

QUESTIONS AND ANSWERS WITH THE SEC

Securities Act of 1933

1. Registration of Deferred Compensation. What is the current status of the SEC position regarding 1933 Act registration of deferred compensation plans?

Answer: The Staff has not definitively concluded that deferred compensation obligations are or are not securities. The Staff is leaving it to counsel to determine whether the obligations are securities, but reserves the right to later determine that particular obligations are securities. Two possible approaches are a Howey analysis [*Scrivener's note: SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946)] and the Reves test [*Scrivener's note: Reves v. Ernst & Young*, 494 U.S. 56 (1990)] which deals with when a note that has both investment and commercial features will be treated as a security.

The Staff recognizes that there is a stronger argument that "plain-vanilla" interest-only plans do not involve securities than for other types of plans, but will not categorically say that registration is not required for such plans. However, if the deferred compensation is invested in phantom stock, there will almost always be a security. The Staff will no longer issue no-action letters in this area for any type of deferred compensation plan.

Regardless of whether a security is involved, no registration is required if the offering qualifies as a private placement under Section 4(2) of the 1933 Act.

For purposes of both registration on Form S-8 and exemption under Rule 701, the "amount" of securities would be the principal amount deferred.

2. Participation Interests. Are there participation interests in a fully self-directed 401(k) plan (i.e. a plan in which each employee's account in the plan is a brokerage account which the employee can direct be invested in any publicly traded security)?

Answer: The traditional analysis under Releases 33-6188 and 33-6281 looks at whether there is a difference between holding the securities under the plan and holding them outright. The tax and distribution rules applicable to 401(k) plans have been viewed as creating such a difference. As a result, interests in such plans would be participation interests. (There was discussion of the fact that many plans today permit same-day fund-switching, which minimizes the differences between holdings through plans and outright. The Staff acknowledged that this might be a topic for future consideration, but was not ready to depart from the traditional analysis at this time.)

With a fully self-directed plan, the mere fact that there is no prohibition on buying company stock under the plan results in "solicitation of an offer to buy" such stock, which requires registration of such stock and the participation interests. This is true whether or not anyone actually acquires company stock through the plan. In order to avoid registration, such a plan would have to exclude company stock from the permissible investments of the brokerage account.

Even though the stock would be bought on the open market, Release 33-4790 would not apply. That Release provides that no registration is required if the company is performing merely ministerial functions such as payroll deductions. The establishment of a 401(k) plan is more employer involvement than release 33-4790 would permit.

3. Rule 701. The proposed amendment to Rule 701 would require issuers using that Rule to deliver financial statements that satisfy the requirements of Form 1-A. That Form requires that the financial statements be prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"). However many foreign companies that currently use Rule 701 because they are not registered under the Exchange Act do not prepare financial statements in accordance with U.S. GAAP. Was it intended to deny use of Rule 701 to such companies, or will the final rule permit the delivery of home country financial statements?

Answer: The proposal was not intended to preclude foreign issuers from using Rule 701. Canadian issuers are permitted to use Reg A if they provide a reconciliation of their financial statements to U.S. GAAP, and it is expected that foreign issuers would be permitted to provide a similar reconciliation for purposes of Rule 701.

Supplemental Question: Will mutual insurance companies be permitted to use regulatory accounting rather than GAAP for purposes of Rule 701?

Answer: Further Staff consideration on this point is needed.

4. S-8 for Former Employees of Acquired Company. When Acquiror acquired Target, it assumed outstanding options held by current and former employees of Target. Can Form S-8 be used to register the shares of Acquiror to be sold to former employees of Target upon exercise of the substituted options? Does it matter if Target was acquired in a stock deal or an asset deal?

Answer: The Staff takes the view that the instructions to Form S-8 permit use of that Form only for options issued while the optionee was an employee of that issuer. Thus, Form S-8 would not be available for former employees of the acquired company. These former employees have no information nexus to the new issuer. This would also be true in the case of a spin-off. The solution is to register the shares on Form S-3 if the issuer is eligible to use that Form (or, if an S-4 is being used for the acquisition, register the option shares on that Form and flip it to an S-3 or

S-1.) The Staff recognizes that this approach may not have been consistently taken in the past, but intends to take this position from now on.

5. 401(k) Purchases in IPO. What mechanism can be used to enable employees to direct the investment of their 401(k) plan accounts into company stock in an IPO? If the stock is registered on Form S-1, must information about the plan and its tax consequences similar to that required by Form S-8 be provided to employees? In what type of document is that provided? Is it reviewed by the Staff? Alternatively, if the company's Exchange Act registration statement will become effective at or before the effectiveness of the IPO, can an S-8 be used?

Answer: Form S-8 is not appropriate for an IPO, which is essentially a capital-raising activity. This is true whether or not the company's 1934 Act registration has already gone effective. [*Scrivener's note:* 1934 Act registration is what normally permits use of Form S-8.]

If a portion of the IPO stock is being reserved for 401(k) plan participants, that fact needs to be fully disclosed in the IPO prospectus, together with a statement of whether the plan participants will buy at the IPO price or net of underwriting commissions. This information is part of the plan of distribution and may impact the cover page. A statement that "the underwriter is reserving x% of the shares for employees" is insufficient.

If employee purchases are being made through a 401(k) plan, the issuer is offering both stock and participation interests. Thus, in addition to the information being provided in the general IPO prospectus, the prospectus for employees must contain information about the plan and the tax consequences. This can be done by providing alternative pages in the S-1 prospectus that are applicable to plan participants.

6. "Offers" prior to filing S-8. The Staff has indicated that, in the case of S-8 registration, stock options may be granted and may become exercisable (i.e. an "offer" may be made) before the filing of the S-8, so long as the S-8 is filed before the option is exercised. Would it similarly be permissible to distribute information about a 401(k) plan to employees before the S-8 is filed, so long as the S-8 is filed (and prospectuses distributed) before the first employee contributions are deducted from paychecks? Is it also permissible to collect employee election forms for participation in the plan before the S-8 is filed if employees can revoke their elections after receiving a prospectus and before the first payroll deductions are made?

Answer: No. The Staff's position permitting options to become exercisable before an S-8 is filed is strictly an administrative accommodation that recognizes that most option recipients won't exercise their options when they first become exercisable. This position does not apply to other benefit plans.

Section 16

1. Transactions on Day of Becoming Insider. A person becomes a director of a company and the same day is granted stock options by that company. Should the Form 3 filed by the director include the stock options? Should the option grant instead (also?) be reported on Form 4 or 5?

If the new director was an insider/shareholder of a company which was acquired in a stock-for-stock merger and joins the acquiror's board on the day of the merger, should the Form 3 report the stock acquired in the merger?

Does it matter if the transaction in question happened before or after the first board meeting at which the insider is serving on the board?

Answer: If a transaction occurs on the same day that a person becomes a director, it should be reported on Form 4 or 5 (as a "transaction") rather than on Form 3 (as a "holding"). It doesn't matter when in the day the transaction took place.

The staff is still considering whether Rule 16b-3 will exempt the exchange of acquiring company options for target company options in a merger.

2. Amendment of stock option. Is a Form 5 filing required to report the amendment of an option to accelerate the vesting schedule? What about an amendment changing the exercise price?

Answer: An amendment of an option only needs to be reported if it is deemed to be a cancellation of the original option and grant of a new option. An acceleration of vesting is not considered such a cancellation/regrant, and so a Form 5 filing is not required. See Foster Pepper & Shefelman (12/20/91). However an amendment changing the exercise price would be considered a cancellation/regrant, which would be required to be reported. Other features that are sometimes added to an option are transferability or the right to defer the receipt of stock upon exercise. Since these features do not change the economic value of the option, the Staff has not been inclined to view amendments adding these features as cancellation/regrants.

However, any amendment changing a "material term" of the option needs to satisfy one of the approval conditions of Rule 16b-3(d) in order to avoid being a "purchase," regardless of whether the amendment would be treated as a cancellation/regrant. Thus an amendment to accelerate the vesting of an option needs specific approval.

3. Transfer to a Trust. An executive transfers shares to a trust of which he is the trustee and his adult children are the sole beneficiaries. Is this a transaction that must be reported or can it be treated as a change in form of beneficial ownership which is exempt from reporting? What if the sole beneficiaries of the trust are the executive and his/her spouse (on the theory that there has been no change in the beneficial ownership since the two spouses share an economic interest in the shares both before and after transfer to the trust even if before the transfer the shares were legally owned only by the executive)?

Answer: Rule 16a-13 has been construed very narrowly. It is available only when there is absolutely no change in pecuniary interest. Here the adult children would be gaining a pecuniary interest, so Rule 16a-13 would not be available.

Where the sole trust beneficiaries are the insider and spouse, it is a closer case. It may depend on how the legal title was held before the transfer to the trust and on whether it is a community property state.

4. Charitable Remainder Trust. An executive transfers shares to a charitable remainder trust of which he is the trustee and the beneficiary for his lifetime, and a charity is the remainder beneficiary. Under the trust, the executive receives distributions from the trust in either a fixed dollar amount or a fixed percentage of trust assets.

a) Is the transfer to the trust reportable? Under what code?

b) Are transactions by the trust in the shares reportable?

Answer: This situation is analogous to the Peter Kight letter [(available October 16, 1997)] regarding GRATs. [*Scrivener's note:* A GRAT is a grantor retained annuity trust. It is funded with stock contributed by the grantor. The grantor receives a fixed annual annuity payment from the trust, and at the end of a specified period any remaining assets (generally representing appreciation on the assets originally contributed) are held in trust for or distributed to the remaindermen (generally, the grantor's heirs).] In that letter, the insider was both a trustee and beneficiary of the GRAT trust and the remaindermen were his children. The staff took the position that Rule 16a-13 (change in form of beneficial ownership) was available for both the transfer to the trust and the shares of stock paid out of the trust as annuity payments to the grantor.

In the case of the charitable remainder trust, Rule 16a-13 is available for the transfer by the insider to the trust. Transactions by the trust would be reportable because the insider is the trustee. The charity which is the remainderman does not have a beneficial ownership interest during the life of the trust, pursuant to Rule 16a-8(c). At the end of the trust, there would be a gift to the charity, which would be exempt under Rule 16b-5.

5. Reporting Contributions to Deferred Compensation Plans. Many companies with deferred compensation plans found it burdensome to report amounts credited to the phantom stock account on a line item basis for each crediting (which, in the case of salary deferrals could be as often as weekly or biweekly). Is there any possibility for relief from this reporting requirement?

Answer: The Staff addressed this question in the American Bar Association letter (December 1996) and concluded that aggregate reporting is not available. The American Express letter (February 1997) provides a limited exception for company contributions where the insider controls neither the amount nor the timing of the amounts credited. The Staff does not feel that it has authority to allow aggregated reporting, but will reconsider whether there is room under the rule for interpretive relief.

6. Stock Option Exercise by Attestation. If a Section 16 insider "pays" the exercise price for an in-the-money stock option by means of "attestation" (i.e. identifying specific already-owned shares having a value equal to the aggregate exercise price, but not actually delivering such shares to the issuer), does this method of exercise constitute a "disposition" to the issuer, (i) for purposes of Section 16(a) reporting, and (ii) for purposes for requiring advance approval of the transaction in order to qualify for the 16b-3 exemption? In other words, is "attestation" treated as an actual disposition for these purposes even though it is only a "deemed" disposition, and no shares change hands?

Answer: Deemed dispositions are considered the same as actual dispositions for purposes of both Section 16(a) reporting and requiring advance approval for the 16b-3 exemption.

7. Late Form 5. A Form 5 due in February 1998 with respect to calendar year 1997 was filed late. Should this be disclosed in the 10-K for 1997 (and the related proxy statement for the 1998 annual meeting), or should it be disclosed in the 10-K for 1998 (and the proxy statement for the 1999 annual meeting)? Note that Item 405 of Reg S-K requires a report of late filings "required by Section 16(a) ... during the most recent fiscal year or prior fiscal years."

Answer: It could be disclosed either way. If it is disclosed in the earlier year, the disclosure need not be repeated in the next year.

8. Reporting Phantom Stock. In reporting the grant of phantom stock, what is required to be reported in column 2 of Table II (conversion or exercise price of derivative security)? Can the box be left blank?

Answer: It depends on whether the phantom stock is "granted" or purchased (e.g. through salary deferral). Either Column 2 or Column 8 (price) needs to show the executive's ability to profit. If the phantom stock was purchased, Column 2 would show "1 for 1" (assuming 1 phantom stock unit is equivalent to 1 share) and Column 8 would show the dollar amount deferred. If the phantom stock was granted, Column 2 would show the fair market value of the stock equivalent on the date of grant and Column 8 would show \$0.

9. Reporting Phantom Stock with Different Vesting and Settlement Dates. An insider received a grant of phantom stock that vests in 2001, but will not be settled (i.e. paid in cash) until 2003. Which date should be used in responding to column 6 of Table II (date exercisable)? What should be reported if the phantom stock was credited under a deferred compensation plan which permits the insider to switch to a different phantom investment at any time?

Answer: Vesting (in the traditional sense of having a non-forfeitable right to the amount) is not a recognizable event for purposes of Section 16. The important date is the date the amount will be paid out (i.e. the settlement date), and this is the date that should be reported in Column 6.

10. Zero-Cost Collar. A zero-cost collar is a strategy used by a stockholder as a hedging device. Zero-cost collars involve selling a call with an exercise price above fair market value (FMV) of the stock and using the proceeds to buy a put with an exercise price below FMV of the stock. If a Section 16 insider settles the exercise of the call portion of the zero-cost collar in cash, does settlement result in a deemed simultaneous sale and repurchase of the underlying stock, requiring the insider to disgorge any profits realized in connection with sales made within six months prior to or after the deemed repurchase? If so, is the relevant purchase price (for the deemed repurchase) the exercise price of the call or the FMV of the stock at the time of call exercise?

Answer: Release 34-34514 (the 1994 proposing release on Section 16) discusses "equity swaps" and the same analysis would apply here. The settlement would be an exempt exercise by the counterparty, an exempt deemed disposition to the counterparty under Rule 16b-6(b), and a non-exempt deemed reacquisition by the insider.

With respect to the relevant purchase price, Rule 16b-6(c)(2) directs the court to look at the market price of the underlying security.

Proxy Statement

1. Beneficial Ownership Table. An executive owns phantom stock through a non-qualified plan. The same number of actual

shares of stock are held in a rabbi trust established by the Company, which are voted in accordance with the executive's instructions. Are these shares/phantom shares required and/or permitted to be included in the beneficial ownership table?

Answer: The analytical framework for this question is the 13(d) test of beneficial ownership, which looks to whether the person has the power to direct either the investment or the voting of the security. See Merchants Bank (1991) and Rio Grande (1989) letters. The answer turns on whether the employee has a legally binding right to direct the voting of the shares. If he does, the trust would probably not be a rabbi trust. If the employee's right is not legally binding, but merely a direction which the trustee may or may not follow, this is probably not beneficial ownership.

With respect to phantom stock, beneficial ownership may be reported if the phantom stock will be settled in stock or if the employee has the right to choose cash or stock, though the nature of the ownership should be explained in a footnote. The phantom stock should not be included in the beneficial ownership table if it will be settled in cash or if the employer can choose the form of settlement. Notwithstanding arguments that all phantom stock represents an economic interest which is aligned with that of shareholders, the Staff feels it would be misleading to have phantom shares which are payable in cash reported in (or in a footnote to or separate column of) the beneficial ownership table, even if the nature of the ownership was explained in a footnote. This is because the Staff feels the table was designed to disclose equity interests.

Stock which has been awarded but is unvested (e.g. restricted stock) should be included in the beneficial ownership table only if the insider has the right to vote the shares or to acquire the stock within 60 days.

2. Compensation Committee Report. Even though the item calls for discussion with respect to the "last completed fiscal year," if the Committee had a major change in policy after year-end and prior to the writing of the Report, can the Report include the subsequent development? Does the Staff encourage such disclosure? If disclosed in the current year, must it be disclosed again in the next year's report?

Answer: If the Committee's change affected prior year compensation (e.g. changing criteria for payout of the bonus payable for the prior year), it should be included in the Report, even if the action was actually taken after the close of the year. If the action affects only future compensation, the Staff encourages, but does not require, such disclosure. Committee actions described in one year's Report need not be described again in the following year's Report.

Note, however, that regardless of the technical S-K rules, if a compensation decision is sufficiently "material" (e.g. a megagrant to the CEO), Rule 14a-9 would require disclosure.

3. Leased Management. In some public companies, all management services are provided by a management company, which supplies and pays the various executive officers of the public company. Is it sufficient to disclose the fact of the company's agreement with the management company and the aggregate amount paid for management services, or must the proxy statement disclose individual compensation paid by the management company to its employees who are performing services for the public company? Is the answer different if the management company employee performs services for more than one company?

Answer: The Staff is unwilling to accept aggregate compensation reporting where a public company outsources its management. The company should allocate what it is paying out to come up with individual compensation disclosure. (The Staff has, in the past, been willing to allow aggregate compensation reporting where a REIT outsources management to its general partner.)

4. Option Repricing Table. The option repricing table required by Reg. S-K item 402(i) requires information about repricings of options "held by any executive officer during the last ten completed fiscal years."

a) Does this item require disclosure of a repricing of an option held by a person who is currently an executive officer but who was not one at the time of the repricing?

Answer: No.

b) Does this item require disclosure of repricings of an option held by a person who was an executive officer at the time of the repricing, but who is no longer an executive officer?

Answer: Yes.

5. Parachute Gross-Up Payment. A named executive officer received a severance payment under a golden parachute agreement, which will be reported as "All Other Compensation." The same parachute agreement provides for a tax gross-

up payment on the severance payment. Should the tax gross-up payment be reported as "Other Annual Compensation" or as "All Other Compensation," or is either way acceptable?

Answer: All gross-ups, including under 280G (parachutes), should be reported under "Other Annual Compensation." No other way is acceptable.

6. Reimbursement of Relocation Costs. Should reimbursement of relocation costs be reported as "Other Annual Compensation" or as "All Other Compensation," or is either way acceptable?

Answer: If the company treats relocation costs as a perk, it goes under "Other Annual Compensation." If not, it goes under "All Other Compensation." However it is not reportable at all if all employees are subject to the same reimbursement policy and it's not discriminatory in favor of executives.

7. Shareholder Proposals. Can an issuer exclude from the Company's proxy statement a shareholder proposal to require shareholder approval of all stock option plans in which officers participate? Would such a proposal be considered to involve ordinary business operations excludable under Rule 14a-8(c)(7) in the same way as the proposed bylaw amendment to require shareholder approval of option repricings which the Staff allowed the issuer to exclude in Shiva Corporation (March 10, 1998)?

Answer: The answer to both questions is yes, with a lot of caveats. Where the proposal involves a broad-based arrangement available to all employees, the Staff is willing to treat it as ordinary business, even if executives are also included. This was the situation in Shiva. However, if the focus of the proposal is on executives, this transcends ordinary business because the shareholders have a particular interest in executive compensation.

It should also be noted that the Shiva letter dealt with 14a-8(c)(7), not with (c)(1). There is an unresolved issue under (c)(1) whether under state law shareholders can adopt a bylaw amendment covering such matters or whether this impinges on the board's power to manage the business.

Also, Shiva has been sued, so these issues may be decided by the court.

Rule 144

1. Volume Limit. Where a trustee of a qualified plan is selling shares on behalf of an affiliate and the affiliate's sales under Rule 144 are limited by reference to the trading volume of the issuer's stock, will purchases by the qualified plan count as part of the trading volume? Does it matter if the purchases are for the account of the affiliate or for the accounts of other participants?

Answer: The general rule is that an affiliate can't take advantage of his own sales to increase the trading volume. Here the trustee is acting as a mere agent of the affiliate. Purchases by the plan count as part of the trading volume.

2. Zero-Cost Collar. If an affiliate settles the exercise of the call portion of a zero-cost collar in stock or exercises the put portion of the zero-cost collar by selling stock, is Rule 144 available for the sale (assuming the entity that is exercising the call or that has written the put is the broker through which the affiliate created the zero-cost collar)? Is the analysis impacted by whether the broker is a market-maker in the stock?

Answer: See Release 6099 and Bear Stearns (1991) for the analytical framework applied here. The key is the nature of the instrument. A negotiated transaction will not satisfy the manner of sale requirements of Rule 144. Thus Rule 144 will not be available unless the transaction involves exchange-traded puts.

It makes no difference whether the broker is a market maker for the stock.

Accounting

1. Board Discretion and Pooling. A stock option plan provides that in the event of a change of control, all options become fully exercisable unless the board determines that they should not become exercisable. Does such a provision prevent pooling accounting if the board does not act (i.e. so that the options automatically accelerate in accordance with their terms) or does the board's retention of negative discretion cause loss of pooling treatment?

Answer: The board's retention of negative discretion does not cause loss of pooling, so long as the discretion is not exercised.

Note that any exercise of discretion by the board will cause loss of pooling. Thus, for example, if a plan provides for automatic vesting upon a change of control but leaves the definition of whether the transaction is or not a change of control subject to management discretion, there would be a loss of pooling.

A plan amendment to "cure" a pooling problem (e.g. elimination of SARs) can also cause a pooling problem if made "in contemplation of" a transaction. In general, any plan amendment within two years before a transaction is presumed to have been made in contemplation of the transaction, but the presumption can be overcome by facts and circumstances. There would not be a pooling problem if, instead of eliminating the right, employees agreed to waive the right.

2. Effect of Affiliate's Zero-Cost Collar on Pooling. If an affiliate of the issuer enters into a zero-cost collar, would this destroy pooling?

Answer: Yes. Acquisition (but not exercise) of any put or call by an affiliate causes loss of pooling.

Investment Company Act

1. Deferred Compensation Plans. The Staff has orally indicated that a deferred compensation plan, including one "funded" with a rabbi trust, is not required to register as an investment company. Is this still the Staff's position? Is it set forth in writing?

Answer: The Staff position has not changed. It is not set forth in writing.

Rule 13e-1

1. An employer that sponsors a 401(k) plan is the target of a tender offer. The plan permits employees to direct that their contributions be invested in Company stock or other investments, and requires Company contributions to be invested in Company stock. Will the plan trustee's purchases of Company stock for the plan on the open market during the pendency of the tender offer violate Rule 13e-1? Does it matter if the investment is directed by the employee, by the Company, or by the terms of the plan?

Answer: The staff plans to interpret Rule 13e-1 narrowly. The Staff is not ready to answer this question because it involves Labor Department issues. The following is an analytical framework. The focus of the analysis is the Rule 13d-3 definition of beneficial ownership (i.e. voting or investment power). The question is whether the employee's investment direction under the plan is a power to direct the investment under Rule 13d-3. This may turn on the extent to which the 401(k) plan trustee has a fiduciary override in the case of a tender offer. Note that in the case of voting of ESOP shares the Staff has concluded that employees had a power to vote sufficient to constitute beneficial ownership notwithstanding the plan trustee's fiduciary override. See Merchants Bank (1991) and Rio Grande (1989). But the situation is not clear in the case of participant-directed purchases in a 401(k) plan. It is clear that purchases by the trustee to fulfill the company's obligation to make matching contributions will be treated as purchases by the company. The Staff's general reaction is there would be a tendency to impute to the company anything the trustee does under the plan unless it is clear that the employee has the power to direct the trustee's actions and the trustee has no power to override that direction.

There are also 10b-13 issues here that are not being commented on.

Supplemental JCEB Questions for SEC -1998

1. Regulation S. The recent amendments to Reg S add a 1-year holding period for shares issued by US companies under Reg S, including shares issued to foreign employees under foreign benefit plans. Does this holding period requirement apply where an independent plan trustee purchased shares on the open market for allocation under a benefit plan? (The benefit plan is the foreign equivalent of a 401(k) plan.) Would the answer be different if the shares were purchased with employee contributions?

Answer: If Reg S is the only available exemption, then the 1-year holding period would apply. If U.S. companies want the shares to be freely available, they should register on S-8.

2. Proposed Rule 701 Amendments. What is the status of the proposed amendments to Rule 701?

Answer: The comment period has just recently closed. The comments were generally favorable about raising the limits, and less favorable about requiring additional disclosure. The SEC will consider all comments carefully.

3. Proposed S-8 Amendments. What is the status of the proposed S-8 amendments?

Answer: The comment period has just recently closed. The comments were generally favorable on transferability. The Staff is not inclined to let the Form be available for all transferees; it will look to an objective test, but perhaps one broad enough to include non-traditional families. Other comments were from insurance companies who want to make the Form available for non-exclusive agents. Also Silicon Valley commenters have raised concerns regarding the requirement to disclose confidential information about the identity of and compensation paid to consultants. The SEC will consider all comments carefully.

Rule 701 and S-8 can be expected some time this year, but not necessarily together.