AMERICAN BAR ASSOCIATION

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

Questions and Answers

May 8, 2007

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 meeting, and has not been reviewed by SEC staff members. 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 – 2007

Proxy Rules

Item 402(c) – Summary Compensation Table

1. **Bonus Taken in Stock.** Instruction 2 to Item 402(c)(2)(iii) and (iv) provides that registrants are to include in the Salary column or Bonus column of the Summary Compensation Table any amount of salary or bonus forgone at the election of a named executive officer under which stock, equity-based, or other forms of non-cash compensation instead have been received by the named executive officer. Q&A 4.03 of the Staff's Guidance on Item 402 of Regulation S-K (last updated February 12, 2007) repeats this general principle, but then goes on to provide that "[t]he result would be different . . . if the agreement pursuant to which the named executive officer had the option to elect settlement in stock or equity-based compensation was within the scope of FAS 123R." In this case, the award would be reported in the Stock Awards or Option Awards columns.

It is our understanding that if an executive is given the type of election contemplated in the Instruction before earning the bonus or award, the award would be considered to be "within the scope of FAS 123R" and would be treated as a liability award under that standard.

(a) Given this understanding, is the only circumstance in which an election to receive stock or equity-based compensation would not be within the scope of FAS 123(R) (and, thus, would be subject to disclosure in the Bonus, rather than the Stock Awards or Option Awards, column) when the election is offered only after the amount of the bonus is determined?

This distinction is significant since a stock award that is classified as a liability for financial reporting purposes is subject to "variable" accounting treatment until the award is settled and, thus, could appear in the Summary Compensation Table for several years, while a bonus that is foregone for stock or some other form of non-cash compensation that is reported in the Bonus column will only appear in the Summary Compensation Table once (in the year earned).

(b) For purposes of the Instruction, is there a distinction between an advance election to take a bonus or other incentive payment in stock and a post-year decision to forego the receipt of salary or bonus otherwise payable in cash in favor of the receipt of a stock or other equity award?

SEC RESPONSE: The short answer is that FAS 123R governs. Under paragraph 4 of FAS 123R, the test is whether a possibility of settlement in stock is an inherent part of the award. The timing of an employee's election to take cash or stock is irrelevant.

2. **Determining NEOs when Bonus is Unknown.** Instruction 1 to Item 402(c)(iii) and (iv) provides that, if the amount of salary or bonus earned in a given fiscal year is not calculable through the latest practicable date, a footnote is to be included to the appropriate column disclosing that the amount of salary or bonus is not calculable through the latest practicable date and providing the date that the amount of salary or bonus is expected to be determined. Such amount must then be disclosed in a filing under Item 5.02(f) of Form 8-K.

(a) Instruction 1 to Item 402(a)(3) states that the determination as to which executive officers are most highly compensated is based on the Total Compensation figure as required to be disclosed in the Summary Compensation Table, reduced by the amount shown in the Change in Pension Value and Nonqualified Deferred Compensation Earnings column. Please confirm that this same approach is followed to determine the most highly compensated executive officers even where the amount of bonus earned in a given fiscal year is not known at the time the registrant is required to provide its disclosure under Item 402.

(b) Once the amount of the bonus has been determined, is it necessary to recalculate who are the most highly compensated executive officers?

SEC RESPONSE: The Staff stated that the disclosure under Item 5.02(f) of Form 8-K is not intended to result in "a whole new proxy statement." They wanted to think further about whether the identity of the NEOs would change from the officers named in the proxy statement if it turned out that an executive officer who was not named would be one of the most highly compensated after taking the bonus amounts into account. This is relevant for determining which officers would be subject to ongoing 8-K reporting, however the issue is likely to occur only rarely.

3. **Prior Year Information for New NEO.** An individual was an executive officer, but not an NEO, in years 1 and 2 and becomes an NEO in year 3. Is the Summary Compensation Table for year 3 required to include information about this person for years 1 and 2? Q&A 4.01 of the Staff's Guidance on Item 402 of Regulation S-K (last updated February 12, 2007) indicates that if a "person" was not an NEO in the earlier years, then only the year 3 information is required. This interpretation appears to be clarifying Item 402(a)(4), which provides, in part, that if an NEO served as an executive officer during any part *of the fiscal year* with respect to which information is required, information shall be provided as to all compensation of that individual for the full fiscal year. Since the Summary Compensation Table calls for information with respect to years 1 and 2, some have questioned whether Item 402(a)(4) could be read to require inclusion of the prior year information. Is it a proper interpretation of Q&A 4.01 that it clarifies that Item 402(a)(4) calls for only current year information in the Summary Compensation Table in this situation?

SEC RESPONSE: An individual who is new to the Summary Compensation Table has only one year of compensation reported in the first year he is an NEO, even if the individual has been an executive officer in prior years.

4. **Forfeiture of Previously-Reported Equity Awards.** A registrant made restricted stock awards to its Chief Executive Officer in 2004 and 2005 and, as required by the former rules, reported the full value of those awards in the Summary Compensation Tables included in its proxy statement reporting 2004 and 2005 compensation. The CEO retired in 2006, forfeiting 85% of the awards (with 15% of the award shares vesting prior to his retirement).

(a) Should the reversal of the previously-recognized compensation cost for these awards be reflected in the Stock Awards column of the registrant's Summary Compensation Table reporting 2006 compensation?

(b) Would the result be different if the awards in question were stock options and the registrant had reported the number of options granted, but not their value, in the prior proxy statements?

SEC RESPONSE: The Staff left this open for further consideration. Their current thinking is that only amounts that have been disclosed under the new rules (i.e. expensed in 2006 and later) should be able to be backed out. There is also the question of whether reversals should be permitted for amounts expensed in or after 2006, but where the individual in question was not an NEO in the year of the expense.

5. **Dividends on RSUs.** The All Other Compensation column of the Summary Compensation Table is required to include the dollar value of dividends or other earnings "paid" on stock or option awards when those amounts were not factored into the grant date value of those awards under FAS 123R. If pursuant to this standard a company is required to report dividends on RSUs and the company credits dividends on unvested RSUs, but does not pay them until the RSU vests, should the dividends be reported in the year credited or in the year vested (and actually paid)?

SEC RESPONSE: The dividends should be reported in the year credited.

6. **Perquisites.** The response to Q&A 4.07 of the Staff's Guidance on Item 402 of Regulation S-K (last updated February 12, 2007) exempts from disclosure as a perquisite or other personal benefit any item for which an executive officer has actually fully reimbursed the company for its "total cost." If "total cost" is something other than the "aggregate incremental cost" of the benefit, what measure is used to determine an item's "total cost?"

SEC RESPONSE: The Staff stated that "total cost" is not necessarily the same as "aggregate incremental cost," but declined to provide a "bright line" definition or to provide guidance as to how to calculate "total cost." They provided two examples: (1) If the company bought season tickets for business purposes and the executive used an otherwise unused seat for personal purposes – there is no aggregate incremental cost, but the executive must pay the cost of the seat for that day in order to avoid disclosure as a perq. (2) If the company buys a country club membership for business purposes and the executive has a personal meal there – the aggregate incremental cost is the cost of the meal,

but the total cost also includes some portion of the annual membership. The Staff gave no guidance as to how to determine the appropriate portion of the membership to be included in the total cost.

7. **Relocation Expenses.** The new rules, in Item 402(a)(6)(ii), revised the list of types of plans that could be omitted from disclosure if they do not discriminate in scope, terms or operation to delete the reference to relocation plans. The Adopting Release, in the text at footnote 340, states that this revision was made because such plans, "even when available generally to all salaried employees, are susceptible to operation in a discriminatory manner that favors executive officers, [and therefore] this exclusion may have deprived investors of disclosure of significant compensatory benefits." Elsewhere the Adopting Release states that examples of items requiring disclosure as perquisites or personal benefits under Item 402 include "housing and other living expenses (including but not limited to relocation assistance and payments for the executive or director to stay at his or her personal residence)." Is this intended to mean that the Staff considers relocation payments to *always* constitute perquisites, or may such payments be analyzed under the general two-part perquisite test, so that they are not perquisites if they are either integrally and directly related to the performance of the executive's duties (such as when a company requires one of its executives to relocate overseas to manage a particular part of the company's business) or are available on a non-discriminatory basis to all employees?

SEC RESPONSE: Relocation expense, by its nature, is <u>always</u> a perquisite. The Adopting Release reached this conclusion after applying the 2-part test. The Staff felt that since relocation expenses involve providing housing, this is a personal rather than business expense, even if it relates to an overseas assignment.

<u>Item 402(f) – Outstanding Equity Awards at Fiscal Year-End Table</u>

8. **Showing Unrealized Appreciation.** Is it permissible to add a column to the Outstanding Equity Awards at Fiscal Year-End table to show the unrealized appreciation in outstanding option awards as of the end of the registrant's last completed fiscal year?

SEC RESPONSE: Yes. It is always permissible to add a column to a Table as long as it does not make the disclosure misleading or unclear.

9. **Reporting Outstanding Equity Incentive Awards.** Instruction 3 to the Outstanding Equity Awards at Fiscal Year-End table states that the number of "unearned" options or shares should be based on achieving threshold performance, except that if the *previous fiscal year's* performance has exceeded the threshold, the number should be based on the next higher level of performance (target or maximum).

(a) Does the phrase "previous fiscal year" in this Instruction mean the last completed fiscal year or does it mean the year before that?

(b) Where more than one year of the performance period has elapsed at the time of the disclosure, is it permissible to base disclosure on the actual multi-year performance to date (through the end of the most recent year) rather than looking solely at the most recent year?

SEC RESPONSE:

(a) **"Previous fiscal year" means the last completed fiscal year. So for the proxy statement being written in spring of 2007, it means look at 2006 performance.**

(b) **If the award is structured to look at multi-year performance, that is what should be used.**

Item 402(f) and (g) – Outstanding Equity Awards at Fiscal Year-End Table; Option Exercises and Stock Vested Table

10. **Option with "Early Exercise" Feature.** A registrant grants stock options that provide for immediate exercise in full as of the date of grant subject to a right of repurchase (at the original exercise price) if the recipient terminates employment with the registrant prior to a specified date (generally, three - four years from the date of grant). Typically, this right of repurchase lapses on a periodic basis over a three - four year period. As a result, if an executive exercises the option before the repurchase restrictions have lapsed, she effectively receives restricted stock that is subject to forfeiture (repurchase) until the restrictions lapse; if the repurchase restriction is triggered, the executive forfeits any upside appreciation. Please confirm that this type of award should be reported in the following manner:

(a) If the option is exercised before the repurchase restrictions lapse, then this is treated like the conversion of an option into shares of restricted stock. In the Outstanding Equity Awards table, those shares are not shown as being subject to an Option Award but instead are shown as being subject to Stock Awards (just as Equity Incentive Plan Awards can move to the columns used for reporting restricted stock if performance conditions have been satisfied but service vesting conditions remain on the shares). The "exercise" is not reported in the Option Exercises and Stock Awards table, but as shares acquired by the executive cease to be subject to the repurchase provision, those shares are reported under the Stock Awards column in the Option Exercises and Stock Awards table.

(b) If the option is exercised after the repurchase restrictions lapse, it is reported in these tables in the same manner as a traditional stock option.

SEC RESPONSE: The exercise should always be reported in the Option Exercise Table because there is a volitional exercise. In the case of an "early exercise" what is being acquired is restricted stock, so the award should continue to be shown in the Stock Awards column of the Outstanding Awards Table until the repurchase restriction lapses. Footnotes should be used to clarify what is being reported. If the option is exercised after the repurchase restrictions have lapsed, it is reported solely as an option exercise.

Item 402(h) – Pension Benefits

11. **Cash Balance Plan in Pension Table.** What is the correct way to report the present value of the accumulated pension benefit under a cash balance plan in the Pension Benefits Table? Typically under such a plan, assuming interest is credited using a market rate of return, the "accrued benefit" is defined as the amount credited to a participant's cash balance account as

of any date, and the participant has the right to receive that amount as a lump sum upon termination of employment at any age.

Suggested Answer: Under these circumstances it is permissible to report the amount credited to the cash balance account as the present value of the accumulated pension benefit.

SEC RESPONSE: A cash balance plan is a defined benefit plan, and therefore the actuarial present value of the benefit must be used. It may be desirable to show the actual account balance (i.e. the "real" benefit) in a footnote.

Item 402(i) – Nonqualified Deferred Compensation Plans

12. **Definition of Earnings.** Item 402(i)(2)(iv) requires disclosure in the Aggregate Earnings in Last Fiscal Year column (column (d)) of the dollar amount of aggregate interest or other earnings accrued during the registrant's last fiscal year. What types of items constitute "earnings" for these purposes?

Suggested Answer: For purposes of Item 402(i)(2)(iv), "earnings" includes dividends, stock price appreciation (or depreciation), and other similar items. The purpose of the table is to show changes in the aggregate account balance at fiscal year end for each named executive officer, and thus "earnings" should encompass any increase or decrease in the account balance during the last completed fiscal year that is not attributable to contributions, withdrawals or distributions during the year.

SEC RESPONSE: The Staff agreed with the suggested answer.

13. **Footnote Disclosure of Previously-Disclosed Amounts.** Q&A 10.01 of the Staff's Guidance on Item 402 of Regulation S-K (last updated February 12, 2007) indicates that, for purposes of complying with the Instruction to Item 402(i)(2), amounts only need to be disclosed by footnote if they were actually previously reported in the Summary Compensation Table.

(a) Please confirm that this response means that, for purposes of the amounts reported in the Aggregate Balance at Last Fiscal Year-End column (column (f)), it is not necessary to quantify the extent to which those amounts were reported in Summary Compensation Tables prepared under the former rules.

(b) Once the transition period described in Section VII of Securities Act Release No. 8732A has expired, will it be necessary to quantify the extent to which amounts reported in the Aggregate Balance at Last Fiscal Year-End column (column (f)) were previously reported in Summary Compensation Tables prepared under the new rules for all years, or only to the extent such amounts are reported in the three years covered by the Summary Compensation Table included in the proxy statement?

Some people believe that reporting amounts shown in the three years covered by the Summary Compensation Table of the proxy statement serves the purpose of preventing readers from double-counting reported compensation, and that showing the amounts reported in previous year's Summary Compensation Tables will not be a useful number, because it will only pick up an executive's contributions during years

in which the executive was a Named Executive Officer following the adoption of the new rules (and thus does not fully reflect the extent to which the year-end balance is attributable to an executive's contributions).

SEC RESPONSE:

(a) **Confirmed. You could choose to go back to before the new rules, but the footnote should make clear what you are disclosing**

(b) **It is sufficient to footnote the amounts reported in the 3 years covered by the Summary Compensation Table. You could choose to go back further, in which case the footnote should make clear what you are disclosing.**

14. **Non-Equity Incentive Awards subject to Time-based Vesting.** A company makes performance-based cash incentive awards which provide that, after the performance target is satisfied, the recipient must remain employed with the company for an additional three years in order to vest in his or her award, during which period the award is credited with interest at a specified rate. Pursuant to the Instructions to Item 402(c)(2)(vii), (1) the amount of the award is reported in the Non-Equity Incentive Plan Compensation column in the year the award is earned (that is, when the performance target is satisfied) and is not reportable again in the fiscal year when amounts are paid to the executive, and (2) the interest credited on the award during each of the years of the subsequent vesting period is reported in that column (and quantified in a footnote) in the year credited regardless of when the interest is paid.

(a) Questions have arisen as to whether the award is required to be included in the Nonqualified Deferred Compensation Table after it is earned from a performance standpoint but before the completion of the three-year vesting period. However, if it were reported in the Nonqualified Deferred Compensation Table, then the earnings on the award would be reported in both column (g) of the Summary Compensation Table and in the Nonqualified Deferred Compensation Table. Please confirm our understanding that such an award is not required to be included in the Nonqualified Deferred Compensation Table after it is earned from a performance standpoint but before the completion of the three-year vesting period.

(b) Please confirm that if the NEO has elected to defer payout of the award following completion of the three-year service vesting condition, then upon vesting the amount earned (and any earnings that likewise are deferred) is reported as an employee contribution in the Nonqualified Deferred Compensation Table.

SEC RESPONSE: The question points out a difference in the treatment of cash versus equity awards. The Staff will give further thought to this question. They encouraged people to use narrative disclosure to discuss links between the tables reporting the same benefit or to address aspects of the tables that are out of sync.

Item 402(j) – Potential Payments Upon Termination or Change-in-Control

15. **Triggering Event Occurring After Year-End.** Instruction 4 to Item 402(j) provides that, where a triggering event has actually occurred for a named executive officer and that

individual was not serving as a named executive officer of the registrant at the end of the last completed fiscal year, the disclosure required by Item 402(j) for that named executive officer shall apply only to that triggering event. In the case of an individual who was serving as a named executive officer of the registrant at the end of the last completed fiscal year who subsequently terminates his or her employment with the registrant following the end of the last completed fiscal year and before the registrant files its proxy statement, please confirm that the disclosure requirement of Item 402(j) may be satisfied as to that individual by simply presenting the termination scenario that has actually taken place.

SEC RESPONSE: Yes, if the following are true – (1) the officer who left would not be an NEO for the year in which she left (i.e. she left in early 2007 and would not be an NEO for 2007), and (2) the NEO didn't negotiate a new deal at the time of termination. (Where a proxy statement covers both the election of directors and a merger, it is <u>not</u> sufficient to disclose just the termination payments payable upon the merger. The merger might not be approved, but even if approved, shareholders should be able to compare the merger payout with payouts in other scenarios.)

16. **Non-discriminatory Accelerated Option Vesting.** Instruction 5 to Item 402(j) provides that a registrant need not provide information with respect to contracts, agreements, plans, or arrangements to the extent they do not discriminate in scope, terms or operation, in favor of executive officers of the registrant and that are available generally to all salaried employees. If a registrant's employee stock option plan contains a provision that provides for full and immediate vesting of all outstanding unvested awards upon a change in control of the registrant and this provision is included in each recipient's award agreement (whether the recipient is an executive officer or an employee), may the registrant omit these awards when quantifying the estimated payments and benefits that would be provided to named executive officers upon a change in control of the registrant?

SEC RESPONSE: No. Instruction 5 is intended to be narrowly construed. Options would not be of the "same scope" for executives and rank and file unless grant sizes were all the same.

17**. Calculation of Parachute Gross-Up.** The disclosure regarding potential payments upon a change in control is required to include a quantification of estimated payments and benefits on the assumption that the change in control took place "on the last business day" of the last completed fiscal year.

(a) Please confirm that where the last business day of the year is not the last calendar day (e.g. in 2006, the last business day for calendar year companies was December 29), a registrant may calculate the excise tax and gross-up on the assumption that the change in control occurred on December 31 rather than on the last business day.

(b) Under the tax laws, the "base period" used for determining the amount of parachute payments subject to excise tax (and thus the amount of any related gross-up for such tax) is the most recent five calendar years ***ending before*** the date of the change in control. Where the change in control is assumed to occur on December 31, 2006,

should the calculation of the gross-up for purposes of Item 402(j) be based on a "base period" ending December 31, 2005 or 2006?

SEC RESPONSE: The Staff wanted to give further thought to this question.

Item 402(k) – Compensation of Directors

18. **Compensation of Non-Officer Employee Director.** A director is an employee, but not an executive officer, of the registrant.

(a) Must his or her compensation as an employee be included in the Director Compensation Table? If so, in what manner?

(b) Must his or her compensation as an employee be disclosed as a related party transaction under S-K Item 404 (assuming it is in excess of $120,000)? Does the answer depend on whether the compensation has been approved by the compensation committee (since such approval exempts disclosure of non-NEO executive officer compensation)?

SEC RESPONSE:

(a) **Interpretation 12.02 of the Staff's Compliance and Disclosure Interpretations on S-K Item 402 (stating that compensation of a non-NEO executive officer for services as an employee need not be included in the Director Compensation Table provided that a footnote to the table states this fact) also applies where the director is a non-officer employee.**

(b) **The director's compensation as an employee must be disclosed under S-K Item 404. Instructions 5.a and 5.b don't apply in this situation.**

19. **Pension Benefits for Former Employee.** A current non-employee director was once an employee of the registrant. He is receiving pension payments in respect of his service as an employee. Must the registrant disclose these pension payments in the Director Compensation Table?

Suggested Answer: Interpretive Response 12.02 of the of the Staff's Guidance on Item 402 of Regulation S-K (last updated February 12, 2007) provides that employee compensation that is not required to be disclosed in the Summary Compensation Table is not required to be disclosed in the Director Compensation Table. Based on this response, pension benefits earned for services rendered as an employee do not need to be disclosed in the Director Compensation Table, whether or not the former employee-director receives compensation for services provided as a director.

SEC RESPONSE: The analysis is the same as for Question 18.

20. **Grant Date Fair Value of Equity Awards.** The Instruction to Item 402(k)(2)(iii) and (iv) provides that, for each director, a registrant must disclose by footnote to the appropriate column the grant date fair value of each equity award computed in accordance with FAS 123(R).

Please confirm that this disclosure requirement only applies to stock and option awards made during the registrant's last completed fiscal year, and not to each award for which a dollar amount recognized for financial reporting purposes with respect to that fiscal year in accordance with FAS 123(R) is reflected in the appropriate column, nor to each award outstanding at fiscal year end.

SEC RESPONSE: This Instruction is intended to parallel the comparable disclosure requirement for NEOs. Therefore the grant date fair value need only be provided for grants made during the registrant's last completed fiscal year.

21. **Outstanding Equity Awards.** The Instruction to Item 402(k)(2)(iii) and (iv) provides that, for each director, a registrant must disclose by footnote to the appropriate column the aggregate number of stock awards and the aggregate number of option awards outstanding at fiscal year-end. Please confirm that this requirement covers only unexercised option awards (regardless of whether or not exercisable) and only unvested stock awards (including unvested stock units), but that shares acquired upon exercise or vesting of such awards and that have not been sold or disposed of (and shares deferred upon exercise or vesting of such awards) do not need to be reported.

SEC RESPONSE: This Instruction is intended to parallel the comparable disclosure requirement for NEOs. Therefore information need only be provided with respect to unexercised stock options and unvested stock awards.

22. **Charitable Matching Gift Programs.** Instruction 1 to Item 402(k)(2)(vii) provides that "[p]rograms in which registrants agree to make donations to one or more charitable institutions in a director's name, payable by the registrant currently or upon a designated event, such as the retirement or death of the director, are charitable awards programs or director legacy programs for purposes of the disclosure required by Item 402(k)(2)(vii)(G)." Does this definition pick up charitable matching gift programs of a registrant that do not discriminate in scope, terms or operation in favor of executive officers or directors of the registrant and that are available generally to all salaried employees as well as to directors?

SEC RESPONSE: Charitable matching gift programs must be disclosed, even where they do not discriminate in favor of officers or directors.

Item 404 – Certain Relationships and Related Transactions

23. **Family Member Compensation.** A director's immediate family member is employed by the registrant and earns more than $120,000 in compensation. How much information is required to be provided in order to disclose the "amount involved" in the transaction for purposes of Item 404(a) of Reg S-K? Is it sufficient to disclose the person's salary and bonus? Is information about stock option exercises required to be provided?

SEC RESPONSE: The disclosure should be more than just salary and bonus, but need not be the full proxy disclosure. The Staff did not say how much disclosure is necessary, but suggested it would include at least equity grants. There is no need to disclose option exercises. A question was raised (but not resolved) as to whether the $120,000 should be

applied to annual compensation or should also include some portion of the fiscal year in which the proxy statement is being drafted.

24. **Family Member Compensation.** An executive officer who is not an NEO has an immediate family member who is employed by the registrant and is not an executive officer but earns more than $120,000 in compensation. The executive officer's compensation is approved by the Board's compensation committee and therefore is not required to be disclosed pursuant to Instruction 5.a. to Item 404(a). The fact that the executive's immediate family member is an employee and the terms of that employment (including the compensation) is reviewed and approved or ratified by the Board's audit committee or another committee composed of independent directors. In these circumstances, does the immediate family member's compensation need to be disclosed under Item 404(a) even though the compensation of the executive that results in the family member being subject to Item 404 is not required to be disclosed?

SEC RESPONSE: Instruction 5.a does not exclude this from 404 disclosure. The general standard of whether there is a direct or indirect material interest would apply.

Section 16

25. **Discretionary Transactions under Rule 16b-3.** The definition of discretionary transaction under Rule 16b-3 excludes transactions that are "required to be made available" under the tax laws. Under staff interpretations of this definition, transfers out of a company stock fund pursuant to tax law ESOP diversification provisions are not discretionary transactions. The Pension Protection Act of 2006 added a requirement that diversification rights be made available for all company stock accounts in tax-qualified plans – immediately for accounts holding 401(k) and after-tax contributions, and after 3 years of service for accounts holding company contributions. While plans can place some limits on the timing of sales under these diversification rights, they must be made available at least quarterly, and generally at the same frequency as other transfers between the plan's investment funds. How does this change in the tax law affect the definition of discretionary transaction for purposes of Rule 16b-3? Are transfers out of a company stock fund pursuant to a diversification right added under the Pension Protection Act exempt from the definition of discretionary transaction?

SEC RESPONSE: The change made by the Pension Protection Act now requires plans to make available precisely the types of transactions that were intended to be treated as discretionary transactions. These transfers should be viewed as discretionary transactions. The Staff's Section 16 interpretations will be updated soon and will address this issue.

26. **Filings by Estate.** Rule 16a-2(d) provides that an executor need not report transactions in securities held by an estate for the first 12 months following appointment as executor.

(a) Is an estate which holds more than 10% of the issuer's stock nevertheless required to file a Form 3 to report its holdings?

(b) If the executor is already an insider (e.g. by virtue of being an officer of the issuer), does the executor need to file an additional Form 3 in the capacity of executor?

SEC RESPONSE:

(a) **Yes. An estate that holds more than 10% of the issuer's stock is required to file a Form 3. It may be appropriate to include a footnote that transactions in the first 12 months will not be reported by virtue of the exemption in Rule 16a-2(d).**

(b) **No. Becoming an executor is just adding a new capacity. The executor need not file an additional Form 3, but will need to check an additional box to indicate the new capacity on the next Form 4 or 5 filed.**

Form 8-K

27. **Plan Subject to Shareholder Approval.** A company's board of directors has adopted a plan subject to shareholder approval and made grants under that plan that are subject to shareholder approval of the plan. Is an 8-K filing (with respect to either the plan or the grant) required at the time of board action? At the time of shareholder approval? Do the FAQs issued in 2004 interpreting what was then Item 1.01 of Form 8-K continue to apply in this area?

SEC RESPONSE: The date of shareholder approval is the 8-K trigger.

28. **Grants "Materially Consistent" with Plan.** Instruction 2 to Item 5.02(e) of Form 8-K provides that an 8-K is not required to be filed with respect to grants made under a plan, contract or arrangement that are "materially consistent" with the previously-disclosed terms of that plan, contract or arrangement.

(a) If a previously-disclosed employment agreement provides that the CEO is entitled to receive a cash bonus in an amount determined by the compensation committee in its discretion, would the following be deemed "materially consistent" with that agreement (and thus not need to be reported in an 8-K)?

(1) The committee makes an ad hoc determination of the amount of the CEO's bonus at the end of the first year that the contract is in effect?

(2) The committee makes an ad hoc determination of the amount of the CEO's bonus at the end of the second year that the contract is in effect, where the amount of the bonus is not a material increase from the amount of the prior year bonus that was disclosed in the proxy statement?

(b) If a previously-disclosed bonus plan lists three or four performance criteria which the compensation committee may choose from in setting the performance targets for an award, would the particular criteria chosen for a particular year's award need to be reported in an 8-K? Is the answer different if the plan lists 30 possible performance criteria?

SEC RESPONSE:

(a) **Generally, 8-K disclosure is not required for discretionary bonuses. Presumably, they will be discussed in the CD&A.**

(b) **If disclosure has already been made (in a prior 8-K or proxy) as to what the target criteria are, there is no need for an 8-K when the actual targets are set. It's hard to say at what point the number of possible goals previously disclosed is too large to provide sufficient prior disclosure that would avoid the need for an 8-K when the actual criteria are chosen.**

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29. **Diversification of Company Contributions under Qualified Plans.** A company maintains a tax-qualified defined contribution plan under which only company contributions can be invested in a company stock fund. Accordingly, the plan has not been registered under the 1933 Act. Until now, the plan has required that all company contributions be invested in a company stock fund. As a result of requirements added by the Pension Protection Act, the plan has recently been amended to allow participants to diversify out of the company stock fund into other investment funds which have been made available under the plan, as well as to allow those amounts (including earnings while held in the other investment funds) to be transferred back from the other investment funds into the company stock fund. The plan administrator keeps two accounts for each participant, with one reflecting employee contributions and one reflecting employer contributions. Thus, the company is able to track amounts attributable to the employer contributions, and allows only those amounts to be allocated back into the company stock fund. Is 1933 Act registration required for the plan as a result of participant ability to direct that the company contributions be reinvested in the company stock fund?

Suggested Answer: 1933 Act registration is not required as a result of participant investment elections with respect to company contributions, so long as no participant contributions (pre-tax or after-tax) can be invested in the company stock fund.

SEC RESPONSE: If the company can set up accounts so that there is no co-mingling of employee and employer money, there is no need to register the plan.

30. **Open Brokerage Window.** A 401(k) plan has an open brokerage window which allows plan participants to buy any stock listed on a major stock exchange for their plan account. Is 1933 Act registration for the plan required if there is no specific company stock fund under the plan but company stock is a permitted choice under the open brokerage window?

Suggested Answer: Registration of the plan should not be required in this situation *provided that* the company does not affirmatively promote or encourage the purchase of company stock. The employee's purchase is being made on the open market and, from an investment standpoint, is no different from a purchase made directly through his broker. The fact that the funds are required to remain in the plan's trust should be irrelevant as long as the employee's ability to sell the company stock in his plan account is the same as would be the case had the transaction been made directly with his broker. A requirement to register plans that offer an open brokerage window would create administrative burdens because it would require companies to monitor and track self-directed investment accounts of their employees and could result in registration of many plans in which no company stock was purchased.

SEC RESPONSE: Release 33-4790 (permitting open market stock purchase plans with limited employer involvement to be operated without 1933 Act registration) has been construed narrowly by the Staff. Merely having the purchases made through a 401(k) plan goes beyond what 33-4790 covers, so registration is required (unless purchase of Company stock is prohibited). The Staff will give further consideration to this issue.

1933 Act General

31. **Nonprofit Entity Deferred Compensation Plan.** A tax-exempt nonprofit hospital establishes a nonqualified deferred compensation plan under section 457(b) of the Internal Revenue Code for its physicians and management employees. The hospital structures the plan so that it is an unfunded arrangement (to comply with ERISA and the Internal Revenue Code) and obligations are to be paid out of the hospital's general assets. The plan allows participants to select from among a number of measuring investments to determine the rate of return earned by their contributions. Does the plan involve an offering of securities that must be registered under the Securities Act of 1933, or would the plan be exempt from registration pursuant to Section 3(a)(4) of the Securities Act, which exempts from registration: "Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual …"?

SEC RESPONSE: Obligations under non-qualified deferred compensation plans are securities of the issuer. Having an IRS tax-exempt ruling is only the first part of the analysis as to whether the securities would be exempt under Section 3(a)(4). There are prior cases and no-action letters in the area under which a more nuanced analysis is required. The Staff advised using caution in this area.

Topic for Discussion
Above-Market or Preferential Earnings on Deferred Compensation

The Summary Compensation Table is required to include "above-market or preferential earnings on compensation that is deferred on a basis that is not tax-qualified." The Instructions to this item address how to determine whether interest is above-market and whether dividends on company stock are preferential, but do not address other types of actual or deemed investments on deferred compensation. Interpretation 4.03 of the Staff's Guidance on Item 402 of Reg S-K (last updated February 12, 2007) provides that earnings on deferred compensation are not preferential where the return is calculated in the same manner and at the same rate as earnings on externally managed investments made available to employees in broad-based tax-qualified plans. However, the Interpretation then appears to limit the application of the position expressed in the preceding sentence by stating that such position "may not be appropriately applied" if the non-qualified plan bears no relationship to a tax-qualified plan of the issuer.

We would like the Staff to reconsider the above interpretation. We believe that earnings on deferred compensation should not be treated as "above-market or preferential" if calculated in the same manner and at the same rate as earnings on any actual investments that are publicly available. The purpose of the earnings disclosure in the Summary Compensation Table is to disclose amounts that, while ostensibly paid as "earnings" are in reality additional compensation. To the extent the earnings that are credited on deferred compensation represent an actual rate of return on a specified actual investment, they should be viewed as earnings, not as additional compensation, and thus are not appropriate for disclosure in the Summary Compensation Table. This is the approach taken by the tax laws, such as the regulations under Section 162(m) and Section 409A and the FICA regulations under Section 3121(v) of the Code.

It is our view that whether a non-qualified plan is or is not related to a tax-qualified plan should be irrelevant to whether the earnings credited under the non-qualified plan are preferential or not. Moreover, we believe that there may be valid reasons for an issuer to use different investment funds for its tax-qualified and non-qualified plans, and that the use of different investment funds should not drive the determination of whether the earnings are above-market or preferential.