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QUESTIONS AND ANSWERS

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Questions relating to registration

1. What is the status of the staff’s reexamination of no-action relief for unregistered bank collective trusts and insurance company separate accounts sold to plans qualified under Section 457 of the Internal Revenue Code sponsored by state or local governments? Would it make any difference if the collective trusts or the separate accounts include monies received from retirement plans qualified under Section 401(a) of the Internal Revenue Code?

**ANSWER:** The staff is getting ready to start the process of issuing no-action letters again. The staff has met with the IRS, insurance companies and banks. The staff’s concern is to limit access to plan assets by employers (e.g. through a rabbi trust). The staff would require, as a condition to no-action relief, disclosure of the terms of the trust/account and is considering requiring an independent third party to determine employer insolvency (in which case the assets would be paid to the company’s creditors), e.g. a court.

The staff does not want to impose such stringent conditions on unregistered securities that they afford greater protection than if the securities were registered. The staff is also cognizant of the tax ramifications of 457 plans and does not want to cause taxation of employees. They want to avoid the Los Angeles County situation.

There are no further developments on the registration requirement for investments in collective investment funds pursuant to the 1992 studies. It was determined that such a requirement would require legislation, and the staff, accordingly, is not pursuing it further.

2. What is the proper method of correction for failure to file an S-8 registration statement regarding interests in a voluntary, contributory 401(k) plan which allows its participants to invest up to 100% of their accounts in publicly-traded employer securities?

**Suggested analysis:** In most circumstances, counsel would likely advise a client with such a problem to allow plan participants to rescind their investment in the unregistered security. Presumably this would involve rescission of the participants’ participation in the 401(k) plan retroactive to the date the plan became a security for
'33 Act purposes (or, perhaps, rescission of their plan participation for all periods). Such action might require a distribution from the 401(k) plan in an amount at least equal to the participants’ original investment in the employer securities.

Such action would appear to cause the plan to be disqualified for tax purposes, because such a distribution is not for one of the permitted reasons for a 401(k) plan. Further, where the amount required to be distributed to remedy the failure to register exceeds the participant’s account balance (e.g. where the value of the securities has declined), the fiduciary making the distribution may be exposed to fiduciary liability under ERISA for allowing the distribution to occur.

Simply filing an S-8 registration statement after the fact would appear only to give prospective relief. It does not seem rational to require distributions that would disqualify the plan for tax purposes. Perhaps the best way to correct this problem is to allow plan participants to direct the sale of the employer securities in their plan accounts to the employer at a price equal to the greater of (i) the current fair market value of the securities, or (ii) the participant’s basis in the securities.

ANSWER: As a matter of policy, the staff will not advise on how to correct a failure to register, other than to recommend that registration be made as soon as possible.

Rescission doesn’t cleanse the violation of the registration rules, it merely limits the exposure. If a rescission offer cannot be made without disqualifying the plan, the employer needs to do an evaluation of the risk of disqualification vs the risk of a Section 5 violation. The SEC has no enforcement history against qualified plans. There is no concept of a partial rescission (i.e. rescission of the stock but not the plan interests). The staff would not insist on a registered rescission offer.

3. If a plan was not previously subject to the requirements of Section 15(d) of the 1934 Act, concurrently with the filing of the registration statement, the plan must file an annual report for its latest fiscal year. (General Instruction A.2 to Form S-8.) Because the data needed for the plan to complete its annual report typically is not available until several months after the end of its fiscal year, this requirement would literally preclude an employer from filing the Form S-8 for several months following the end of the plan’s fiscal year. Is this result intended?

ANSWER: The proviso in the last sentence of Instruction A.2 applies to ongoing plans. In essence, it says to treat them as a new plan for purposes of the 11-K filing.

4. Employees of a wholly-owned subsidiary of a Japanese corporation are offered the opportunity to purchase stock in the Japanese parent corporation through the U.S. subsidiary’s 401(k) plan. The stock is traded on the Tokyo stock exchange and nowhere
else. Must the stock of the Japanese parent corporation or the plan of the U.S. subsidiary be registered with the SEC?

**ANSWER:** This would be viewed the same as any other offering of securities, that is, it requires registration unless an exemption is available. Staff members stated that they believed that, in the majority of cases, issuers would be able to rely on Rule 701; that the dollar limitations in that Rule were unlikely to make that exemption unavailable for many foreign companies with U.S. employees. In this connection, the Staff noted that a no-action response to Nissan Motor Corporation (4/22/94, addressed to Ron Mueller, not yet avail.) addresses the availability of Rule 701 to exempt an offer by a subsidiary of its parent’s American Depositary Receipts and indicated that Rule 701 is available when the plan trustee acquires the ADRs in the market. Although Nissan’s stock trades in the U.S., the analysis would not be different if it involved a company whose stock did not trade in the U.S. No immediate consideration is being given to use of a foreign form, but the staff is "not unsympathetic" to the complications that present themselves if Rule 701 is not available and there is no U.S. registrant. None of the Staff members present were aware of the status of the Commission’s position on the suggestion by the ABA Business Law Section, Federal Regulation of Securities, Employee Benefits and Executive Compensation Subcommittee to adopt a new form similar to Form S-8 for use by foreign issuers, but certain Staff members expressed skepticism that such a form would be an appropriate form of registration when the parent is not otherwise a U.S. reporting company.

5. Tax-qualified retirement plans have been required since 1993, under Section 401(a)(31) of the Internal Revenue Code, to permit participants eligible for a distribution to direct that the distribution be made in the form of a rollover to an individual retirement account (IRA) or another tax-qualified retirement plan (i.e. of the participant’s next employer). This is likely to cause a significant increase in rollovers to qualified plans.

Assume the recipient plan has an employer stock fund that is otherwise not required to be registered under the 1933 Act because no employee contributions can be invested in the fund. If the recipient plan permits the direct rollovers to be invested in the employer stock fund, must the recipient plan now be registered? Should SEC Release No. 33-6281 be interpreted to treat direct rollovers as employee contributions for registration purposes? The original source of the direct rollover amounts may (depending on the structure of the source plan) be employer contributions under a grant-and-award type arrangement, or pre-tax employee contributions (401(k) contributions) and/or related matching contributions. In either case, the employee making the rollover into the recipient plan would have had the opportunity to receive the rollover amount in cash.
ANSWER: If a qualified plan accepts direct rollovers and permits them to be invested in the employer stock fund, registration will be required under the 1933 Act. Under the principles of SEC Release Nos. 33-6188 and 33-6281 a direct rollover should be treated as an employee contribution for registration purposes. The original source of the funds being rolled over is not relevant; i.e., it makes no difference whether the funds were originally derived from employer contributions or employee contributions. What matters is that the employee had the right to receive the funds in cash in lieu of a direct rollover.

In a transaction in which funds are transferred from one plan to another (and invested in the employer stock fund) and the employee has no cash election, registration may not always be required. The SEC staff noted that in the Heinold Hog letter (Heinold Hog Market, Inc., May 28, 1987) registration was avoided in a case where employees were given a special one-time election to transfer funds from a profit sharing plan to an ESOP in the context of an acquisition. The participants did not have a right to receive a cash distribution from the profit sharing plan in lieu of the transfer to the ESOP. If they elected not to transfer their account balance, it would remain in the profit sharing plan.

Finally, the SEC staff noted that a rollover to a qualified plan would not trigger the need for registration where it is invested in any fund other than an employer stock fund under the plan.

6. Section III.B of Release 34-6281 permits non-affiliates who receive unregistered securities from a plan to resell securities if, among other things, the total amount of shares distributed by a plan to its participants "during a fiscal year" does not exceed 1% of the outstanding securities of the class. Does the 1% threshold apply to the employer’s fiscal year, the plan year of the plan, or the calendar year?

ANSWER: The test relates to the issuer, and therefore the test should relate to the issuer’s fiscal year.

In specific circumstances, the staff has taken a no-action position with respect to increases of the 1%. See, e.g. Zenith. In an extraordinary circumstance such as an ESOP termination, the distribution might have to be registered.

Questions relating to Section 16 of the Exchange Act

7. What is the status of Rule 16b-3’s phase-in date? Is there an expectation that the effective date could be delayed? Can you tell us whether (and to what extent) the Rule is likely to be modified? The final deadline for amending tax-qualified plans with calendar year fiscal years to comply with the Tax Reform Act of 1986 and later legislation is December
31, 1994. Such plans will require significant revision to comply with Rule 16b-3 as currently promulgated. If the Rule is likely to be revised or if the phase-in date is to be extended, it would be helpful to have guidance as soon as possible.

**ANSWER:** The SEC is committed to new rulemaking, but had great hopes it would move faster than it has. Even if the new rules were released "tomorrow" there would be a delay in the phase-in date because issuers would need time to digest the rules and make necessary plan amendments, if any. The new rules will not be a comprehensive overhaul of Rule 16b-3, but there will be revisions with respect to broad-based plans. Cash-only plans may also be revisited.

8. Does the term "extraordinary distributions of all of the issuer’s securities held by the plan" in Rule 16b-3(d) comprehend the sale of the employer’s stock pursuant to a tender offer? Does it comprehend sales in order to liquidate the plan’s assets and make cash distributions in connection with a termination of the plan?

**ANSWER:** "Distributions" in Rule 16b-3(d) means distributions of stock by the plan to participants. It does not comprehend dispositions by the plan itself. If the sale by the plan is at the direction of a participant, then it is a participant-directed transaction, in which case it will be necessary to determine whether the plan itself is an insider. To the extent the unorthodox transaction doctrine is implicated here, it is beyond the scope of the staff’s interpretive powers.

9. Will an irrevocable election to tender stock in a tender offer, made 6 months prior to the closing of a tender offer make the disposition in the tender offer an exempt disposition pursuant to Rule 16b-3(d), assuming the other requirements for satisfying the Rule are met? Would it make a difference if the irrevocable election were made prior to the onset of the tender offer?

**ANSWER:** It does not appear that an irrevocable election to tender stock, made at least six months in advance of a tender, would be practicable, given that tender offers are not generally open for as long as six months and the price at which an offer may be made in the future would be unknown. Therefore, a more practical issue is whether Rule 16b-3(d)(1)(i) permits a "standing election" to tender shares in the future and more broadly, whether the Rule permits standing elections to be made on specified conditions. The only form of standing election endorsed in Rule 16b-3 is for tax withholding (see Phillip Morris), although the Staff has considered standing elections in other contexts. The Staff has not squarely addressed whether Rule 16b-3(d)(1)(i) permits an election such as an election to sell shares held in an account at or above a certain price more than six months from the date of the election. Staff members were skeptical that such an election would be exempted Rule 16b-3(d)(1)(i), because that was not what was
contemplated in Rule 16b-3(d)(1)(i). What was contemplated was an election where the insider would be at market risk for six months. However, the Staff indicated a willingness to consider the issue more fully if it were presented in a particular case.

10. In Jesse Brill (avail. March 25, 1994), the staff declined an invitation to interpret old Rule 16b-3 to permit the grant of options that could be transferred, for no consideration, to members of the grantee’s immediate family. Neither the request letter nor the staff’s response addressed more limited forms of option transfers such as a transfer to a trust where the optionee/settlor retains the power to revoke the trust at any time during his lifetime (and is the sole beneficiary during such time). This type of inter vivos trust is widely used in estate planning to avoid probate. These trusts are the very same as those exempted from Section 16(a) reporting obligations by Rule 16a-8(b)(4). In essence, a transfer to such a trust is not in substance a transfer as the settlor retains full power over the option. For this reason, such transfers would appear to come within the scope of both the old and new versions of Rule 16b-3 and should not raise the same interpretive difficulties and policy concerns as do inter vivos transfers to family members. Do you concur?

ANSWER: The staff has not interpreted restrictions on transferability to permit any transfers other than those expressly permitted under the rule and is not likely to do so. The staff duly noted that the IRS would not consider such a transfer to be a transfer for tax purposes, and that if the transferor is still reporting beneficial ownership under Section 16(a), then an argument could be made that there has been no transfer for securities laws purposes, either. The staff is willing to consider issues raised by inter-vivos transfers the next time there is rulemaking in this area.

11. Is an amendment to an option agreement converting a tax-qualified incentive stock option to a non-qualified option (which does not affect the exercise price or the term of the option) constitute a new grant requiring a new 6-month holding period under Rule 16b-3(c)? In general, the only difference to the grantee between the two is that taxation of the "spread" on a tax-qualified option is deferred until the disposition of the shares acquired on exercise if certain holding periods are satisfied, whereas with a non-qualified option, the "spread" is taxed at exercise. Would it make a difference if, because of the operation of the old sequential exercise rule (which required tax-qualified options (including some that may still be outstanding in 1994) to be exercised in the order they were granted) the tax-qualified option could not have been exercised (because of earlier-granted underwater options) unless it were converted to a non-qualified option?

ANSWER: In order to answer this question, the staff would have to have a more detailed analysis of the tax results and the economic effects of the cancellation-regrant, including a detailed description of how the option was converted.
12. Is an amendment to a new plan that occurs within six months of the establishment of the plan (other than an amendment to comport with changes in ERISA or the tax laws) prohibited by Rule 16b-3? In other words, is the establishment of the plan treated as an amendment for this purpose?

**ANSWER:** In order to answer this question, the staff would have to have more facts as to why it was necessary to amend the plan so soon after it was established. It should not be assumed that an amendment within the first 6 months of establishment of a plan would be within the rule.

13. Assume that an employee stock purchase plan under Internal Revenue Code Section 423 provides that the options to purchase the stock are only exercisable on the last day of the calendar year, and only by individuals who are employed by the issuer on the last day of the year. Assume that the issuer receives an acquisition offer from another corporation, for a transaction to be consummated prior to the end of the year.

   A. If the target company amends the plan to provide that options may be exercised on the day before the acquisition, will such an amendment require shareholder approval in order for such exercise to be exempt under Rule 16b-3? Note that, absent the amendment, grantees would not be able to exercise options, because as of the last day of the year, they would no longer be employed by the issuer.

   **ANSWER:** It depends on whether the employees would be receiving a comparable benefit. It is likely that shareholder approval would be required.

   B. If under such circumstances, shareholder approval is required for continued qualification of the plan under Rule 16b-3 and such approval is not obtained in view of the lack of time, would the disqualification of the plan for 16b-3 purposes be prospective only? If so, the only remaining plan transaction, namely the exercise of the "option" under the 423 plan, would appear to be exempt under Rule 16b-6(b), assuming that the option had been granted more than six months previously.

   **ANSWER:** It is hard to answer this question without knowing more about the context. Assuming it is a traditional 423 plan, relying on Rule 16b-3(d) (ongoing acquisition exemption) Rule 16b-6 would not be available, because the price is not fixed until the end of the period. Therefore there is no grant until the end of the period. Therefore, no exemption is available. If it is a nontraditional plan (i.e. the price is fixed at the beginning of the period), then Rule 16b-6 would be available.

14. Assume an employee stock purchase plan under Internal Revenue Code Section 423 provides that all employees may participate in the plan after completing a year of service with the employer/registrant. For ease of administration, the plan provides that newly eligible employees who elect to participate will begin participation as of the next
January 1. If the plan is amended to provide that newly eligible employees who elect to participate will begin participation as of the next January 1 or July 1 (whichever comes first), is that a material amendment requiring shareholder approval? While there would be no change to the underlying eligibility requirement (1 year of service), the amendment would cause some eligible employees (those whose hire date is in the first half of the year) to begin participation earlier.

**ANSWER:** This can only be answered in an interpretive letter based on real (not hypothetical) facts. The issues are whether the amendment is merely an administrative convenience, or whether there could be a material increase in benefits as a result of the dual entry dates, whether the dual entry dates as a factual matter opens the plan to a whole new class of people. Such a change could be considered a change in eligibility requirements.

More broadly, the 1991 Release regarding the shareholder approval requirement rescinded the Staff’s previous view that the Staff would consider the number of insiders affected by the proposed amendment. Re. 34-29131 § II.B. (April 26, 1991) 4 Fed. Sec. L. Rep. (CCH) ¶ 26,086A. Now, even if one insider is potentially affected, it is necessary to consider whether the change is a material amendment. In this connection, the Staff indicated that it might be relevant, when presented in a particular context, that none of the existing insiders’ eligibility for participation in the plan would be affected, even though future insiders’ participation or eligibility might be affected.

It would be acceptable to bifurcate the plan so that insiders would continue to be subject to the single annual entry date.

15. Assume a tax-qualified profit sharing plan with the following types of contributions, each kept in a separate recordkeeping account:

Grant-and-award employer profit sharing contribution (kept in a "Profit Sharing Account")

Employee 401(k) contributions matched by the employer (kept in a "Matched Account"), and

Additional employer matching contributions (kept in a "Match Only Account")

Employee 401(k) contributions not matched by the employer (kept in a "Savings Account")

Plan participants direct the investment of their accounts into any or a combination of 4 funds available under the plan, one of which is an issuer stock fund. The other three contain no issuer securities.
A. If an insider-participant makes a withdrawal from the issuer stock fund, new Rule 16b-3(d)(2)(i)(B) requires that he cease further purchases for 6 months. Does this rule require the insider to avoid transfers (such as through directing investment of employer profit sharing contributions made during the six-month period and intra-fund transfers into the issuer stock fund) from the Profit Sharing Account?

**Suggested analytical approach:** We believe the relevant authorities in these matters to be American Bar Association, July 3, 1991, Hewitt Associates, April 30, 1991, and Thompson, Hine and Flory, March 29, 1991. Under these authorities, to meet the cessation of participation requirement, a participant must cease ongoing contributions to

the Matched Account,
the Match Only Account, and
the Savings Account,

but not to the Profit Sharing Account, because contributions to the Profit Sharing Account do not involve employee discretion.

These authorities also permit an insider to leave money from all accounts invested in the issuer stock fund during the six-month period.

Finally, under these authorities an insider would be prevented from transferring existing balances from

the Matched Account,
the Match Only Account, and
the Savings Account

to the issuer stock fund during the six-month period. However, the above-referenced authorities do not consider the consequences of an insider's ability to direct the investment of the Profit Sharing Account. (Please confirm this analysis.)

**ANSWER:** Where the participant directs the investment, the 6-month "drop-out" period would apply to all accounts, including the profit sharing account.

B. The staff has stated in the past that, for a transaction in which an employee is awarded employer stock to be considered a "purchase," the transaction must be discretionary and contributory. In the case of employer profit sharing contributions the contributory requirement is not met, because the investment in the issuer stock fund is made solely with employer money. (Please clarify whether the staff continues to apply this approach, and address whether it would apply in this context.)
If transfers into the issuer stock fund involving Profit Sharing Account balances are not "purchases," does this exempt participant directions as to the allocation of both existing account balances and ongoing contributions to the Profit Sharing Account during the time participation in the plan has otherwise stopped under the cessation of participation rule? Does it also exempt transfers of Profit Sharing Account money among the investment funds under the plan (including transfers into and out of the issuer stock fund)?

If transactions involving Profit Sharing Account money and the issuer stock fund are not "purchases" or "sales" under the above rules, are they subject to any of the 16b-3 rules? If so, please explain the rationale for this position and indicate to which rules the transactions are subject.

**ANSWER:** The foregoing "purchase" analysis applies to whether plan interests need to be registered. It does not affect the Section 16 analysis. Section 16 applies to insiders who acquire beneficial ownership of stock, whether or not they made an investment decision to acquire it.

Questions relating to executive compensation disclosure

16. How does one report the benefits under a cash balance plan in the Pension Plan Table (Item 402(f))? Alternatively, should a cash balance plan be treated as a defined contribution plan (and reported as All Other Compensation in the Summary Compensation Table)?

**ANSWER:** The staff would have no objection to reporting a cash balance plan as a defined benefit (actuarial-based) pension. It does not strictly fit in the pension table, however. The pension table is intended for plans that base the benefit on both final pay (or final average pay) and length of service. Therefore cash balance plans (like career average plans and flat dollar benefit plans) are most appropriately disclosed in the alternative disclosure format, since accruals under cash balance plans are not based on final compensation.

17. It is common practice for employers to combine the benefits under a tax-qualified retirement plan and a non-tax qualified plan providing either supplemental benefits or benefits in excess of the maximum permitted under the tax-qualified plan for purposes of the Pension Plan Table under Item 402(f), particularly where the qualified and non-qualified plans are based on the same or a similar formula. Where the formulas under the two plans are radically different, for example where one is based solely on length of service and the other is based solely on compensation, it would seem it is nevertheless appropriate to combine the amounts for presentation on the Pension Plan Table, given the SEC's apparent goal of disclosing as much information as possible in tabular format. Should the two plans be shown separately?

**ANSWER:** The pension table should be only for pensions based on final average
pay (or final pay) and years of service. Thus, if both the pension and the supplemental or excess pension base benefits on formulas based on both those factors, it would be appropriate to combine them and show them in the table. However, if a plan has a formula based on only one or neither of those factors, it would be appropriate to use the alternative disclosure format (i.e., narrative disclosure). The goal of showing the totality of the benefit in tabular format is overridden in this case by a desire not to mix two dissimilar forms of benefit. Moreover, the narrative disclosure of benefits not based both on final pay and length of service seems to be required by the literal language of the release. Accordingly, in this example, no pension table would be used.

For offset plans, where the formula is based on final pay and years of service, but the benefit is offset by some other amount, appropriate disclosure should be made that shows the relationship between the plans. The rules would permit footnote disclosure of offsets for social security or other offset amounts, under either tabular or alternative narrative disclosure.

18. What, if anything, should be shown in the new benefits table where an option or omnibus plan is being submitted to shareholders for approval of increasing the number of shares available, where the awards under the plan are purely discretionary on the part of the compensation committee? Is it sufficient to state that the awards are discretionary, or is it necessary to estimate what the size of the awards might have been if the higher share number had been in place the previous year?

**ANSWER:** Item 10(a)(2)(i) applies only if the benefit is determinable (i.e. only where the amounts are fixed in advance, or already granted, but subject to shareholder approval). Disclosure pursuant to Item 10(b) is only required for a new plan or an amendment to a plan that incorporates an objective feature where it is possible to project what the prior year's results would have been; it does not require estimates where the plan is solely being "refreshed" with additional shares and the grants are purely discretionary.

No tabular disclosure is required for new discretionary plans. For an amended option plan, cumulative historical grant disclosure is required (but not future projections unless the plan is a formula plan).

For a Section 423 plan, where the employee rather than the employer has the discretion, it is necessary to show an assumed amount (usually the maximum available under the plan). The staff recognizes that Section 423 plans are an area where additional guidance may be needed, because they don't fit the rules precisely and there may be a divergence of practice developing.
19. What, if any, continuing coordination is there between the IRS/Treasury Department and the SEC staff concerning the development of regulations under Internal Revenue Code Section 162(m) (the $1 million dollar limit on deductible executive compensation)?

**ANSWER:** The SEC staff is happy to help out whenever the IRS calls. Of 373 compensation committee reports analyzed by the staff, approximately 2/3 said the company would take steps, if necessary, to preserve the deductibility of executive compensation, about 10% said they would not try to comply with the deductibility rules, and the rest said they were still studying the issue.