conclusion. There is no potential for abuse because the shares sold under the plan cannot enter the US market without registration or an exemption.

**SEC Answer:** The Reg S adopting release looks to whether there is an expectation that registration would be required in the various circumstances. The staff initially contemplated that the employee plan exemption would apply only to foreign issuers. However, if a US issuer divided its plan into a US portion and non-US portion, it could also use the exemption. This would require a formal sub-plan that addresses tax law or other practices that apply to a specific non-US country.

### Proxy Rules

17. **Beneficial Ownership of Management.** A company has a director who is an investment manager of a fund which includes company stock among its holdings. The director has designated someone else to make all decisions regarding company stock for the fund, and believes that as a result he has no power to direct the voting or disposition of the company stock on behalf of the fund. What, if anything, must the company's proxy statement report with respect to the director's beneficial ownership of the shares of company stock held in the fund?

**Suggested Answer:** If the director has divested himself of voting and dispositive power over the shares, and has no right to reacquire such power within 60 days, the shares held in the fund should not be deemed beneficially owned by the director, and no disclosure should be required.

**SEC Answer:** The suggested answer is focused in the right place. It's not enough that the director gave someone else the voting and investment power. The key inquiry is whether the director has the power to revoke the delegation. The specifics of the contractual relationship are important. It's a facts and circumstances test. See Release 34-13291 (Feb. 4, 1977), Example 11.

18. **Reporting Above-Market Earnings.** A company credits above market earnings on deferred amounts under its deferred compensation plan. These earnings are fully vested when credited to a participant's account, but are not paid until some future date when the deferred compensation is paid. Please confirm that these earnings are not treated as "paid or payable" in the current year, and are therefore reported in the "All Other Compensation" column.

**SEC Answer:** Yes. If earnings are merely vested, but not paid or payable during the year, they are reported as "All Other Compensation".

19. **Omission from Proxy Statement.** Shortly after mailing its "plain vanilla" proxy statement for its annual meeting, a company discovered that it had a 5.1% shareholder who should have been identified as such in the proxy statement, but was inadvertently omitted. Does the company have an obligation to make a supplemental mailing? Is a supplemental mailing required if the company discovered after mailing that the CEO's compensation was inadvertently understated by 10%?

**SEC Answer:** Since these are line item requirements of Schedule 14A, generally speaking a supplement would be required. A minor error, for example in the number of shares, may not require a supplement if under the facts it's not material. But where the statement in question is a line item, there is a presumption of materiality.

**Follow-up Question:** What are the consequences of failing to provide a supplement if the issuer in good faith thought the omission or misstatement was not material?

**SEC Answer:** This is too fact intensive to answer in a general way.

20. **Option Repricing.** Is either of the following transactions an option repricing for purposes of the proxy statement:

- . if a company cancels underwater stock options and grants a lesser number of shares of restricted stock?
- a. if a company repurchases underwater options at their Black-Scholes value and later grants new unrelated options using the shares made available by the repurchase?

**SEC Answer:** The staff will construe the option repricing rules broadly to cover any situation where the company is giving something of value to make up for the loss of value in a prior grant. As to the specific questions asked:

- b. Yes. The grant of restricted stock in place of underwater options is a repricing.
- c. The staff disagrees with the premise that the later grants are unrelated to the canceled options. This is a factual question. If the grants are made to the same people, the staff would generally think they are related.

**Follow-up Question:** Under the recent FASB interpretation of APB 25, a new grant that occurs more than six months after a cancellation is not treated as a repricing. Will the staff take the same position for proxy reporting purposes?

**SEC Answer:** The staff has not considered this and will have to look at the accounting rule and give it some thought.

### **Section 16**

21. **Blanket Approval of Prior Option Grants.** An issuer that is not subject to Section 16 maintains a stock option plan. The committee that approves grants under the plan consists of two officers of the issuer. The committee awarded grants that permit share withholding to cover applicable withholding taxes. The issuer later becomes subject to Section 16 as a result of an initial public offering. Shortly after the offering, the issuer's board of directors reapproves all outstanding stock options and the terms of such options, which include the share withholding feature. Will the exercise by Section 16 insiders of their share withholding rights under those stock options be exempt transactions under Section 16 by virtue of the board's blanket reapproval of the options shortly after the issuer became subject to Section 16?

**Suggested Answer:** The transaction should be exempt because the options were reapproved by the board after the issuer became subject to Section 16. Blanket board approval of the grant containing the stock withholding rights is sufficient for the 16b-3 exemption in this situation.

**SEC Answer:** Note 3 to Rule 16b-3 says that the terms of a subsequent transaction that are approved as part of a grant are also considered approved. The 1996 ABA letter (Question 4(a)) says that blanket approval is permitted for things like cashless exercise tied to a specifically limited option grant, even though not permitted for deferred compensation elections. In any situation, the issue is whether the approval was both specific enough and by the right people for purposes of Rule 16b-3. In this situation, both aspects are satisfied.

**Follow-up Question:** What is the effect of the *Skadden* letter?

**SEC Answer:** The *Skadden* letter laid out high specificity requirements which were felt necessary due to the extraordinary nature of the merger transaction. It wasn't meant to overrule the 1996 ABA letter for transactions in the normal option grant context.

22. **Non-employee officer.** Can a non-employee who performs the functions of an officer be an "officer" for purposes of Rule 16a-1?

**SEC Answer:** Yes. Rule 16a-1(f) specifically contemplates "any other person" who performs policy-making functions. It is not limited to employees.

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