

## **AMERICAN BAR ASSOCIATION**

### **Technical Session Between the SEC Staff and the Joint Committee on Employee Benefits**

#### **Questions and Answers**

**May 4, 2004**

The following questions and answers are based on informal discussions between private sector representatives of the JCEB and SEC staff members. The questions were submitted by ABA members and the responses were given at a meeting of JCEB and government representatives. The responses reflect the unofficial, individual views of the government representatives as of the time of the discussion, and do not necessarily represent the position of the agency. This report on the discussions was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meetings. The questions were submitted in advance to the agency, and it was understood that this report would be made available to the public.

## JCEB Questions for SEC 2004

### New Form 8-K

[Questions regarding Form 8-K were addressed in Frequently Asked Questions published by the SEC Division of Corporation Finance on November 23, 2004, which can be accessed from the SEC website at <http://www.sec.gov/divisions/corpfin/form8kfaq.htm> ]

### S-K Item 703

1. **[Substitute Question] Transactions relating to Stock Options.** Do the following transactions by an issuer in connection with benefit plans or awards require disclosure under S-K Item 703:
- (a) “net” option exercises to pay tax withholding and/or the exercise price of an option?
  - (b) stock-for-stock exercises?
  - (c) option exchange programs?
  - (d) issuer repurchases of shares acquired by an executive under an equity award in excess of the number needed to pay taxes or satisfy the exercise price?

**SEC Response:** “Net” exercises, where shares are never issued under an option but are retained by the company to pay the exercise price or withholding or other taxes associated with the exercise do not require Item 703 disclosure because they involve shares that are never issued. Because a stock-for-stock exercise involves delivery of already outstanding shares, it is required to be disclosed under Item 703, including when shares are delivered by attestation. Option exchange programs are not covered by Item 703 if the options are not registered under Section 12. Issuer repurchases are required to be disclosed under Item 703.

2. **Cash-out of Restricted Stock Units.** A company grants restricted stock units (RSUs) and either the company or the participant elects to have the units settled in cash, or the participant elects that upon vesting the cash value of the units will be deferred pursuant to a deferred compensation plan. Is the cash settlement a transaction that needs to be reported under Item 703?

**Suggested Answer:** No. The RSUs are not equity securities registered under section 12, and therefore the cash settlement of them is not a repurchase covered by the rule. Similarly, a net issuance of shares upon the vesting of RSUs, where the number of shares issued is net of the number required to satisfy tax withholding obligations or other taxes associated with the vesting does not require Item 703 disclosure.

**SEC Response: The Staff agreed with the Suggested Answer.**

3. **[Substitute Question] Transactions relating to Restricted Stock.** Do the following transactions by an issuer in connection with benefit plans or awards require disclosure under S-K Item 703:
- (a) withholding shares subject to a restricted stock award to pay tax withholding when the award vests?
  - (b) forfeitures of restricted stock upon failure to satisfy vesting conditions, when (i) no consideration is paid by the company to the employee upon the forfeiture, or (ii) the company returns the employee's initial purchase price (which may be par value or greater) upon the forfeiture?
  - (c) cash-out of the restricted stock (similar to facts in Question 10)?

**SEC Response:**

- (a) **Withholding shares to pay taxes due upon vesting of restricted stock is required to be disclosed under Item 703 because it involves delivery of already outstanding shares in payment of a tax obligation.**
  - (b) **Forfeitures of restricted stock without the payment of any consideration do not require disclosure because they are not repurchases; but if a payment is made upon the forfeiture of outstanding shares of restricted stock (even if the payment is only nominal par value) then it is a repurchase that must be disclosed.**
  - (c) **A cash-out of restricted stock is required to be disclosed.**
4. **[Substitute Question] Transactions By Benefit Plans.** Do the following transactions by or under tax-qualified employee benefit plans such as a 401(k) plan or an employee stock ownership plan (ESOP) require disclosure under S-K Item 703?
- (a) purchases by the plan as a result of netting participant elections to sell and buy issuer stock (e.g. investment elections under a 401(k) plan)?
  - (b) purchases by the plan on the open market pursuant to employee investment elections?
  - (c) purchases by the plan on the open market where the plan requires employer cash contributions to be invested in employer stock?

**SEC Response: Item 703 disclosure would be required if the purchaser is the issuer, or is purchasing on behalf of the issuer, or is an “affiliated purchaser” as defined in Rule 10b-18(a)(3). However, if the transactions are effected by an “agent independent of the issuer” as defined under Rule 10b-18(a)(4), they need not be counted under Item 703. This is consistent with both the discussion in Release No.**

34-19244 (Nov. 17, 1982), adopting Rule 10b-18 (“The criteria contained in ... the rule that are used to determine whether the purchasing agent is independent of the issuer are designed to insulate the market in the issuer’s securities from influence by the issuer or an affiliate”) and the position of the Division of Market Regulation in response to Q&A number 24 in the FAQ Concerning Rule 10b-18 (May 18, 2004), where the Staff confirmed that transactions by an “agent independent of the issuer” are not treated as issuer repurchases and therefore Rule 10b-18 is not applicable to such transactions.

### Proxy Rules

5. **Severance Agreement.** A person who was a named executive officer in 2003 leaves the company early in 2004 (at a time when his 2004 salary and bonus will not make him an NEO for 2004) pursuant to a severance arrangement negotiated in 2004. Is the severance arrangement required to be disclosed in the company’s proxy statement for its upcoming 2004 annual meeting and/or filed under S-K Item 601(b)(10)(iii)(A)?

**Suggested Answer:** Because he was a named executive officer for the most recently completed fiscal year at the time the severance agreement was negotiated, the severance agreement must be described in the proxy statement pursuant to S-K Item 402(h) (payments to be received on termination of employment), assuming the dollar thresholds of that Item are exceeded. It need not be reflected in the Summary Compensation Table since it was not accrued or payable in 2003. The severance agreement must be filed under S-K Item 601(b)(10)(iii)(A).

**SEC Response:** The Staff agrees with the Suggested Answer. Disclosure would also be required under Item 1.01 of Form 8-K. Both the proxy statement and 8-K disclosure should quantify the amount payable under the severance arrangement.

6. **Pension Disclosure.** A company provides the alternative pension plan disclosure pursuant to Reg S-K Item 402(f)(2), pursuant to which the company discloses the estimated retirement benefits payable to each named executive officer at normal retirement age. What, if any, additional disclosure is required with respect to a named executive officer who is working beyond normal retirement age?

**Suggested Answer:** No additional disclosure is required, but it would be good practice to provide the estimated retirement benefit payable as of a recent date.

**SEC Response:** The additional disclosure is more than just good practice – it is required under Exchange Act Rule 12b-20 and the antifraud rules to avoid confusing investors about the status of the NEO. Note that Rule 402(f)(2) narrative disclosure is available only if plan benefits are not determined primarily by final compensation (or final average compensation) and years of service

7. **Outside Director Perqs.** A company provides certain perq-type benefits to its outside directors. For example, the company pays for the director’s spouse’s air travel when accompanying the director to board meetings.

- (a) Can they be excluded from proxy disclosure if below a minimal amount, in the same way that perqs to executive officers below a specified threshold can be excluded from the Summary Compensation Table?
- (b) Is it permissible to describe the benefit without valuing it?

**Suggested Answer:**

- (a) No. There is no de minimis exclusion for compensation to outside directors.
- (b) Yes. It is permissible to describe the benefit without valuing it.

**SEC Response:**

- (a) **Agree. No de minimis exclusion.**
- (b) **Disagree. S-K 402(g) requires stating the “amounts” of director compensation. The Staff views this as requiring disclosure of the dollar value of compensation. For valuation purposes, the same aggregate incremental cost to the company standard prescribed in Instruction 2 to Item 402(b)(2)(iii)(C) would apply.**

- 8. Gross-up on Perqs.** A company provides perqs having a value of less than \$50,000 and grosses up the recipient for taxes on the perqs. Can the company treat the gross-up as a perq and therefore not disclose it as long as the aggregate value of the gross-up plus the other perqs does not exceed \$50,000?

**Suggested Answer:** Yes. The company should be permitted to treat the gross-up as a component of the perq.

**SEC Response:** No. The requirement to disclose gross-ups is separate from the requirement to disclose perqs, and does not allow any exclusion.

- 9. Gross-up on Insurance Benefit.** A company provides an insurance benefit that is disclosed under All Other Compensation and grosses up the executive for taxes on that benefit. Can the company disclose both the insurance benefit and the related tax gross-up in the All Other Compensation column as long as it separately itemizes them?

**Suggested Answer:** Yes. The company should be permitted to disclose the gross-up together with the insurance benefit because the disclosure of the two related items of compensation in the same column will be more easily understood by readers.

**SEC Response:** No. The gross-up should be included in the column expressly calling for that disclosure, which is the Other Annual Compensation column.

- 10. Imputed Income on Split Dollar Policy.** A company has previously funded a split dollar insurance benefit (which was appropriately reported in the Summary Compensation Table in the years payments were made). The company is no longer

making payments under the policy and the executive is not currently receiving any benefits under the policy, but the executive is now subject to imputed income under the tax rules. The company grosses up the executive on the imputed income. Please confirm that the company need only report the tax gross-up but need not report the imputed income.

**Suggested Answer:** Yes. This would be consistent with other areas under S-K Item 402 where the tax rules are not determinative of how or when something is reported.

**SEC Response:** Agree. The company would need to report the gross-up, but not the imputed income.

11. **Disclosure Rules.** Is there a current project for review/ revision of the compensation disclosure rules of Reg S-K Item 402 and/or the related party transaction rules of Reg S-K Item 404, and if so, what is the current estimate of when changes may be proposed?

**SEC Response:** The Staff is looking at both 402 and 404. There is no particular goal or timeframe for this review, and it may or may not result in any changes. The Staff wants to revisit these rules with an open mind.

12. **S-K Item 404.**

- (a) Item 404(b) requires disclosure of transactions between the registrant and an entity of which a director or director nominee is an executive officer or greater-than-10% owner, unless the amount involved does not exceed 5% of the revenues of either the registrant or the entity. The staff has taken the position in the Telephone Interpretations Manual (I.25) that a transaction between a registrant and an entity of which a director or director nominee is an executive officer, which transaction does not exceed 5% of the revenues of either the registrant or the entity, not only doesn't have to be disclosed under Item 404(b), but also does not have to be analyzed separately under Item 404(a) (which has a \$60,000 threshold) if the director or nominee does not receive any "special benefit" from the transaction. If the director or nominee owns an equity interest in the entity, in addition to or instead of being an executive officer of the entity, may the director or nominee rely on Interpretation I.25, or does the equity interest give rise to a "special benefit," requiring the transaction to be analyzed under Item 404(a) as well as Item 404(b)?

**Suggested Answer:** Interpretation I.25 also applies to a director or nominee who is an equity owner of the entity. Item 404(b) expressly addresses transactions with an entity of which a director or nominee is an executive officer or a greater-than-10% owner, and therefore Item 404(b) and the staff's interpretations thereof should apply equally whether the director or nominee is an executive officer or an equity owner of the entity (or both). A director or nominee should be deemed to receive a "special benefit" from a transaction only when s/he receives a benefit that is not inherent in equity ownership or status as an executive officer (e.g., a percentage of revenues from transactions with the registrant).

- (b) Does the same analysis apply where a director and the director's children are each greater-than-10% owners of the entity that engaged in transactions with the issuer, where the transaction does not exceed 5% of the revenues of either the issuer or the entity? In other words, can the transaction be analyzed solely under 404(b) by analogy to Interpretation I.25?

**Suggested Answer:** Yes. If stock ownership in an entity by a director does not trigger 404(a) disclosure, ownership in that entity by the director's family members (which is even more attenuated than ownership by the director) should also not trigger it.

**SEC Response:** The Staff disagreed with the Suggested Answers. They acknowledged that the cited Telephone Interpretation has caused confusion. The Interpretation focused on Instruction 9 to 404(a), which says there may be instances in addition to those specifically addressed in the Instructions to 404(a) where the insider's interest is not a "material interest" and in those instances disclosure is not required. The Interpretation then looks to the thresholds in 404(b) in deciding whether an interest is "material" for purposes of applying Instruction 9. However, Instruction 8 to 404(a) identifies specific situations where an interest is "not material" – including ownership of less than 10%. The implication of this Instruction is that an ownership interest of more than 10% would be material for purposes of 404(a).

#### Rule 144

13. **Holding Period for Deferred Compensation.** An affiliate participates in a non-qualified deferred compensation plan that is not registered under the 1933 Act, and elects an investment return that is based on the issuer's common stock (i.e. phantom stock). Payment is made by delivery of actual shares of common stock on the date specified in accordance with the plan. When does the Rule 144 holding period begin with respect to the stock that is ultimately paid out?

**Suggested Answer:** The holding period begins on the date the deferred amount is credited to the individual's phantom stock account in the plan, since this is the date the individual assumes the economic risks of ownership of the shares. (The individual has already paid for the shares by the act of deferring compensation that he/she would otherwise have received.) This should be the case whether or not the phantom stock can be settled in cash as an alternative to delivery of shares (and whether the choice of cash or shares as a settlement option is made by the employer or the employee).

**SEC Response:** The Staff would agree with the Suggested Answer if the first sentence were revised to read "...account in the plan *so long as* this is the date the individual *irrevocably* assumes the economic risks of ownership of the shares."

14. **Acting in Concert.** A tax-qualified retirement plan places a limit on the aggregate number of shares of employer stock that can be sold at one time. Participants in the aggregate elect to sell a number of shares that exceeds the plan's limit, and under the terms of the plan their elected sales are proportionately reduced. Would the participants

be considered to be “acting in concert” for purposes of Rule 144, even if they don’t have any information about the other participants who wish to sell (*e.g.*, their names or the number of shares that the other participants wish to sell)?

**Suggested Answer:** No. Acting in concert requires that there be an express or implicit agreement or arrangement among the parties, which is absent here.

**SEC Response:** **The Staff agreed with the Suggested Answer. So long as there is no express or implied agreement among the participants, there is no “acting in concert.” The fact that an overall limit is imposed by the plan does not change this.**

### Form S-8

**15.. Shares Registered on S-8.** An employee benefit plan provides for three types of contributions:

- (1) employee pre-tax or after-tax contributions made with his or her own compensation; the employee may (but need not) elect to invest these contributions in employer stock;
- (2) matching contributions (which are made by the employer based on the amount contributed by the employee, but without regard to whether the employee invests his or her own contributions in employer stock); and
- (3) employer “nonelective” contributions that are made without regard to whether the employee makes his or her own contributions.

Where the offer of employer stock under such a plan is registered on Form S-8, it is clear that those transactions in which employee contributions are used to purchase shares must be registered on the S-8. Which (if any) of the following transactions must also be effected with shares that are registered:

- (a) employer matching contributions which, pursuant to the plan terms or in the employer’s discretion, are required to be invested in employer stock?
- (b) employer matching contributions that are invested in employer stock at the participant’s election?
- (c) nonelective employer contributions which, pursuant to the plan terms or in the employer’s discretion, are required to be invested in employer stock?
- (d) nonelective employer contributions that are invested in employer stock at the participant’s election?

**Suggested Answer:** None of the above four categories of transactions needs to be effected with shares registered on the S-8 because there is no offer or sale of employer stock under any of these circumstances. In each case, the employee should be deemed to

be getting “bonus shares” since the employee’s acquisition of the shares is not in any way related to the employee’s decision of whether to invest their own contributions in employer stock. Shares attributable to employer contributions would be required to be registered on the S-8 only if they were expressly conditioned on an employee’s investment of his own contributions in employer stock. (Note that the suggested answer differs from the answer in Q&A-88 in Part G of the Telephone Interpretations Manual.)

Moreover, since the shares in the above four categories should be treated as “bonus shares” they would be able to be resold without registration or compliance with Rule 144 under the staff’s general policy permitting resale of bonus shares (1934 Act issuer, shares widely traded, no significant market impact).

**SEC Response: The Staff continues to take the position expressed in the Telephone Interpretation. Accordingly, shares acquired with matching contributions (situations (a) and (b) above) must be registered, while shares acquired with nonelective contributions (situations (c) and (d) above) need not be registered. There ensued a discussion of the difficulties of counting registered shares.**

16. **[Substitute Question] Shares Registered on Form S-8.** Would the need for registration of the shares acquired with matching contributions (in the above question) be eliminated if the Plan acquired the shares on the open market?

**SEC Response: Release 33-4790 sets out the general standards for when issuer involvement in a benefit plan is minimal enough to avoid the need for registration. In the typical 401(k) plan, these standards are not likely to be satisfied.**

17. **EU Prospectus Requirements.** The European Union has issued prospectus requirements which will affect equity plans of US issuers. Are there any discussions between the SEC and the EU on whether US issuers could use the S-8 prospectus to satisfy the EU requirements?

**SEC Response: The Staff will look into this.**

### **Other 1933 Act**

18. **Puerto Rican 401(k)-type plans under Section 3(a)(2).** Section 3(a)(2) of the 1933 Act provides an exemption for certain securities issued in connection with a “stock bonus, pension or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954” (other than plans in which employee funds are used to purchase employer securities). Residents of Puerto Rico are not subject to the US Internal Revenue Code as amended to date, but are instead subject to the Puerto Rico Income Tax Act which tracks the US Internal Revenue Code in many ways, but is typically behind in terms of amendments. The Puerto Rico Act has a provision which in many ways parallels section 401 of the Internal Revenue Code but with a number of technical differences in the qualification requirements. It also requires approval of the plan by the Puerto Rican Treasury. If a US company established a separate plan for its Puerto Rican employees that would be exempt under section 3(a)(2) but for the fact that it

satisfies the tax qualification requirements of the Puerto Rico Act (and not those of section 401 of the Internal Revenue Code), does the 3(a)(2) exemption apply? If not, is there any other exemption that is applicable?

**Suggested Answer:** The Puerto Rico Act equivalent of section 401 should be treated as the equivalent of section 401 of the Internal Revenue Code.

**SEC Response:** The Staff disagreed with the Suggested Answer, but was sympathetic to the problem. They do not believe they have the authority to issue an interpretation that overrides the express language of Section 3(a)(2). Thus there is no 3(a)(2) exemption for plans subject only to the Puerto Rico Income Tax Act.

### **Sarbanes-Oxley Act**

- 19. Compensation disgorgement under S-Ox Section 304.** Has the Commission taken any action to require disgorgement under Section 304 of the Sarbanes-Oxley Act (which requires reimbursement by the CEO and CFO of certain bonus, incentive, or equity-based compensation following a material restatement required due to misconduct)? If so, in what circumstances? How did the Commission apply the disgorgement in respect of stock options and other stock-based awards (i.e. based on when the award was granted, became vested, was exercised, or was actually paid)?

**SEC Response:** To date, there have been no public actions by the Commission under this provision.