ABA Sections of Business Law, Labor Law, Real Property, Probate and Trust Law, Taxation, and Tort and Insurance Practice

ABA Joint Committee on Employee Benefits

Meetings with Agencies
May 6-9, 1996

Securities and Exchange Commission Questions and Answers

1. **Question:**

What is the status of the Rule 16b-3 project?

SEC Staff Response:

[NOTE: Final rules have been issued, with an effective date of August 15, 1996. The phase-in period for Rule 16b-3 is extended until November 1, 1996. Release Nos. 34-37260; 35-26524; IC-21997.]

2. **Question:**

If a stock-based employee benefit plan is amended to change the membership of the plan's administrative committee in order to enable such committee to meet the requirements prescribed for a compensation committee consisting of "outside directors" within the meaning of Code § 162(m) and the treasury regulations thereunder, would such an amendment require shareholder approval for purposes of complying with (old) Rule 16b-3?

SEC Staff Response:

The change would not seem to require shareholder approval.

[Note that under the final new Rule 16b-3, shareholder approval is only one of several alternative means of exemption.]

3. **Question:**

Can a personal representative of a disabled former employee exercise a stock option without violating (old) Rule 16b-3?

SEC Staff Response:

The answer to this question depends on the facts and circumstances. If the personal representative's authority is simply to act on behalf of the former employee to exercise the stock option, and the shares acquired are the property of the former employee, there would be no violation of Rule 16b-3 and no transfer of a derivative security between the former employee and the personal representative.

Additional Question:

Would the Time Warner no-action letter apply to lifetime transfers of stock options to charity? In Time Warner, the Staff took the position that amending outstanding stock options to permit them to be transferred inter vivos to members of an employee's immediate family, family trusts or family partnerships without consideration for estate planning purposes does not preclude stock options that are granted under the same plan but that are not transferable inter vivos from qualifying for the new Rule 16b-3 exemption.

Answer:

The result under Rule 16b-3 would appear to be the same, whether the options are transferable inter vivos to family members or charitable organizations. However, the Staff is not inclined to extend Time Warner officially, because the new Rule 16b-3 exemption that is in the pipeline at the SEC may not have a non-transferability requirement akin to that contained in the current version of Rule 16b-3.

[Note that under final new Rule 16b-3, non-transferability is no longer a condition to the availability of an exemption.]

Additional Question:

If the company routinely waives the restriction prohibiting lifetime transfers of options on request, would the Staff take the position that the restriction is removable at will and therefore none of the options satisfies the non-transferability requirement, including an option with respect to which the company has not waived the restriction?

Answer:

The Staff is not inclined to take that position. On the contrary, the tentative Staff view is that, until the non-transferability restriction is waived, the options are eligible for the Rule 16b-3 exemption.

[Note that under final new Rule 16b-3, non-transferability is no longer a condition to the availability of an exemption.]

4. Question:

Can an SAR that provides that it is automatically exercised on the last day of its term if the participant does not exercise it prior to that date be considered to be automatic or fixed in advance under the plan and is outside the control of the participant within the meaning of New Rule 16b-3(e)(3)?

SEC Staff Response:

Such a provision would not satisfy New Rule 16b-3(e)(3)'s requirement that the exercise be automatic or on a fixed date.

5. Question:

Is it permissible for the Disinterested Director to delegate to an officer who is not a director whether there has been the occurrence of an event that would cause the forfeiture of a stock option (e.g., entering into competition with the employer following termination of employment) and still have such grants be exempt under Rule 16b-3?

SEC Staff Response:

All discretion must remain with the disinterested directors under old Rule 16b-3 and the 1991 New Rule 16b-3. See Sullivan & Cromwell (April 30, 1991). The same would be true if the discretion were delegated to an officer who is a director but not a Disinterested Director (e.g., the CEO). However, nondiscretionary acts and determinations may be delegated to persons other than disinterested directors. Whether something is discretionary depends on the facts and circumstances. For example, determinations that are based on objective criteria, such as the determination of whether a participant has been convicted of fraud, which would result in forfeiture of an option, would be a permissible delegation, as would a determination (such as the one addressed in the Merck no-action letter) of whether material non-public information is outstanding that, under the terms of the plan, results in a postponement of the automatic grant of options under a formula plan. However, the facts and circumstances will control. For example, if a determination that is nominally based on objective criteria is in fact administered in a discretionary fashion, it will be considered non-delegable for Rule 16b-3 purposes. The Merck no-action letter, which permitted the general counsel of the company (who was not a disinterested director) to determine whether a grantee was in possession of "material non-public information" should not be broadly read to permit delegation. In that case, the general counsel was in the best position to make the determination, and prohibiting exercises when the grantee was in possession of material non-public information furthered public policy.

[Note that under the final new Rule 16b-3, approval by "Non-Employee Directors" (rather than "Disinterested Directors") is one of several alternative means of exemption.]

6. Question:

Is a former officer or director required to report transactions under Rule 16a-2(b) following cessation of such status that occur within six months of a transaction conducted as a director or officer even if all of the pre-and post-termination transactions are of the same variety (i.e., all are sales or all are purchases)?

SEC Staff Response:

Yes. Even if the only pre-termination transaction taking place within six months of a post-termination transaction is a "same way" exempt transaction, the officer or director would be required to report the post-termination transaction under Rule 16a-2(b). The staff noted that as part of the August 1994 pro-

posals, the Commission proposed amending Rule 16a-2(b) so that a post-termination transaction following a pre-termination transaction that was either "same way" or exempt from Section 16(b) would not have to be reported. The staff added that, before deciding to recommend the proposed amendment to Rule 16a-2(b), it determined that the current rule could not be interpreted in a manner that would permit the exclusion of any post-termination transaction occurring within six months of a pre-termination transaction.

[In fact, final new Rule 16a-2(b) adopted May 30, 1996 subjects transactions following cessation of director or officer status to section 16(b) only if they are the opposite way from a transaction occurring while the individual was a director or officer.]

7. **Question**:

Even prior to the issuance of a Department of Labor Advisory Opinion issued to Ian Lanoff on September 28, 1995, relating to an ESOP pass through vote for non-directed allocated shares and unallocated shares (the "Lanoff Letter"), it was uncertain how ESOPs were required to report beneficial ownership for purposes of determining voting power or disposition power for such shares held by the ESOP. The Rio Grande no-action letter issued by the SEC on April 5, 1989 and the no-action letter issued to the ABA Joint Committee on July 3, 1991 stated the SEC's views on reporting voting power or disposition power with respect to non-directed allocated securities and unallocated securities held by an ESOP under Sections 13(d) and 14(a) of the Securities Exchange Act of 1934.

Please confirm whether the Lanoff Letter changes the position of the SEC with respect to reporting beneficial ownership for non-directed allocated securities and unallocated securities held by an ESOP under Sections 13(d) and 14(a) of the Securities Exchange Act of 1934.

SEC Staff Response:

(none)

8. **Question**:

Assume that the participant contributions to an employee stock purchase plan that qualifies under Section 423 of the Internal Revenue Code are held in a trust. The trustee invests those amounts in a money market fund, savings account, or other interest-bearing investments. Are there participation interests in the plan? Do those interests have to be registered?

SEC Staff Response:

Yes. Registration would not be required if stock is acquired directly through a broker. Registration would be required if the funds are not immediately being used to purchase stock. This would be the case whether the funds were held in trust or remained general assets of the company. See Lucky Stores no-action letter from 1974, indicating that plan interests must be registered if more than 35 days elapses between the payroll withholding and the purchase of the shares.

9. **Question**:

Assume that a Named Executive Officer was granted certain stock options that he immediately transferred to another family member. What effect, if any does this transfer have upon the number of shares that must be reported under the Option/SAR Grants Table? Similarly, if the family member (but not the Named Executive Officer) exercises the option, must it be reported in the Aggregated Option/SAR Exercises Table? Also, it appears that the shares acquired upon the exercise of the transferred option by the family member would not be taken into account under the beneficial ownership rules of Item 403.

SEC Staff Response:

The test under Item 403 (by reference to 13d-3) is whether the individual has the power to vote or dispose of the shares. Under this rule, the spouse and minor children are treated as the employee, but non-

minor children are treated as separate holders. Clearly the grant table must disclose the grant to the Named Executive Officer. Also, it should be reported in the Aggregated Option/SAR Exercises Table, regardless of who the transferee is, because it is the Named Executive Officer who has received the compensation. It should not be treated differently if he transfers the option before exercise, or exercises the option and then transfers the proceeds. The fact that the Named Executive Officer had gifted the option could be disclosed in a footnote, if desired.

10. Question:

Could you discuss whether Rule 701 under the 1933 Act covers debt securities, such as deferred compensation obligations?

SEC Staff Response:

Yes, Rule 701 is available for debt securities and deferred compensation obligations. Nothing limits its availability to equity instruments. However, Rule 701 is limited to compensatory arrangements, and debt securities are not often used in compensatory arrangements.

Note that a task force recommended that the $5 million maximum be renewed every six months, however that recommendation has not yet been adopted.

11. Question:

What is the status of the SEC position on the registration of stock under voluntary, contributory 401(k) plans when the plan acquires employer securities in open market purchases (i.e., must an employer register shares acquired by a 401(k) plan on the open market on a Form S-8 registration even though the shares have been previously registered)?

SEC Staff Response:

There is no change of position. The stock must be registered under the plan, whether it is acquired on the open market or is newly issued. Of course, registration is not required unless the employee's contributions (including 401(k) contributions) are used to acquire stock.

12. Question:

Could you clarify the SEC's position on the accounting treatment of options granted subject to approval of shareholders at a later date. It is rumored that the SEC interprets FASB Statement 123 and APB Opinion 25 to require issuers to take an expense to the extent that the price of the issuer's shares rises between the date of an option grant and the date of shareholder approval. Is this statement true?

SEC Staff Response:

The Staff confirmed that the accounting division of the SEC made remarks at the Annual Meeting of the American Institute of Certified Public Accounts earlier in 1996 that option grants or stock awards made subject to stockholder approval of an equity plan or the number of shares available under an equity plan results in a compensation charge where the price of the underlying stock increases between the grant date and the stockholder approval date. This is based on the accounting division's interpretation of new FASB Statement 123 that applies to stock compensation and the statement in FASB 123 that unless stockholder approval is a mere formality, there is no fixed measurement date. The Staff also has picked up on the statement in FASB 123 that approval is not a mere formality unless management and directors control over 50% of the voting power of the corporation.

The accounting division of the SEC appears to be interpreting what otherwise was intended to be an example of a "mere formality" as the only proper interpretation of when a "mere formality" is deemed to exist.

13. Question:

With respect to the Pan Agora problem under the '40 Act, in light of the Standish, Ayer no-action letter, is it contemplated an investment adviser could set up

several funds which meet the criteria of one of the investment options offered under a 401(k) plan and allocate a participant assets among the separate funds so that no fund had more than 50% of any investment option? For example, suppose that a 401(k) plan offered participants the option of allocating their accounts among three managed account categories: fixed income, growth and income and growth. Assume further that to manage assets allocated to the growth and income option, the investment adviser established several different growth and income funds with slightly different investment criteria and different portfolios and allocated the assets of the growth and income option of the 401(k) plan among the several funds so that no fund contained more than 50% of the assets allocated to the growth and income option under the plan. Is this structure something that was contemplated as being within the scope of Standish, Ayer so that each plan investing in each of the separate growth and income funds would be counted as one investor for purposes of the 1940 Act?

SEC Staff Response:

The investment program described in the question is not within the scope of Standish, Ayer. The investment program described in the question seems like an artifice to avoid registration. If the investor/participant would not view each separate fund as a substantially different investment, then the funds may be considered to be a single fund. Look at the letters concerning integration of Section 3(c)(1) companies under the Investment Company Act. (The staff is no longer issuing letters on integration.) See also, Integration on Attribution Issues Affecting Hedge Funds, 28 The Review of Securities and Commodities Regulation, (No. 21), December 6, 1995. However, if the 3 funds were managed by different investment managers (instead of by just one) then there could be no integration.

On the other hand, Section 48(a) of the Investment Company Act should also be considered. That section essentially prohibits doing indirectly what cannot be done directly.