

**1999 JCEB QUESTIONS AND ANSWERS TO THE
SECURITIES AND EXCHANGE COMMISSION**

Form S-8

1. Registration of Plan Interests. The Telephone Interpretations Manual (S-8 item #68) states that if only plan interests are being registered, no filing fee would be required. In what situation would there be a requirement to register plan interests but not company stock?

ANSWER: This was aimed at the situation where people forgot to include plan interests in their registration statement.

2. Insurance Agents. The recent amendments to Form S-8 permit the use of that Form for securities issued to insurance agents who "derive more than 50% of their annual income" from the registrant.

a. Can the registrant satisfy this requirement based on the agent's income in the previous year?

ANSWER: This measure was endorsed in the S-8 Release (at note 40) and is the only measure endorsed in the Release.

b. Can the registrant satisfy this requirement based on a good faith expectation of the agent's income for the current year in which the securities are issued?

ANSWER: The staff will not provide any comfort on this approach.

c. If stock options are issued to an insurance agent who satisfied the "50% of income" requirement in the year of grant but who fails to satisfy this requirement in future years, please confirm that the agent would be treated as the equivalent of a former employee so that his exercise (to the extent permitted by the plan or option grant) could continue to be registered on Form S-8.

ANSWER: Yes. This is consistent with the S-8 treatment of former employees.

3. Transition Rule for Options Held by Consultants. The S-8 amendments provide that after May 10, 1999 currently effective S-8 registration statements can no longer be used to register offers and sales to certain types of consultants. What can an issuer do to comply with the new rules in the case where currently exercisable options are held by a consultant who is no longer eligible to use S-8? Can the shares underlying such options be transferred to an S-3 registration statement if the issuer is otherwise eligible to use that form?

ANSWER: The issuer is required to register these shares on a form other than S-8. Form S-3 can be used if the issuer is eligible to use that Form. With respect to these consultant options, issuers can rely on the staff's position (normally applicable only for S-8) that the registration statement can be filed after May 10 (the effective date of the new rules) and after the option is exercisable, as long as the S-3 registration statement is effective before the option is exercised.

4. Written Compensation Contracts. Form S-8 and Rule 701 apply to a written employee benefit plan or a "written compensation contract." Does an individual written stock option grant made outside a plan constitute a "written compensation contract"? Does it matter if the writing is in the form of an "option grant letter" signed only by the issuer as opposed to a "stock option agreement" signed by both the issuer and the employee/optionee?

ANSWER: As long as the option grant letter makes clear that the option is compensation for services, the grant letter is sufficient. However the status as compensation does not have to be spelled out in so many words. One way to do this is if the option terminates upon termination of employment.

5. 401(k) Plan Purchases of Former Employer Stock. Company S was originally a subsidiary of Parent, but was spun off or sold in a public offering and no longer has any ownership relationship with Parent. Employees of Company S previously participated in the Parent 401(k) plan, where Parent stock was a permitted investment for their 401(k) and matching contribution accounts. At the time of the spin-off or sale, Company S assumed the 401(k) plan with respect to its employees, including the Parent stock in those accounts. Company S filed an S-8 covering its own stock and plan interests in the plan. Can Company S let participants in the newly-assumed Company S 401(k) plan continue to purchase Parent stock from the open market? If so, must Company S provide any particular information about Parent other than the same type of investment performance information that is provided for the mutual fund investments available under the plan?

ANSWER: This answer relates to this Question and Question 16. Corp Fin has not dealt with these issues before, so this is only a sense of the analysis involved. The answer may depend on why the employer wants to compensate its employees with the stock of another company. It is possible that the employer (or the plan) would be an affiliate of the issuer whose stock is being offered. The staff does not give advice on affiliate status. If there is a continuing commercial relationship between the two companies (e.g. supplier-customer), this may give rise to affiliate status even without corporate control. If the relationship between the employer and the issuer was deemed to give rise to affiliate status, that status would not be negated by virtue of the fact that individual participants could direct the investment of their accounts among a menu of funds. If the employer was deemed to be an affiliate, perhaps registration of the offer and sale of Parent stock through the affiliate's 401(k) plan would be required.

There are also broker-dealer issues to be considered, but generally these don't arise when purchases are made through a 401(k) plan if the procedures set out in the Universal Pensions letter (1/30/98) are followed.

6. Foreign Tax Disclosure. A company is filing an S-8 covering stock options to be issued to employees in a number of countries. Is it sufficient for the prospectus to describe the US federal tax consequences with a statement that non-US employees should consult their local tax advisers for the tax laws applicable to them?

ANSWER:No. The company should do a prospectus supplement for each country describing the applicable tax consequences in that country.

7. Brother-Sister Subsidiaries. Given the similar purposes of Rule 701 and Form S-8, what was the rationale for permitting use of Rule 701 for securities issuances to employees of brother-sister subsidiaries, but not permitting the use of Form S-8 for this purpose?

ANSWER: The SEC wanted to give more of a break to start-up companies. In addition, shares issued under Rule 701 are not immediately resellable, while those issued under S-8 are immediately tradable.

8. Plain English. Do the plain English requirements apply to S-8 prospectuses?

ANSWER: An S-8 prospectus is a prospectus and as such is subject to the same plain English rules as any other prospectus. The staff has not required people to redo prospectuses currently in use (even though each year's filing of the 10-K is technically the filing of a new registration statement). However, when a new S-8 is actually filed, the company should try to follow the plain English rules. Of course, the staff does not review S-8 prospectuses. The staff also assumes that S-8 prospectuses are already more or less in understandable English.

Rule 701

9. Treatment of Sales Agents. The adopting release for the recent amendments to Rule 701 states that independent agents, franchisees, and salespersons who are not employees of the issuer will no longer be considered "consultants or advisors" for purposes of the rule, and indicates several no action letters that may no longer be relied upon. (Release No. 33-7645, at note 38.) Yet, consistent with Form S-8, insurance agents who are not employees but who work exclusively for one insurance company or who derive over half of their annual income from services to a single insurance company are considered "employees" under the new rule. Sales representatives may be employees or may be independent contractors depending upon the industry or an issuer's practice. Please confirm that where independent sales agents (other than insurance agents) have a long-term "career" relationship working exclusively for one issuer and/or derive over half of their annual income from sales agent services for a single issuer, such sales agents may

still be deemed "employees, consultants or advisors" (1) under Rule 701 and (2) for purposes of Form S-8.

ANSWER: The S-8 release discusses the continuing application of the "de facto employment" position. This position applies for purposes of both 701 and S-8. However, the staff is not prepared to endorse a 50% test as a bright line; the staff views this level as a bare minimum but a higher percentage may be required. For example, in Foundation Health the doctors got at least 50% of their income from the HMO.

10. Sales Calculations for Stock Options. Please confirm our understanding that for all purposes of Rule 701, the grant date of a stock option is the date of its sale. For example, assume Issuer grants options whose aggregate exercise price is both less than 15% of its total assets and less than \$5 million in Year 1, and grants an equivalent number of options in Year 2 (determined by reference to 15% of Year 2 total assets). Please confirm that Rule 701 exempts the exercise of both sets of options even if they occur in the same year, and that the additional disclosure for sales over \$5 million in any year would not be required in this situation.

ANSWER: Assuming all grants in the example were made under the amended Rule 701, the example correctly states the applicability of the \$5 million trigger. You don't have to aggregate grants made in two different years, regardless of when the options are exercised. However, if the disclosure requirement is triggered, the disclosure must be provided at the time of exercise, not at the time of grant.

11. Counting Prior Option Grants. In determining whether an option granted under amended Rule 701 is in compliance with the rule, how are options granted under the old version of the rule taken into account? Specifically, can the issuer treat previously-granted options as having been "sold" on the date of their initial grant, so that such options will not count against the number of options issuable under the amended rule? Is the result the same whether or not the previously-granted options are vested or non-vested?

ANSWER: If options that were granted under the old rule were already exercisable at the effective date of the new rule, they can be treated as having been "sold" under the old rule, and these options will not limit the options that can be granted under the new rule. However options granted under the old rule that first become exercisable after the effective date of the new rule must be counted against the new rule limits. For purposes of these limits, they will be treated as having been sold on the date they are actually exercised. *[After discussion, the staff said they would be willing to consider a proposal for an alternative transition rule.]*

12. Balance Sheet Date. The 15% of assets and 15% of outstanding securities tests are to be measured as of the "most recent balance sheet date."

a. If the issuer completes a financing in the middle of the month, can the issuer use the closing date of that financing as the most recent balance sheet date, thereby enabling it to take immediate advantage of its greater total assets or securities?

b. Can the issuer use its balance sheet as of the end of the prior fiscal year even though it has generated a more recent balance sheet purely for internal purposes?

c. Can the issuer use its year-end balance sheet if the more recent interim financials were presented to a third party?

ANSWER: In each of the above examples, the issuer must use its most recent balance sheet for the applicable 12-month offering period. Once you start a 12-month offering period, you must continue to use the same balance sheet for the remainder of that offering period; a later balance sheet during the 12-month period will neither increase nor decrease the amounts available for that offering period.

The concept of an offering period for Rule 701 is not a rolling 12-month period. Instead it is a fixed 12-month period determined by the issuer (e.g. calendar year, fiscal year, or plan year). This is the "scope of the issue" concept under Section 3(b) and is discussed in the Hicks treatise as it relates to Rules 504 and 505. Thus, assuming a calendar year offering period, if on January 1, 2000 the issuer sold \$1 million of securities and on December 31, 2000 the issuer sold an additional \$4 million, the issuer could sell \$5 million on January 2, 2001 without triggering the disclosure rules, because this would be the start of a new offering period. *[After discussion, the staff said they would be willing to consider a proposal for an alternative rule.]*

Follow-up Question. If options are granted on January 1 of Calendar Year 1, and on January 30 of Calendar Year 2, does the 12-month period with respect to the second grant end on December 31 of Calendar Year 2 or on January 29 of Calendar Year 3? In other words, does the 12-month offering period run from the start of the calendar year or from the time of first grant during the year?

ANSWER: To avoid issues such as this, the issuer should have a plan provision or policy defining how its Rule 701 offering periods will be calculated. However, it would be permissible for the plan or policy to identify either December 31 of Calendar Year 2 or January 29 of Calendar Year 3 as the end of the 12-month period.

13. Effect of Terminated Options. Can options which were granted during the 12-month look-back period before the current grant, but were terminated or cancelled unexercised during that 12-month period, be disregarded in determining the remaining number of options available for grant under Rule 701?

ANSWER: No. Since the "sale" is deemed to have occurred at the time of grant, a subsequent cancellation of the option does not replenish the available shares.

14. New Disclosure Requirements. The adopting release for the Rule 701 amendments provides that if the issuer will sell over \$5 million of securities in a 12-month period, the disclosure must be provided to all investors before sale, not just to those whose sales took the issuer over the \$5 million limit. For purposes of this requirement, where the disclosure is provided with respect to stock options, can the required disclosure be provided after option grant as long as it is provided before exercise?

ANSWER: Yes. The disclosure must be provided a reasonable time before exercise.

Other 1933 Act Issues

15. Rule 145. An acquiring company issues a stock option to the CEO of the target company, in substitution for the stock option that Target previously granted to the CEO. The Acquiror shares issuable upon exercise of the option are registered on Form S-8. Will the Acquiror stock that is issued to CEO upon the exercise of the stock option be Rule 145 stock if the exercise occurs subsequent to the acquisition?

Proposed Response: No. Rule 145(d) refers to "registered securities acquired in a transaction specified in paragraph (a) of this section." Inasmuch as paragraph (a) refers to the acquisition agreement, and the stock would be acquired pursuant to the exercise of a stock option, that stock would not be subject to Rule 145.

ANSWER: Neither the options nor the shares would be deemed to be acquired in a Rule 145 transaction. The optionee would have no resale restrictions unless it was an affiliate of Acquiror.

16. Sale of Securities of Unrelated Issuer. An employer company wishes to offer its employees options to purchase stock of an unrelated publicly traded company. Does the employer need to register any security under the 1933 Act? Are there any other federal securities law implications to this transaction?

ANSWER: See also answer to Question 5. The grant of an option on the stock of an unrelated public company may be a sale for purposes of the Securities Act of 1933. The staff has taken the position (in the 1998 Millennium letter) that a company's grant of an option on its own stock is not a sale, but would not extend this position to the grant of options on an unrelated company's stock. The staff's position that an S-8 registration statement need not be filed until the time of option exercise might also not apply if the option was on another company's stock. The employer would also be required to register as a broker-dealer if it was offering a security that it was not the issuer of. If a trust was involved, there might also be 1940 Act issues.

Section 16

17. Indirect Ownership through Partnership. A director of the issuer owns stock of the issuer through a partnership. Under the instructions to the Section 16 forms, he is permitted to report his share of the partnership's holdings either by reporting the entire

number of shares held by the partnership or just his pro rata interest in those shares. For example, if the partnership owns 300 shares and he owns 50% of the partnership, he could report either the full 300 shares or the 150 shares representing his share of the partnership holdings. Assume that a new partner joins the partnership and as a result, the director's share of the partnership drops to 1/3. If the director had initially reported the full 300 shares owned by the partnership, this change in his relative ownership of the partnership holdings would not trigger a new Section 16(a) filing.

a. If the director had originally reported beneficial ownership of 150 shares, is he now required to report a decrease in his ownership to 100 shares?

b. If so, must it be reported on Form 4?

c. How should the transaction be characterized?

d. Is the decrease in the director's ownership exempt from Section 16(b) by virtue of Rule 16a-10 (on the theory that the decrease would not have been reportable if the director had chosen to report the partnership holdings in the aggregate)?

Proposed Response: Since the director could have chosen to report the partnership's holdings in the aggregate, he should not be in a worse position because he volunteered additional information. Thus the director should not be required to report the change as a separate transaction, but should only be required to "true-up" the end of month holdings shown as indirectly held by him through the partnership. The change in ownership should be exempt from Section 16(b) by virtue of Rule 16a-10.

ANSWER: It depends on the facts and circumstances. In general, if it's a passive situation, the director can just show a change in his total holdings on the next Form 4 or 5 otherwise filed. However, if the director has voting or investment control over the partnership's portfolio, the director should consider filing a Form 4 expressly to reflect the change. This is particularly so if a purpose of selling a partnership interest was to dilute the director's interest in the portfolio company.

Follow-up Question: Would the same analysis apply in the case of a director by deputization?

ANSWER: Yes.

18. Aggregate Reporting of Installment Distributions from Deferred Compensation Plan. An insider has retired as an officer but remains on the issuer's board of directors. At the time of his retirement he had phantom company shares credited to his account under a deferred compensation plan (or a supplemental plan that does not qualify as an excess benefit plan). Prior to his retirement he elected to have distributions from the plan made on a monthly basis. Under the terms of the plan, once distributions have started, the participant cannot change the timing of the distributions, but he can continue to make

fund switches (which would be reportable as "Discretionary Transactions") during this time.

In the December 1996 American Bar Association letter, the staff took the position that (1) each acquisition under a deferred compensation plan had to be reported (on Form 4 or 5) as a separate transaction, and (2) each distribution under such a plan had to be reported (on Form 4) as a separate settlement of a derivative security. In the February 1999 American Bar Association letter the staff permitted aggregate reporting of periodic acquisitions under this type of plan. Can the periodic distributions also be reported on an aggregate basis? (Each fund switch would continue to be separately reported.)

ANSWER: Because the plan permits fund switches, this is a multi-fund plan; therefore, the payout would be a "discretionary transaction." This is a change from a previous staff position. The current position is reflected in the March 1999 supplement to the Telephone Interpretations Manual. Because the participant has a continuing right to make fund switches, you don't know what's in the account until the actual date of payout. As a result, the payout election (for purposes of the discretionary transaction look-back rule) is deemed made on the date of payout.

Periodic distributions cannot be reported in the aggregate.

19. Reporting after Death of Insider. An insider died after making a transaction in company stock but before filing a Form 4 or 5 with respect to the transaction. Is a Form 4 or 5 required to be filed, or does the exemption in Rule 16a-2(d) for transactions by an executor also extend to this pre-death transaction? If a filing is required, who must make it? Does the answer depend on whether the transaction is exempt under Section 16(b)?

ANSWER: A filing is required, whether or not it is exempt under Section 16(b). The executor would be the appropriate person to file. A late filing by the executor would be required to be disclosed under S-K Item 405. While the company is not required to file in this situation, it could choose to do so.

20. Specificity of Approval for Rule 16b-3. The Skadden Arps (Jan. 1999) letter states that board or committee approval in the context of a corporate merger transaction must specify not only the name of each insider and the number of securities involved, but also "that the approval is granted for purposes of exempting the transaction under Rule 16b-3." Is the latter statement required for routine option grants? (It has not been common practice to include such a statement for routine grants, on the theory that directors have previously been told that the Rule 16b-3 exemption is a consequence of their approval of the plan or grant.)

ANSWER: The staff imposed this requirement in the Skadden Arps letter to be sure the board was specifically considering the 16b-3 aspects of the approval, not just the merger. In a routine option grant, directors are more aware that the 16b-3 exemption is a consequence of their approval, so the specific reference to 16b-3 is not required.

Follow-up question: Where the conversion ratio in the merger is to be set after the board meeting (e.g. based on relative market prices) can the board approve a formula adjustment together with a list of shares currently owned by each insider?

ANSWER: The Skadden letter permits use of a formula only with respect to derivative securities, not shares owned outright. However this question was not raised in the Skadden letter. At this time it is an open question; the staff would entertain an interpretive letter request on this issue.

Accounting

21. Accountant Independence. A partner of an accounting firm leaves the firm to become CFO of an audit client of the firm. Do the auditor independence rules require the former partner to take a distribution of his/her benefits under the firm's qualified 401(k) and pension plans? If so, what is the accounting firm supposed to do if the former partner refuses to consent to a distribution from those plans, since under the Internal Revenue Code plan qualification rules a qualified plan cannot force a distribution at least until a former employee has attained age 62?

Proposed Response: The former partner's account balance or accrued benefit in the accounting firm's qualified plans should not constitute an independence problem, since under both ERISA and the Internal Revenue Code the assets in such plans are required to be held in trust for the exclusive benefit of plan participants and cannot be used for the benefit of the accounting firm.

ANSWER: Independence questions are generally addressed by the Office of the Chief Accountant, which is separate from the division of Corporation Finance. These issues are generally addressed on a case-by-case basis. The general position is that a former partner who becomes an officer of an audit client of the firm is required to take a distribution of all financial obligations from the accounting firm, including capital contributions and retirement benefits. The sole exception is if a rabbi trust is created to hold deferred compensation or supplemental retirement benefits and that trust satisfies the following requirements:

- i. the trust obtains an IRS ruling;
- ii. the trust must become irrevocable within 30 days after the IRS ruling;
- iii. the firm's obligation must be fixed at the time the partner leaves the firm; any changes to the firm's obligation (i.e. any additional funding) must be approved by the Office of the Chief Accountant;
- iv. the firm must comply with all other SEC and AICPA rules regarding independence.

Follow-up Question: Would a qualified plan trust be acceptable, since it is even more separate from the firm than a rabbi trust?

ANSWER: If the firm has any control over the funds in the trust there would be a problem. Thus, at the very least, you would need a trustee separate from the firm managing the investment of the trust funds. As to whether participant direction of the investment of his 401(k) plan account from a menu of funds chosen by the accounting firm would be permissible, this question needs to be addressed to the Office of the Chief Accountant. *[Scribe 's note: This response was given by an accountant from Corp Fin after discussion with the Chief Accountant's Office. The staff member who answered this question seemed unfamiliar with 401(k) plans and was reluctant to express a view beyond the "rabbi trust" exemption.]*

Section 13(d)

22. Amendment to Schedule 13G. Assume that an ESOP owns more than five percent of a class of stock that is publicly traded. Assume further that, as of the end of the calendar year, the percentage of the issuer's stock owned by the ESOP changes. What is the minimum level of change in percentage ownership that triggers the filing of an amendment to the Schedule 13G?

ANSWER: If there is any change in the number of shares owned, the Schedule 13G must be amended. There is no de minimis exemption. However, there is no need to file if there is no change in the number of shares owned, and the change in percentage ownership is due solely to a change in the number of outstanding shares. A filing is required during the course of the year if the ownership changes by 5% or more.

23. Beneficial Ownership of ESOP shares. Has the staff changed its position as expressed in the Rio Grande letter that the ESOP trustee is the beneficial owner of the unallocated shares, even though the plan provides for pass-through voting of such shares?

ANSWER: The staff has not changed its position. The issue is now on the back burner and doesn't seem to be generating lots of questions any more.

Form 11-K

24. Form 11-K. Does the staff have specific plans to eliminate the 11-K filing requirement for plans which have registered plan interests under the Securities Act of 1933?

ANSWER: No.