ABA

JOINT COMMITTEE ON EMPLOYEE BENEFITS

Questions for the Securities and Exchange Commission

May 12, 1992

SECTION 16

Qualified Retirement Plans

1. Oglebay Norton Company (September 23, 1991) indicates that insider participants in a defined contribution plan will be subject to Section 16 reporting and short-swing liability with respect to elections to participate in, transfer assets to or from, or make withdrawals from an equity stock fund which includes stock of the employer. The facts in Oglebay were that (1) the equity fund was one of three funds in which plan participants could direct the investment of their account balances, (2) the plan document provided that no more than 50% of the assets of the equity fund could be invested in stock of the employer, (3) plan assets were held in trust by an independent, bank trustee, (4) investment decisions regarding the equity fund, other than purchase and sale of employer stock, were made by an independent investment manager, and (5) investment and voting control over the employer stock held in the equity fund were exercised by a committee comprised of outside directors of the employer. The Oglebay letter does not indicate what portion of the assets of the equity fund were actually invested in employer stock.

Diversified equity funds are commonly provided as one of the participant-directed investment options available in a defined contribution plan. Although such funds may, at any given time, include employer securities, typically such funds are not designed to invest in significant amounts of employer securities. Employers wishing to permit participant-directed investment in employer securities ordinarily will offer an employer stock fund as a separate investment option in addition to or in lieu of a diversified equity fund.

a. Would the result in Oglebay have been different if the limitation on investment in employer stock set forth in the plan document had been a stated percentage of the assets of the equity fund less than 50% -- e.g. 25% or 10%? Would it matter that the limitation on investment in employer stock is set forth in the plan's investment guidelines that are adopted by the plan's investment or administrative committee rather than in the plan document itself?

b. Would the result in Oglebay have been different if investment and voting control over the employer stock held in the equity fund were exercised by the independent investment manager rather than by a committee of outside directors of the employer?

c. If investment and voting control over a diversified equity fund (including any employer securities held by the fund) are exercised by an independent

institutional investment manager or trustee, does it matter whether the plan document or the plan's investment guidelines contain any express limitation on the amount of employer securities that may be acquired by the fund? For example, what if the plan's investment guidelines describe a diversified fund which would not ordinarily contain a significant proportion of securities of any single issuer, but do not contain any percentage limitation on employer stock? Will investment in such a fund at a time when it holds any amount of employer stock be subject to Section 16 reporting and short-swing liability?

d. Would favorable consideration be given to a request for an interpretation exempting from Section 16, interests in a fund such as described in c, above, provided that issuer securities never account for more than a certain percentage (e.g., 10%) of the market value of the fund's assets. Cf. Rule 16a-1(a)(2)(ii)(C)(2) (performance-related portfolio management fees excluded from the definition of "indirect pecuniary interest" where equity securities of the issuer do not account for more than 10% of the market value of the portfolio).

e. What if the equity fund investment option under a participant-directed plan such as in Oglebay is an undivided interest in a bank collective fund which includes retirement plan assets of many different employers?

f. If the equity fund investment option under the plan is a broad-based stock index fund (e.g., S&P 500) and the employer's stock is included in the index, would Rule 16a-1(a)(5)(iii) (which provides that interests in a publicly traded index fund are deemed not to confer beneficial ownership for purposes of Section 16) exempt investment in such fund from Section 16? Same question as to mutual funds under Rule 16a-1(a)(5)(ii). What about a managed index fund which only holds plan assets of a single employer rather than a publicly-traded index fund?

2. Health Management Associates, Inc. (March 6, 1992) indicates that involuntary distributions of cash or employer stock from the employer stock account of a 401(k) plan following the end of a plan year for the purpose of satisfying the limitations of Internal Revenue Code Sections 401(k)(3)(A)(ii) and 401(m)(3) applicable to employee elective contributions and employer matching contributions, respectively, will not be considered a "withdrawal" for purposes of Rule 16b-3(d)(2)(i)(B).

a. Presumably the reference to Internal Revenue Code Section 401(m)(3) should be Section 401(m)(2) (see Question 6.a. below). Please confirm.

b. Would the same result obtain in the case of involuntary distributions required to satisfy other Internal Revenue Code requirements -- for example, distributions of employee elective contributions to correct annual additions that exceed the limitations of Internal Revenue Code Section 415? (Cf. Hewitt Associates (April 30, 1991) Q.3(e) (cessation of contributions resulting from limitations imposed by, inter alia, Internal Revenue Code Sections 402(g) and 415(c) and (e) would not constitute cessation of participation under Rule 16b-3(d)(2)(i)(C)).

c. The limitation on elective 401(k) contributions under Internal Revenue Code Section 402(g) is an annual limitation on the aggregate amount of contributions that an individual may make to all plans in which he participates. For example, an executive who changes employment mid-year may make contributions during the year to two different 401(k) plans, one sponsored by each employer. The applicable Treasury Regulations contemplate that if the aggregate amount of contributions made by a participant during the year exceeds the Section 402(g) limitation, the participant may notify each of the plans to which he has made contributions and designate the amount of the excess deferrals allocable to each plan. Such amount will then be returned to the participant as a corrective distribution. Absent such notification, no distribution would be made by either plan (unless the amount of contributions to a single plan exceeded the Section 402(g) limitation). Will distributions of excess deferrals made pursuant to such a notification procedure be considered a "withdrawal" for purposes of Rule 16b-3(d)(2)(i)(B)?

d. What if the decision whether to make a distribution to correct an excess contribution is discretionary with the plan's administrative committee; for example, where the administrative committee has the discretion to correct an excess annual addition under Internal Revenue Code Section 415 by either keeping the excess in the plan in a suspense account for allocation in the following year or distributing the excess to the participant?

e. Many 401(k) plans provide participants with the option of allowing excess 401(k) contributions (i.e., contributions in excess of the limitation in Internal Revenue Code Section 401(k)(3)(A)(ii)) to be recharacterized as after-tax contributions (subject to the limitation in Internal Revenue Code Section 401(m)(2)). If a participant does not exercise this recharacterization option, but instead receives a distribution of excess 401(k) contributions, will this be considered a

"withdrawal" for purposes of Rule 16b-3(d)(2)(i)(B)? What if the participant elects to have a portion of the excess 401(k) contributions recharacterized as after-tax contributions and the remainder distributed?

3. Southwest Airlines Company (July 17, 1991) involved a profit sharing plan which permitted participants to direct the investment of annual employer contributions among several investment funds, including an employer stock fund. The staff's response notes that the plan had elements of both a grant and award transaction and a participant-directed transaction, and stated that (1) the annual contributions to the plan and allocations to individual accounts are grant transactions, which must satisfy the requirements of Rule 16b-3(c) to be exempt from Section 16(b), (2) employee decisions to apply allocations to investment funds containing equity securities of the issuer must satisfy Rule 16b-3(d) to qualify for exemption from Section 16(b), and (3) for this purpose, transactions under the plan are eligible to use Rule 16b-3(d)(2) for the ongoing acquisition and subsequent intrafund transfers.

a. Accordingly, it is our understanding that in such a plan, cash distributions could be made of amounts invested in an employee's employer stock fund account in connection with death, retirement, disability, termination of employment or a qualified domestic relations order pursuant to Rule 16b-3(d)(2)(i)(B) without regard to the six-month holding period requirement of Rule 16b-3(c)(1). Is this correct? If the holding period requirement applies to a portion of the employer stock fund (i.e., the portion attributable to annual contributions treated as grant transactions), what policy rationale is there for requiring a six-month holding period for this portion when the portion of the employer stock fund attributable to participant-directed transactions would not be so restricted?

b. Many profit sharing plans provide that the accounts of a participant who does not fully withdraw from the plan upon termination of employment shall be automatically converted into a fixed income investment fund. In the Southwest Airlines type of plan, would such an automatic conversion of a terminating participant's employer stock fund account be permissible as, in effect, a distribution pursuant to Rule 16b-3(d)(2)(i)(B) without regard to the six-month holding period requirement of Rule 16b-3(c)(1)? If not treated as a "distribution", would such an automatic conversion nevertheless be permissible under Rule 16b-3(d)(2)(i)(B), without regard to the

six-month holding period requirement of Rule 16b-3(c)(1), provided the terminated participant does not reinvest in the employer stock fund for at least six months?

4. Take the case of an employer which sponsors a profit sharing plan such as described in Southwest Airlines Company (July 17, 1991) and also sponsors a separate 401(k) plan. Each plan permits participants to invest their account balances among several investment funds, including an employer stock fund.

a. A participant directs that the portion of his profit-sharing account invested in the employer stock fund under the profit sharing plan be transferred into a fixed income fund. Does Rule 16b-3(d)(2)(i)(B) require the participant to cease for six months further investment of 401(k) elective contributions in the employer stock fund under the 401(k) plan?

b. If the answer to a, above, is no, does it make any difference if the profit sharing plan and 401(k) plan are set forth in a single plan document, but separate accounts are maintained for employer profit-sharing contributions and 401(k) elective contributions?

5. Cravath, Swaine & Moore (October 22, 1991) (Q.4) indicates that an intra-fund transfer from an issuer stock fund is a withdrawal under Rule 16b-3(d)(2)(i)(B) and, if the insider ceases further purchases in the issuer stock fund pursuant to such Rule, the exemption for purchases made in such fund in the prior six months would be unaffected. The response can be interpreted to indicate that compliance with Rule 16b-3(d)(2)(i)(B) is the exclusive manner of exempting acquisitions in an issuer stock fund occurring within six months prior to an intra-fund transfer involving the issuer stock fund even where the conditions of Rule 16b-3(d)(2)(ii) were satisfied.

a. Rule 16b-3(d)(1)(i) exempts transactions "pursuant to an irrevocable election made by the participant at least six months in advance of the effective date of the transaction." Assuming an inter-fund transfer from the issuer stock fund is made in accordance with Rule 16b-3(d)(2)(ii), if on-going acquisitions in an issuer stock fund were made pursuant to a standing election revocable only upon six months notice (i.e., revocation effective six months after the date irrevocable notice thereof is given), such acquisitions should be exempt under Rule 16b-3(d)(1)(i) (assuming the plan otherwise satisfies Rule 16b-3(a)), and the provisions of Rule 16b-3(d)(2) need

not be complied with to exempt purchases in such fund in the prior six months. Furthermore, compliance with Rule 16b-3(d)(1)(i) should permit continued purchases to occur within the six month period after the intra-fund transfer. See Joseph A. Grundfest (March 4, 1992). Please confirm.

b. What is the policy rationale for the six-month plan purchase suspension requirement in Rule 16b-3(d)(2)(i)(B)? Presumably, a participant who makes a plan withdrawal in compliance with Rule 16b-3(d)(2)(i) can make an open-market purchase of employer stock outside the plan within six months without causing loss of exemption for plan acquisitions. Why then should purchases within the plan be subject to a six-month suspension requirement (particularly when the shares withdrawn may already have been held for six months in the participant's account)?

6. Hewitt Associates (April 30, 1991) indicates that cessation of contributions to a qualified plan resulting from limitations imposed by Internal Revenue Code Sections 402(g), 415(c) and (e), 401(k)(3)(A)(ii) or 401(m)(3) would not constitute cessation of participation and, therefore, would not trigger the Rule 16b-3(d)(2)(i)(C) requirement that the participant not recommence participation for six months.

a. Although Internal Revenue Code Section 401(m)(3) describes how certain ratios are to be computed for purposes of applying the limitations on matching and employee contributions, the actual limitation is prescribed in Section 401(m)(2). Presumably, therefore, the reference in the Hewitt Associates response to Code Section 401(m)(3) should instead be to Section 401(m)(2). Please confirm.

b. What if a participant in a qualified 401(k) plan whose elective 401(k) contributions have reached a limitation imposed by the Internal Revenue Code (for example, Internal Revenue Code Section 401(k)(3)(A)(ii)) has the option to make additional contributions in the form of after-tax contributions. If the participant does not exercise this option, would this constitute a cessation of participation in the 401(k) plan for purposes of Rule 16b-3(d)(2)(i)(C)?

c. Would the conclusion in Hewitt Associates be any different if a participant in a qualified plan whose contributions have reached a limitation imposed by the Internal Revenue Code has the option to have amounts in excess of the limitation credited to a non-qualified excess or supplemental plan, but does not elect to do so? For example, take the case of a non-qualified excess plan such as described in Thacher Proffitt & Wood (December 20, 1991

and February 11, 1992) which permits certain highly compensated employees who participate in the employer's qualified 401(k) plan to have credited to bookkeeping accounts under the non-qualified excess plan amounts that would have been contributed to the 401(k) plan but for the limitations of Sections 401(a)(17), 415 or other provisions of the Internal Revenue Code. If an eligible participant whose contributions to the qualified 401(k) plan have reached the applicable contribution limitations does not elect to participate in the non-qualified excess plan (or elects not to participate in the non-qualified excess plan if participation is automatic in the absence of an election not to participate), would this constitute a cessation of participation in either the qualified 401(k) plan or the non-qualified excess plan for purposes of Rule 16b-3(d)(2)(i)(C)?

d. What if a 401(k) plan participant who is eligible to participate in a non-qualified excess plan such as described above elects to have a portion, but not all, of the amounts in excess of the applicable Internal Revenue Code limitations credited to the non-qualified excess plan? Would this constitute a cessation of participation in either the qualified 401(k) plan or the non-qualified excess plan for purposes of Rule 16b-3(d)(2)(i)(C)?

7. Thacher Proffitt & Wood (December 20, 1991 and February 11, 1992) indicates that a non-qualified "excess plan" which provides benefits beyond limitations imposed by the Internal Revenue Code may be considered together with the qualified defined contribution plan to which it relates for purposes of satisfying the broad-based participation and non-discrimination requirements of both Rule 16b-3(d)(2)(i)(A) and Rule 16b-3(b)(3)(ii). The incoming correspondence cites to limitations under Sections 401(a)(17), 415 and other provisions of the Internal Revenue Code. Presumably such other provisions would include Internal Revenue Code Sections 402(g), 401(k)(3)(A)(ii) and 401(m)(2). Please confirm.

8. Thacher Proffitt & Wood (December 20, 1991) indicates that employees whose benefits under a non-qualified plan may be paid out of a rabbi trust will not have a pecuniary interest (within the meaning of Rule 16a-1(a)(2)) in employer stock held by the rabbi trust where the value of the assets and income of the rabbi trust will not affect the amount of the employees' benefit under the non-qualified plan. Although the incoming correspondence stated that participants in the non-qualified plan did not have any investment control over the assets of the rabbi trust, it does not appear that this fact was relevant to the conclusion reached. Please confirm.

9. Rule 16b-3(f)(3) exempts from Section 16(b) the disposition of plan securities pursuant to a qualified domestic relations order ("QDRO") as defined in the Internal Revenue Code or Title I of ERISA. Would such a disposition pursuant to a QDRO constitute a "withdrawal" under Rule 16b-3(d)(2)(i)(B)?

10. Vorys, Sater Seymour and Pease (October 22, 1991) indicates that the requirement of Rule 16b-3(a)(1) that a plan set forth either the price at which securities may be offered or the method by which the price is to be determined, is satisfied by ESOPs, 401(k) and similar broad-based plans qualified under ERISA that permit discretionary contributions made by or for the benefit of participants to be invested in employer securities by trustees or other fiduciaries at prices in accordance with their fiduciary duties. In order to satisfy this requirement, must such plans contain specific language (e.g., that the price of securities shall be determined by the trustee or other responsible fiduciary in accordance with the fiduciary requirements of ERISA), or is the Rule 16b-3(a)(1) requirement deemed to be satisfied by broad-based ERISA-qualified plans without regard to whether the plan contains any such specific language?

<u>Executive Compensation</u>

11. Is an executive bonus program under which executives receive their cash-denominated bonuses in cash, unless the executive elects to receive employer stock, governed by the grant and award provisions of Rule 16b-3(c) or the participant-directed provisions of Rule 16b-3(d)? If this is a grant and award transaction, the six-month holding period requirement of Rule 16b-3(c)(1) would apply. If it is exclusively a participant-directed transaction, and the executive makes an irrevocable election to receive stock at least six months before the bonus is paid, then the bonus stock could be sold by the executive within six months of its receipt.

12. It is not unusual for employment agreements to require an issuer to include in the severance payments due upon the issuer's termination of an executive's employment an amount equal to the "spread" on the executive's outstanding options based on the market value of the issuer's stock on the date of termination. Such arrangements, even though not founded on the issuer's option plan, could be viewed as being in tandem with the executive's stock options in the sense that the executive would typically receive this cash-out in lieu of, rather than in addition to, the continued right to exercise the option. <u>See</u>, <u>e.g.</u>, SEC Release No. 34-28869 (Feb. 21, 1991) note 210 (SAR granted in tandem with option). Such arrangements raise a number of questions under Section 16.

a. Would the cash-out provision in the employment agreement be eligible for Rule 16a-1(c)(3)(ii)'s exclusion from the definition of "derivative security"?

b. If not, would the cash-out right have to be separately reported or could it be reported as a feature of the options to which it applies? See William M. Mercer (March 6, 1992) (tandem SARs and LSARs may be reported either separately or as a separate feature of the stock option to which they are tandem).

c. If the issuer's option plan does not provide for any form of stock appreciation rights or limited stock appreciation rights, would the inclusion of the cash-out feature in the employment agreements of one or more insiders be viewed as a material amendment of the issuer's option plan for which shareholder approval would be required under Rule 16b-3?

Stock Options

13. Option repricing arrangements raise a number of Section 16 questions.

a. If, after a significant decline in the market value of an issuer's stock, an issuer offers optionees the opportunity to surrender outstanding options with higher exercise prices and to receive in exchange new options with lower exercise prices and a new vesting schedule, is the grant of new options: (i) a grant-and-award transaction eligible for exemption under Rule 16b-3(c); (ii) a participant directed transaction eligible for exemption under Rule 16b-3(d); or (iii) both (i) and (ii).

b. Would the result be different if the new options did not feature a new vesting schedule?

c. What if instead of granting new options, the issuer merely reduced the exercise price of outstanding options, but otherwise did not change the option terms?

PROXY DISCLOSURE

14. What is the current status of the proposal to require proxy and financial statement disclosure of the value of stock option grants?

REGISTERED INVESTMENT ADVISERS

15. What is the current status of the recently issued notice proposing to remove certain real estate investment advisers from the list of investment managers registered under the Investment Advisers Act of 1940? Has the Commission considered the impact of cancelling registration on the ability of such advisers to serve as pension plan fiduciaries and as qualified professional asset managers ("QPAMs") pursuant to the Department of Labor's class exemption for QPAM-directed employee benefit plan transactions? Has there been consultation between the Commission and the Department of Labor regarding the proposal? When is final action expected to be taken regarding the proposal?

2275e
9693e(2)