

**American Bar Association
Joint Committee on Employee Benefits**

**Questions for the Staff of the
Securities and Exchange Commission
Tuesday, May 16, 1995**

1933 Act Registration issues--deferred compensation

In the last year or so, the Staff has on several occasions declined to take a no-action position with respect to the status of elective deferred compensation plans as securities subject to the registration requirements of the 1933 Act. These plans have typically been deferred compensation plans that are not qualified under Section 401 of the Internal Revenue Code or subject to the funding requirements of ERISA, where the participant elects to defer receipt of compensation to a later date. The plans are typically either completely unfunded or are "funded" with a rabbi trust, under which the beneficiaries' interests are subject to the claims of the creditors of the employer. We understand that the Staff has informally and on a case-by-case basis raised the concern that employee interests in such plans may in fact be registrable obligations of the issuer and that, as a result, several issuers have registered interests in such plans. We are not aware of any public statement that would alert issuers and their advisers generally of this apparent change in the Staff's interpretive position. (While we recognize that Staff responses do not affirmatively agree with counsel's reasoning, in numerous no-action letters issued in past years, the Staff has not objected to counsel's opinions to the effect that interests in such plans did not involve securities.)

1. What is the Staff's current thinking on this issue? Are there any plans to issue a rule, release, interpretive letter or other public statement on the issue?

Staff Response:

Contrary to popular belief, the Staff has never relied on the "no security" theory in acquiescing to the non-registration of non-qualified deferred compensation arrangements. Whereas the incoming letters requesting a no-action position generally propounded a "no security" theory, or set forth the proposition that no regulatory policy would be served by requiring such registration, the Staff always relied on the availability of the private placement exemption, because the inquiry letters almost always described the plan as covering a "select group of management or highly compensated employees. Even if in the "early days" of such no-action letters, there may have been a "no security" analysis, that analysis would not apply to the current situation where participants direct the manner in which their deferred compensation accounts are to be invested (or deemed invested). Thus, according to the Staff, there has been no change of position.

The Staff seems to be drawing a distinction between "traditional" or "old fashioned" deferred compensation arrangements and more "modern" arrangements. Under the "traditional" arrangement, the deferral was solely for tax purposes, rather than to obtain investment gains. The participants were not given a choice as to rate of return, and the return was simply pegged to an outside measure, such as an interest rate. Where there is no election to defer, there would be no registration requirement. There is a sense on the part of the SEC Staff that participants engaging in fairly broad-based plans with an array of investment choices, are not merely deferring compensation for tax purposes, but may have a goal of obtaining investment gains as well. It is this feeling that makes the Staff believe registration is appropriate for these plans.

Nevertheless, the Staff is sensitive to the furor caused in the private sector by this issue, and would be receptive to an interpretive request making the argument for non-registration for plans that more closely fit the "traditional" paradigm.

2. Given the earlier no-action letters, many issuers have adopted deferred compensation plans without registration. Some of such plans may include participants in respect of whom it may be difficult for companies to qualify for a private placement exemption. Companies are understandably reluctant to register current offerings under such plans if it were to create an inference that prior offerings should have been similarly registered. What comfort can the Staff give to issuers who now register deferred compensation plan interests that there won't be any fallout relating to prior offerings?

Staff Response:

The Staff believes that on a going-forward basis these securities must be registered. It is unlikely that the Division of Corporate Finance would recommend any enforcement action retrospectively, so long as there was no fraud. Of course, the SEC's enforcement position does not shield issuers from private claims.

The Staff also stated that an excess benefit plan or SERP tied to a qualified plan could not piggyback on the Section 3(a)(2) exemption in the 1933 Act available to tax-qualified plans.

The Staff solicited a request for an interpretive letter which the Staff could use as a vehicle to state its position. The Staff suggested that such a request be submitted in draft form to allow refinement.

3. If registration is required, what is to be registered? Obligations of the issuer? Participation interests in the plan? Both? (This is significant in view of the questions 4, 7 and 8 below.)

Staff Response:

In most cases, the employee looks to the company for payment of the non-qualified deferred compensation. Therefore, it is an obligation of the company, and not the plan. The plan is not a separate issuer. Participation interests in the plan are not separate securities unless there is some feature of the plan that limits the employees' rights against the company, such as limiting the employee's rights to a specified pool of assets. What would be registered are deferred compensation obligations of the issuer. It is important not to characterize these obligations as "debt" or "evidences of indebtedness" for purposes of the Trust Indenture Act (see question 5 infra). There would thus be no need to have the "Plan" signature page in the Registration Statement on Form S-8.

The existence of a rabbi trust to "fund" the plan should not change this result, because creditors of the employer have access to the rabbi trust's funds. The participant's contractual rights are against the company, not the rabbi trust, and the amount to which the participant is entitled is unaffected by whether the rabbi trust is overfunded or underfunded. Hence the rabbi trust is also not an issuer and registration is not required.

There could be an issue with a secular trust where the employee looks to the assets of the secular trust, in whole or in part, for payment. In that case, the secular trust might be an issuer and registration might be required. The provisions of the Investment Company Act should also be considered (see below).

The Staff would be receptive to a letter seeking further guidance on this point.

4. Is an 11-K required? (If the securities to be registered are "interests" of which a plan, rather than the employer corporation, is the "issuer", one would have to consider General Instruction A of Form 11-K which refers to "employee stock purchase, savings and similar plans, interests in which constitute securities under the Securities Act of 1933". As a practical matter, Form 11-K could provide no substantive disclosure to participants in an unfunded deferred compensation plan; an unfunded plan has no plan assets, revenues or expenses to be reflected in the audited financial statements required by Form 11-K. It seems that, for a plan for which financial statements are not required under ERISA (which is virtually all of these plans) the most information that could be provided in a Form 11-K would be a cover page with a statement that no financial statements are required. In that event, should a Form 11-K should be required at all?)

Staff Response:

So long as the securities are deferred compensation obligations of the employer, there would be no need to file any annual reports on Form 11-K. An 11-K is required only where there is a separate issuer. Since the plan is not an "issuer," no Form 11-K would be required.

Form S-8 would generally be available to register these plans. The filing fee would presumably be based on the amounts initially deferred, not amount eventually paid (after adding in earnings).

5. If unfunded deferred compensation plans give rise to securities, please confirm that such securities are exempt from the Trust Indenture Act ("TIA") under Section 304(a)(1)? (For this purpose, the Staff should assume that TIA Section 304(b)'s exemption for privately placed debt securities would not be available.) (Questions 3 and 4 above may intersect with this question.)

Staff Response:

The Staff has not and will not require a trust indenture. The securities being registered under these plans are not a "note, bond, debenture, or evidence of indebtedness" within the meaning of Section 304(a)(1) of the Trust Indenture Act.

6. Many of the letters in which the Staff had taken favorable no-action positions regarding deferred compensation plans included a conclusion that the plan did not constitute an investment company for purposes of the Investment Company Act of 1940. What is the Staff's thinking with respect to this issue?

Staff Response:

These plans are not the "issuer" of a security and thus cannot be an investment company within the meaning of Section 3(a) of the Investment Company Act; the "issuer" is the company. See question 3 above. Therefore, unless the employer itself is an investment company, there should not be an Investment Company Act registration requirement.

See Question 3 above regarding the effect of a rabbi trust or a secular trust on this analysis.

7. If the employer is a not-for-profit corporation, is the security exempt under Section 3(a)(4) of the 1933 Act? (The question may be trivial if the issuer of the deferred compensation security is the not-for-profit corporation. The question is

intended to cover the possibility that the Staff might deem the plan itself to be the issuer.)

Staff Response:

See the answer to question 3. In the normal case, the not-for-profit corporation will be the issuer, and the exemption will be available. However, any definitive answer would depend on the facts and circumstances of the particular contractual arrangement. For example, if there was something about the contractual obligations that gave the obligee access to a separate pool of assets for repayment, the result might be different.

8. If the plan is maintained by a governmental entity, is the security exempt under Section 3(a)(2) of the 1933 Act? (Once again, the question is intended to cover the possibility that the Staff might deem the plan itself to be the issuer.)

Staff Response:

See the answers to questions 3 and 7. In the normal case, the governmental entity will be the issuer, and the exemption will be available.

1933 Act Registration issues--Form S-8

9. In view of the Commission's proposal to ease the transferability restrictions of Rule 16b-3, many companies have begun to consider the implications of amending their option plans in this regard. One such implication is that Form S-8 would appear to be unavailable for the exercise of options that had been transferred to persons who do not satisfy the definition of "employee" in General Instruction A.1.(a) of Form S-8. Would the Staff be willing to consider a modest expansion of the definition of this term "employee" to include transferees who are members of the immediate family of the original option grantee (or trusts for the benefit of such immediate family members)? By virtue of the family relationship, such persons could be expected to enjoy substantially similar access to information as the original employee-grantee.

Staff Response:

There is no rulemaking authority as to S-8s emanating from the Section 16 Release. It would require a new rulemaking proposal under the Administrative Procedure Act. Even apart from such requirements, the Staff believes the theory underlying Form S-8 is that employees are familiar with their own companies. The Staff is skeptical that a successful argument could be made why such knowledge should be imputed to others, including members of the employees' immediate families, notwithstanding that Form S-8 has already been extended to cover family members after the employee's death. The Staff is of this view even though Section 16 of the 1934 Act would impute beneficial ownership and pecuniary interest to such transferees.

The Staff did confirm that it is the fact that the option is held by an employee that makes the S-8 available, not the fact that the option is non-transferrable. Thus, an employee held a transferrable option, Form S-8 would be available for the exercise by the employee. If, however, the option were transferred to a non-employee, the availability of Form S-8 would be lost.

1933 Act Registration issues--Rule 701

10. Another question flowing from the increased interest in option transferability is the its effect on the availability of Rule 701.

- (a) As a threshold question, would Rule 701(b)(1) be satisfied in connection with a plan that provides for transferable options? Would the nature of the persons to whom options were transferable affect the Staff's response?

Yes and yes. See the answer to question 9 above. Rule 701(b)(1) would not fail to be satisfied in a situation where the plan provided that the options granted thereunder were transferrable. However, Rule 701 would not be available to provide an exemption for the transfer of the option or the exercise by the transferee who is not an employee.

- (b) Under Rule 701(c)(3), stock acquired by employees, consultants or advisors of a nonreporting issuer upon exercise of options may be resold, beginning 90 days after the issuer has become a reporting company, without compliance by nonaffiliates with paragraphs (c), (d), (e), and (h) of Rule 144 and by affiliates with paragraph (d) (holding period). Would a private sale or transfer of a Rule 701 stock option create a new holding period or otherwise jeopardize the availability to the transferee of the 701 resale provision? Would it matter to whom the option were transferred? Compare *Allied Telesyn International*

Corp. (March 3, 1995) with *Central Point Software, Inc.* (March 9, 1993).

Suggested analysis: Rule 701(c)(3) on its face applies to all securities issued in a 701 transaction; it is not conditioned on the reseller being the person who originally received the option or the person who exercised it. Moreover, the 90-day holding period would appear to be based on the widespread availability of public information regarding the issuer of the security -- a consideration which is not linked to the identity of the reseller. Accordingly, a private sale of Rule 701 stock (whether before or after the IPO) should not create an additional holding period.

Staff Response:

The Staff does not understand on what theory a non-employee (other than a consultant or advisor) could have Rule 701 available following a sale by an affiliate. A private sale of an option by an affiliate would result in the transferee holding restricted securities and the issuer would need to find an exemption for the exercise of the option by someone other than the employee. Rule 701 would not be available. If the security transferred was common stock received in a Rule 701 transaction, Rule 701 would be available for a transfer by gift or to a living trust (see Brobeck, Phleger and Harrison, 8/27/92, and Allied Telesyn International, 3/3/95), but would not be available if the transfer was a sale (see Central Point Software, 3/9/93).

A transferee of stock acquired under 701 does not have Rule 701 available for his resale.

11. The dollar amount limitations of Rule 701(b)(5) are unduly difficult to explain and apply. Would the Staff be receptive to simplification?

Staff Response:

Yes, the Staff would be receptive, but such simplification would probably not be given a high priority.

Section 16 Rules

12. What is the current status of the Section 16 rule amendments proposed last year? Are there particular problem areas which are causing the delay? Is there anything the private bar can do to expedite the adoption process?

Staff Response:

Since there was no scheduled time by which the amendments were to have been finalized, there has been no "delay." There is no scheduled time for finalization that can be publicly announced. The Staff is working toward adoption. There are a number of complex issues but no one particularly troublesome issue.

While there is nothing the private bar can do to expedite the adoption process, the Staff would appreciate more information on mirror and excess plans and deferred compensation plans, so that the Staff can better understand the permutations contained in the universe of such plans.

13. Has there been any change in the Staff's position that a company which previously elected to be under "new" Rule 16b-3 can elect to switch back to former Rule 16b-3? What is required to evidence such an election? Can a company which has switched back later elect to come under the "new" rule? Is there any limit on the number of switches?

Staff Response:

There has been no change in the Staff's position. The Staff has not required anything in particular to evidence the change. It must be something that would suffice under state corporate law. An example could be a board of directors resolution, but the Staff does not take the position that a resolution is required. The Staff has not imposed any limit on the number of switches.

14. In its *Terra Industries Inc.* letter (8/11/92), the Staff took the position that an executive of a parent company would be "disinterested" for purposes of new Rule 16b-3 with respect to its publicly-traded subsidiary if the only equity securities received by the executive were stock appreciation rights of the parent company which could only be settled in cash. Would the executive still be "disinterested" if he received parent company stock options? The letter suggests that the answer should be "yes" since it is not conditioned on the stock appreciation rights not being encompassed within the definition of "equity security."

Staff Response:

The analysis is not limited to cash-only awards. The relevant considerations are that (1) the parent company executive was eligible for awards under only the parent company's plan (and not the subsidiary's plan) and (2) there not be any participant in the subsidiary's plan who administers a plan in which the parent company executive participates (i.e., that there be no opportunity for "back scratching").

15. Under the 1994 proposed amendments (the "Proposed Amendments") to Rule 16b-3, many issues and concerns raised under the 1991 version of Rule 16b-3 would be resolved. However, the Proposed Amendments leave some questions to be resolved, particularly with respect to tax-qualified retirement plans. Listed below are some issues which, to our knowledge, have not already been raised in comment letters on the Proposed Amendments. Has the Staff developed an understanding of how the Proposed Amendments would apply in the following situations?

NOTE: Since the proposed amendments are only proposed, the Staff cannot interpret them. What is expressed below is the Staff's indication of intention under the proposals, should they become final. For each of these questions, the Staff has invited a comment letter.

a. There are a number of common purchase transactions in tax-qualified retirement plans which do not neatly fit the obvious meanings of resulting from an "employee contribution" or "employer contribution," and it is thus not clear whether such purchases would be exempt under the Proposed Amendments.

Note: The preamble to the Proposed Amendments provides with respect to purchases under employee benefit plans that, "... all purchase transactions in a thrift, stock purchase or similar securities acquisition plan" would be exempt if the plan provides for broad-based employee participation, does not discriminate in favor of highly compensated employees, and is qualified under the Internal Revenue Code. The reference to "all" purchase transactions in the preamble is broader than the language of proposed Rule 16b-3(d)(1), which refers to "any purchase transaction resulting from an employee contribution and/or an employer contribution, other than an intra-plan transfer."

(1) Under the Internal Revenue Code, an ESOP may apply cash dividends payable with respect to employer stock held in the participant's account to the repayment of the ESOP loan, provided that shares of stock with a fair market value at least equal to such dividends are allocated from the ESOP suspense account (which serves as collateral for the loan) to the participant's account. For example, assume an ESOP has allocated 1,000 shares to a participant's account. Assume each share has a fair market value of \$10. A \$.10 dividend becomes payable with respect to the stock. Thus, the 1,000 shares would produce a dividend of \$100. Under the ESOP, the \$100 would be used to reduce the ESOP's debt, and 10 additional shares (\$100 worth) would be allocated to the participant's account. Would these shares represent an exempt purchase under the Proposed Rules? Would a 6-

month holding period apply (assume the underlying 1,000 shares had been allocated to the participant's account more than 6 months prior to the payment of the dividend)?

Staff Response: It would be the Staff's intention that such allocations would be exempt as company contributions.

(2) Assume an employee voluntarily rolls over a distribution from the plan of a former employer to the plan of his or her new employer, or that his benefit is involuntarily transferred to a new plan incident to a plan merger. Under the plan of the former employer, the funds derived from both 401(k) (i.e. employee) and employer contributions. Assume the employee is a Section 16 insider with respect to the new employer, and immediately directs, pursuant to the terms of the new employer's plan, that the rollover or transferred amount be invested in the securities of the issuer fund made available under the plan. Would the investment in the securities of the issuer fund be an exempt purchase resulting from an employer or employee contribution? Would there be some other basis for exemption under the Proposed Amendments?

Staff Response: It is the Staff's intention that all contributions to a plan be covered, and not to quibble as to whether a particular contributions would qualify as an "employer" or "employee" contribution.

b. Under Internal Revenue Code Sections 401(a)(9) and 401(a)(14) a tax-qualified plan is required to make distributions to an employee, regardless of whether he is still employed. There appears to be no exemption in the rule for distributions mandated under the Internal Revenue Code.

Staff Response: The Staff previously solicited comments regarding Code Section 401(a)(9), and in response a number of commenters addressed Code Section 401(a)(9) generally. There were no comments on Code Section 401(a)(14). The Staff would be interested in a letter explaining why it would be appropriate to exempt such distributions. The Staff also needs to understand exactly how these sections work in practice. The mere fact that they are involuntary may not be sufficient, since there is no general exemption for "involuntary" transactions. The letter should explain how these code sections operate and whether the potential problem could be avoided by some action, such as a six-month prior irrevocable election, or whether there is an existing exemption that works equally well.

Proxy Compensation Disclosure Rules

16. How is the dollar value of the insurance premium determined for term life insurance under a whole life insurance policy? Is it determined, for example, by reference to standard tables (e.g. P.S. 58 or Table I) or is it the insurer's actual rates?

Staff Response:

The Staff allows flexibility on this point. Issuers may use either approach (IRS tables or insurer's actual rates), so long as the same approach is used consistently from year to year. Tax tables may be used, even if the insurance carrier provides actual rates which are different from the tax tables.

17. Instruction 8.a to S-K Item 402(c) provides that the Option/SAR Grants Table may include a column showing the registrant's historic rate of appreciation over a period equivalent to the term of the options and/or SARs. Please confirm that an issuer that elects this approach would compute the amount of option spread that would develop over the remaining option term if the company's stock continues to appreciate over the option term at the same average annual rate as it appreciated over a prior period of a length equal to the option term (e.g., 10 years if it is a 10-year SAR).

Staff Response:

Yes, the period even which the historic rate of appreciation is determined should conform to the term of the option. Of course, the amount would only be shown in the year of the grant.

18. Instruction 5 to Item 402(l) requires that an issuer disclose the identity of the members of its peer group. Is it sufficient to simply state that the group consists of all companies within a specified Standard Industrial Classification Code?

Staff Response:

The use of SIC codes for this purpose was never expressly approved as a "quasi-index" by the Staff but the Staff has not objected to the practice that has developed of using a standard SIC code, provided the SIC code used is identified in the proxy. It is also acceptable to use more than one SIC code, so long as all publicly reporting companies in those SIC codes are included in the index. However, if the issuer changes the SIC code used from year to year, or adds or deletes companies from those in the SIC code, it is considered to be a self-constructed index, which would require naming the component companies in the proxy statement. Some companies using SIC codes to identify a peer group have added an undertaking to provide a list of companies

included in the SIC code upon request of a shareholder. The Staff would be "displeased" if such an undertaking were not included.

The use of SIC codes to identify a peer group seems workable, but it has not been formally approved by the Staff. Therefore, if problems or issues surface, the Staff thinking may change.

19. Is a bonus agreement between a registrant and a named executive officer that does not otherwise provide (i) any terms and conditions of employment or (ii) for any payments with respect to resignation, retirement, or upon any other termination of employment or change in control required to be described under Section 402(h) of Regulation S-K?

Staff Response:

The Staff has a hard time understanding in what circumstances a bonus agreement would not be part of the terms and conditions of employment. The Staff's position is that all terms of an employment relationship must be disclosed. A bonus arrangement seems to be a type of employment arrangement. Whether it is or is not needs to be analyzed in the totality of the circumstances, i.e., whether the employee believes it is a term or condition of his employment. Moreover, it is not clear whether independent disclosure would be required if an employee expects to participate in an executive bonus plan or arrangement as part of his employment. If the terms of employment contemplate participation in the plan, then an argument could be made that it should be disclosed in connection with the discussion of the individual's employment (not just in the discussion of the plan itself). In this regard, it may make a difference if the individual has an employment agreement that does not mention participation in the bonus plan but the individual nevertheless is included in the bonus plan. In such a case, it would appear that the bonus arrangement would not need to be described under Section 402(h).

20. Instruction 1 to paragraph b(10) of Section 601 of Regulation S-K provides that registrants need only file copies of compensation plans and need not file each individual or executive officer's personal agreement under such plans, unless there are particular provisions in such agreements where disclosure in an exhibit is necessary to an investor's understanding of that individual's compensation under the plan. If a specific agreement with specific earn-out provisions is described in the proxy, would discussion of this earn-out provision be sufficient to avoid filing the individual agreement pursuant to Instruction 1?

Staff Response: If the individual agreement is not filed, the company could expect a Staff comment. If the earn-out arrangement is proprietary business information, that concern should be addressed in a request for confidential

treatment. In any event, the totality of the circumstances governs the situation. Thus, it may be necessary to file an individual's option agreement under an option plan, if the individual option agreement is specifically tailored to the individual. On the other hand, if the option agreement does not contain unique terms, and if there is sufficient detail in the summary disclosures so that not disclosing the individual option grant is not misleading, then filing the individual grant agreement may not be necessary.

Other

21. Will the Staff revisit Rule 14a-8 (shareholder proposals) in light of the *NYCERS* case?

Staff Response: No, at least not while the petition for rehearing is pending.

The American Society of Corporate Secretaries has submitted a proposal in this area, but it is not high on the list of priorities.

22. Assume that a retirement plan of a publicly-traded company allows employee contributions to be invested in employer stock, so that it is obligated to file a Form S-8 registration and a Form 11-K each year thereafter. Assume that before the end of the year, all of the stock of the issuer is acquired by another entity for cash. As a result of the transaction, participant contributions may no longer be invested in stock of the employer or its new parent. The company could, therefore, deregister the S-8.

a. Is Form 11-K still required to be filed? To be able to cease filing an 11-K, must the S-8 first be deregistered?

Staff Response:

In general, yes, because the plan is a separate issuer. The resolution depends on whether the Plan can use Rule 12h-3 under the Exchange Act to suspend the filing. Rule 12h-3 is by its terms not available during any year in which a registration statement under the 1933 Act is effective, so the Form S-8 would have to be deregistered.

b. Must the plan file a Form 15 under the 1934 Act? If so, what is the appropriate box to check?

c. Would the answer be different if, instead of merely ceasing employee contributions invested in employer stock, the plan were either

terminated or merged out of existence so that at the end of the year there was no plan?

Staff Response: Yes. Rule 12h-3 is available if the issuer is merged out of existence.

23. Are there any developments in the Staff's thinking on the Pan Agora Group Trust issue?

Staff Response:

Section 3(c)(1) of the Investment Company Act of 1940 exempts private investment companies that have not made and do not intend to make a public offering and the beneficial interests in which are not held by more than 100 persons. Pan Agora involved a participant-directed defined contribution plan. Individual participant elections to participate in [group funds] were aggregated, and only the plan trustee was counted toward the 100 person limit, thereby permitting the fund to avoid registration as an investment company. There, the Staff said that because the plan was participant-directed, for purposes of the Investment Company Act, one must look through the trust, and each plan participant counts in calculating whether there are more than 100 persons investing in the fund. In Latham & Watkins (12/28/94) the Staff reiterated the Pan Agora position, but gave timing relief on compliance with the Investment Company Act to 12/31/95. After that date, funds will have to register if they have more than 100 investors, counting each participant in a participant-directed plan.

This position applies any time there is a participant-directed investment choice, whether the participant chooses, e.g. a particular hedge fund, or merely chooses a general investment fund (e.g. an "equity" fund, in which the specific investments are chosen by a trustee or investment manager). The Staff would be willing to consider limiting the scope of its "look through" position in order to provide some relief where there is no participant choice as to a particular investment, but only a choice as to a particular type of fund. The Staff solicited a letter requesting such relief.