January 15, 1997

SEC Issues Interpretations to New Rule 16b-3

The Staff of the Securities and Exchange Commission (SEC) has recently issued three interpretative letters answering questions raised in applying new Rule 16b-3.[1] These letters codify some positions previously stated in public forums by Staff members and provide guidance on some additional issues. Generally, the Staff's approach is consistent with the liberal and ease-of-administration approach inherent in the new Rule. The issues covered include: the determination of "non-employee director" status, distinctions between "discretionary transactions" and other volitional transactions, and tax-conditioned plan questions.

As a refresher, Rule 16b-3 is the avenue the SEC has provided to exempt compensatory stock-based insider stock transactions from the short-swing profit recovery provision of Section 16 of the Securities Exchange Act of 1934. Without the Rule, it would be extremely difficult to effectively operate executive and director stock plans since plan and non-plan opposite-way transactions within six months of one another, e.g., the acquisition of a stock option followed by a sale of company stock (or vice versa) could be matched. In the absence of exemptive relief, this would require the company to recover any resulting "profit" from the insider involved.

Effective November 1, 1996, all public companies have had to rely on a new Rule 16b-3 for such exemptive relief. Most observers would agree that this Rule is a major improvement over the two concurrent rules it replaced. Under the new Rule, which is focused solely on transactions (as opposed to plan design and shareholder approval requirements), there are four avenues by which transactions by officers and directors can be exempted from Section 16(b) short-swing profit recovery:

1. ***Tax-Conditioned Plan Transactions*** -- Many transactions, e.g., new contributions and purchases and fund switching under ERISA-mandated diversification requirements, are simply exempted if the transaction occurs under a tax-qualified plan or a clone plan intended solely to keep whole participants in higher pay levels who are affected by the contribution limits imposed by ERISA. Exceptions to the tax-conditioned plan exemption are (1) switches between a company stock fund and another investment fund (or account), and (2) certain cash settlements of stock-based funds.

2. ***Company-Sponsored Grants, Awards and Other Acquisitions*** -- The receipt of stock-based awards, e.g., stock options, SARs, restricted stock, etc., is exempted if approved by a committee of "non-employee directors," the full Board, or shareholders. Alternatively,

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[1] In chronological order, these interpretative letters are: *Gibson, Dunn & Crutcher LLP* (November 2, 1996); *American Society of Corporate Secretaries* (December 11, 1996); and *American Bar Association* (December 20, 1996).

if a stock award, or a stock-based award and the underlying securities, is retained by the officer for at least six months, such an acquisition will be exempt.

3. ***Dispositions to the Company*** -- Any cash-out by the company of a stock-based award will be exempt if approved in advance by a non-employee director committee, the full board, or by shareholders.

4. ***Discretionary Transactions*** -- These involve certain transactions triggered by volitional elections by officers or directors to convert stock or stock units into cash, or cash into stock or stock units. In particular, volitional fund-switching transactions within a retirement, savings or deferred compensation plan are deemed discretionary transactions. In order for a discretionary transaction to be exempt, the *election* triggering the transaction must occur at least six months after any prior *election* triggering an opposite way transaction, e.g., an election to move deferred bonus dollars from a cash account to a company stock account must be made at least six months following an election to move 401(k) plan money from a company stock fund to another fund.[2]

With the above as background, the following briefly explains the initial interpretations of Rule 16b-3 that have been provided by the Staff.

Non-Employee Directors

Since most companies will be relying on committee pre-approval to exempt officers' acquisitions from and dispositions to the company,[3] it is essential that the committee be comprised solely of two or more persons who meet the Rule's definition of non-employee director. Other than, of course, not being a current employee of the company, a director qualifies for Rule 16b-3 committee approval purposes if he or she:

— is not earning (other than for board duties) more than $60,000, either directly or indirectly, in remuneration for services to the company;

— does not have a pecuniary interest of over $60,000 involving the company which would require proxy statement disclosure; and

— is not engaged in any other business relationship that requires disclosure in the company's annual proxy statement.

The Staff has provided the following interpretative guidance on meeting the non-employee director criteria. First, if a company's compensation committee is not totally comprised of non-employee directors, use of a sub-committee of at least two non-employee directors for actions needing Rule 16b-3 approval will suffice. Alternatively, the abstention from voting on Rule 16b-

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2 Note that it is the timing of the *elections* that is key and not the timing of the actual transactions.

3 This is the case because of corporate governance issues, tax deduction concerns in the face of the $1 million cap, and consistency with past practice.

3 approvals by all non-complying members will also suffice, provided, of course, at least two non-employee directors vote. Another solution, alluded to in the Staff's interpretation and inherent in the Rule, is to permit the full committee to vote, but require that for any committee action to be effective, it must be ratified by the full Board.[4]

The proxy statement disclosure rules that can taint a director's "non-employee" status look back to the start of the last fiscal year and carry through to the proxy statement mailing date. In addition, any then-currently contemplated transactions or business relationships also require disclosure. This raises the question as to whether a person can qualify as a non-employee director in the current fiscal year when, for example, a business relationship requiring current disclosure has been terminated, or a transaction or relationship might result during the remainder of the current year. The Staff took the reasonable position that if a tainting condition had been previously terminated, the person would qualify as a non-employee director for subsequent approval items. As to the possibility of a future transaction or a relationship emerging that would taint non-employee status, the Staff held that a company must make a good faith effort, based on the best information available to the company, including responses to queries put to directors by the company, to ascertain that no tainting disclosure condition will arise during the year. Once a company has good reason to believe that a tainting condition will emerge, the affected director will no longer qualify for non-employee status. However, such a determination will *not* result in a retroactive retraction of the exemptions for transactions approved by the director earlier in the year.

One of the SEC's proxy statement disclosure requirements is that any direct or indirect transaction in excess of $60,000 between the company and a family member of a director must be disclosed. The Staff has taken the position that any such transaction in which the director does not have a direct or indirect interest will not taint the director's non-employee status, even though the transaction is disclosed. Finally, the Staff made it clear that companies can rely on exemptive relief under the disclosure rules and interpretative positions taken by the Staff to preserve non-employee director status, presumably even where disclosure has been made because of conservative or fuller disclosure positions taken by legal counsel.

Pre-Approved Exemptions

Confirming previous public statements by Staff members, subsequent transactions which occur in conjunction with grants and awards that were exempted under one of the predecessor Rules must meet the conditions of the new Rule to secure their own exemptions. Thus, for example, tax withholding using grant shares at the time of option exercise or the vesting of restricted stock, will need proper approval in advance. If the compensation committee approving the original grant containing the tax withholding feature had one or more participating member who did not qualify as a non-employee director under the new Rule, the disposition will not be exempt unless the tax withholding right is re-approved by a complying committee, the full board or

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4 Presumably, consistent with the Staff's position on committee voting, approval of a CEO transaction by all members of the board, *except* the CEO who had recused himself, will meet the Rule's approval requirement.

shareholders.[5] Presumably, companies facing such situations have had a complying committee or the full board of directors already ratify the prior inclusion of post-grant transaction features such as stock-for-stock exercises, reload stock option rights and, of course, stock-for-tax withholding. If not, they should act now to assure proper pre-approval.

To be exempt under the pre-approval conditions, a disposition to the company cannot include a discretionary transaction. While the exercise of a stock appreciation right settled in cash in lieu of exercising a tandem stock option would appear to be a "discretionary transaction" under the Rule ("... a cash distribution funded by a volitional disposition of an issuer equity security"), the Staff has confirmed that such a transaction, though volitional, is exempted as a disposition to the company if the terms and conditions of the exercise are included in the original grant or are properly approved prior to the actual exercise. More importantly, the Staff appears to be saying such a transaction cannot be a discretionary transaction since "the security has not been held in a multi-fund plan." Thus, until there is further clarification from the Staff, volitional cash settlements of derivative securities such as stock options, and SARs or other phantom stock rights need to rely solely on the pre-approval exemption for dispositions to the company.

One of the interpretative letters from the Staff deals with the exemptive relief for deferred compensation plans where participants' accounts are denominated in stock units. Provided (1) that the participants cannot move account dollars out of or into a deferred stock unit account, and (2) the terms of the plan or the specific transactions have been spelled out as part of the complying approval, the creation of a deferred account and additional credits for future deferrals (as well as dividend reinvestment credits) *and* the eventual cash settlement can all be exempted as pre-approved transactions. However, the Staff has made it clear that if a participant is permitted to subsequently elect the payment date(s) or change the originally chosen payment date(s), exemptive relief for the eventual cash settlement would have to come from a subsequent pre-approval of the payment timing election.[6]

The Staff also confirmed that pre-approval of a plan by the committee of non-employee directors or the full board can secure exemptive relief for elections by outside directors to take annual retainer and meeting fees in shares or stock options.[7] The Plan, however, would have to spell out the election timing, terms, scope of fees and retainer eligible, the formula for determining the number of shares involved, and all other relevant conditions. This means that pre-approval of each transaction resulting from a director's election to take stock in lieu of cash would not be necessary for Rule 16b-3 purposes. The same would be true for proper pre-approval of a deferred compensation plan for officers.

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5 The only exception is the settlement of cash-only grants which were awarded in reliance on the blanket exemption of old Rule 16a-1(c)(3) which excluded these grant types from the purview of Section 16.

6 If the deferred stock unit account could only be settled in shares, reliance on the six-month holding period for exemptive relief for acquisition of the shares would appear to be available.

7 Approval by the shareholders will also work, including approval *after* the initial transactions under the Plan, provided such approval occurs no later than the annual meeting following the first plan transaction.

Discretionary Transactions

The Staff's distinction between what constitutes a discretionary transaction and what does not appears to focus on either of two conditions:

— Volitional fund switching regardless of whether real stock or stock units are involved; or

— Voluntary cash-outs of a plan stock that result from market sales, as opposed to sales to or cash-outs by the company (except for such cash-outs exempted under the tax-conditioned plan exemption, e.g., a distribution from an excess plan upon retirement).

If either of these conditions exists, then generally a discretionary transaction has occurred.

What is not clear is whether an elected payment of cash from a deferred stock unit account can be exempted as a discretionary transaction since no sale of shares in the open market has occurred and instead there has been a disposition to the company.[8] Where the only discretionary transactions permitted by officers are dispositions (thus, eliminating the possibility of any prior opposite-way discretionary acquisitions subject to the Rule), such relief may be preferred by a company since pre-approval of cash payment elections by officers would not be needed. While providing discretionary transaction relief would appear consistent with the language of the rule ("cash distribution funded by a volitional disposition"), the Staff appears to have taken a counter position, though, admittedly, the above example was not in any of the interpretative requests released by the SEC.

The Staff has cited two situations which are not discretionary transactions because they are not subject to Section 16. The first is a decision to not purchase shares under an employee stock purchase plan and instead withdraw the cash that has been withheld through payroll deductions. The second is to elect to take current cash instead of stock as a form of payment of one's bonus.

Six-Month Holding Period

If an insider dies, does the exercise of a stock option by the deceased's estate and concurrent sale of the underlying shares within six months of the option's grant result in retroactive loss of the grant's exemption in reliance on the holding period exemptions? Provided the estate or the executor is not subject to Section 16, the Staff holds that the six-month holding period exemption will not be lost. Interestingly, although not cited in either the requesting letter or the Staff's response, the SEC had given a similar but broader response in regards to the application of interim Rule 16b-3.[9]

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8 As noted in footnote 6, a payment in stock resulting from an election to receive stock as the form of payment of a deferred stock unit account should be exempt under the six-month holding period relief for acquisitions from the company.

9 *Shea & Gould*, Q. 2 (April 26, 1991); this interpretative response gave a blanket exemption to such a disposition within six months of acquisition in reliance on Rule 16a-

Tax-Conditioned Plan Transactions

The Staff provided several interpretative positions regarding exemptive relief for transactions conducted under tax-conditioned plans. For one, the tax-conditioned exemption is *not available* to plan transactions if the plan includes deferred stock unit accounts made up of credits for both an "excess benefit plan" and an executive deferred compensation plan. Transactions under such a plan cannot be bifurcated so that excess benefit plan credits are exempted under tax-conditioned plan provisions, and the deferred compensation credits are exempted under the pre-approved plan or six-month holding period exemptions.[10] Both transactions would need to look to the company-sponsored acquisitions exemption.

A movement out of a company stock fund or account which is required to be made available to participants under ERISA and its regulations for portfolio diversification reasons is exempted as a transaction under a tax-conditioned plan. The Staff held that, if a company provides more liberal diversification terms than the minimum ones required under tax law, the tax-conditioned plan exemption will not be lost, provided the more liberal provisions are extended to all plan participants and are allowable under ERISA. Likewise, earlier than ERISA-mandated initial distributions from a tax-qualified plan and an excess benefit plan will be afforded the exemption.

In the adopting release for new Rule 16b-3, the SEC noted that loans funded by a sale of company stock under a tax-conditioned plan would be a discretionary transaction and, accordingly, would not qualify for the tax-conditioned exemption. However, in an interpretative response, the Staff concurred that the repayment of the loan involving an investment in company stock fund under a qualifying plan is exempted as a tax-conditioned plan transaction, even when the participant has determined the timing of the investment, i.e., accelerated repayment of the loan.

Reporting of Stock Units/Phantom Stock Awards

The SEC provided reporting guidance for exempt transactions involving stock units. For one, an election to participate in a plan, e.g., to have a future bonus payment deferred into a company stock unit account, is not a transaction subject to Section 16 and thus is not reportable. Further, the acquisition date for the deferred stock units would be when they are credited to the participant's account, provided vesting and earn-out is not subject to performance criteria other than continued employment and/or passage of time. The Staff's response used the term "any performance criteria" apparently overlooking the fact that in the adopting release such performance criteria was limited to "non-market price based condition(s)." Presumably a phantom stock award that is earned based on the company's stock price reaching a prescribed higher level would *not* cause a delay in reporting until the award was earned.[11]

2(d)(1)(i) which exempts from Section 16 transactions by executors and administrators of an estate during the first 12 months following appointment as such.

[10] Intra-fund transactions would need to rely on the discretionary transaction exemption regardless of the funding source.

[11] Our firm has challenged the SEC, to no avail, on the logic of deeming a derivative security not to exist simply because its earn-out or conversion to actual stock is

Additionally, the Staff, consistent with prior interpretative positions, stated that companies can elect to report non-performance contingent stock units which are only payable in stock as equity securities rather than derivative securities, thus avoiding the somewhat confusing alternative reporting of the simultaneous disposition of the stock units and the acquisition of actual stock at time of payout.

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The information in this letter represents our understanding of the Staff's interpretative positions and the application of new Rule 16b-3. Specific company situations should be reviewed by legal counsel. Questions or comments of a general nature may be directed to Larry Bickford in our firm's New York office at (212) 986-6330.

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contingent on company financial performance, e.g., return on equity. Our position is that a contingent derivative security is no different from an equity security for Section 16 purposes; thus, a performance-based derivative security should exist on day one just like a restricted performance share does.