August 2, 1996

SEC ADOPTS A RADICALLY DIFFERENT RULE 16b-3

On May 31, 1996, the SEC adopted a new Rule 16b-3[1] (New Rule) which does not differ significantly from the rule change proposed this past October.[2] The New Rule, which is effective August 15, 1996, with a phase-in period extending through October 31, 1996, will make it much easier for companies to exempt compensatory stock transactions by insiders from the reach of short-swing profit recovery. The rationale behind the New Rule is that compensatory transactions under tax-qualified plans or ones that meet other objective "gate-keeping" standards do not generally provide the opportunity for the speculative abuse which Section 16(b) of the Securities Exchange Act of 1934 was intended to deter. Profits gained from compensatory stock-based transactions between an insider and the company are typically at the expense of the company rather than the public market participants for whose protection Section 16 was designed.

Highlights of the New Rule

— The requirement for plan approval by shareholders has been eliminated

— Obtaining exemptive relief for many acquisitions and dispositions of stock between an insider and the company can be as simple as securing approval for the transaction from the compensation committee, board of directors or shareholders

— Generally, an acquisition of stock from the company will be exempt if the shares, or a stock option and its underlying shares, are not transferred or sold until at least six months after the grant has been made

— The concept of a "disinterested" compensation committee has been replaced by a tougher standard of independence which is similar to that under Internal Revenue Code (IRC) Section 162(m) -- the $1 million compensation deduction cap

— "Routine" transactions under tax-qualified and mirror "excess" plans will be automatically exempt

— Elections to switch funds and volitional cash settlements under §401(k) or deferred compensation plans have to occur six or more months after an opposite-way election for these transactions to be exempt

1 SEC Release No. 34-37261.
2 See our letter of November 3, 1995.

— Requirements for "window-period" transactions have been eliminated

— Stock-for-tax withholding transactions can be exempt if the underlying grant is exempt and contemplated such a transaction

— The exemption for cash-only awards that derive their value from stock price movement has been eliminated; these grants will be treated like all other equity-based grants under the New Rule

— "Tax-conditioned plan" transactions exempted under the New Rule will be totally exempt from Section 16(a) reporting requirements

Like the current and predecessor Rule 16b-3, the New Rule is intended to provide exemptive relief to insiders for employee plan transactions in company stock from the six-month buy-sell and sell-buy prohibitions imposed by Section 16. In the absence of such a rule it would be very difficult for officers and directors to participate in company compensatory stock plans and arrangements without triggering inadvertent short-swing profit violations.

Four Categories of Exemptive Relief Under the New Rule

There are four categories of transactions between an insider and the company which may have exemptive relief. This is not to say, however, that all types of transactions entered into by an insider must qualify under Rule 16b-3 for exemptive relief since there are other places within Section 16(b) that provide means for some transactions to be exempted.[3] Also, Section 16 provides no exemptions for purchases and sales on the open market. (See the Attachment for a technical summary of avenues for exemptive relief for many compensatory transactions.)

1. Transactions under Tax-Conditioned Plans[4]

Many transactions under plans that comply with or mirror Internal Revenue Code (IRC) or ERISA requirements are automatically exempt. Such plans include "Qualified Plans" (i.e., those that satisfy the coverage and participation criteria of IRC Sections 410 and 401(a)(26)), "Excess Benefit Plans" (i.e., those operated strictly in conjunction with a qualified plan) or "Stock Purchase Plans" (including some that do not satisfy IRC Section 423 non-discrimination criteria). Shares acquired through new or on-going company or individual contributions and dispositions in the form of cash withdrawals resulting from termination of employment are automatically exempted. However, transactions under these plans that are the result of volitional fund-switching or certain cash withdrawals prior to termination of employment are deemed to be "Discretionary Transactions" and must satisfy other requirements to be exempt (see discussion below).

[3] E.g., Rule 16b-5 (bona fide gifts and inheritance) and 16b-6(b) (exercise or conversion of a derivative security)

[4] Rule 16b-3(c).

2. Grants, Awards and Other Acquisitions from the Issuer[5]

For acquisitions (other than "discretionary transactions") of stock, stock options and other stock-based grants, there is broad exemptive relief available under the New Rule through two avenues: proper approval of the transaction or a six-month holding period. The *prior* approval of an acquisition by the board of directors, a committee comprised solely of no less than two "non-employee" directors[6], or shareholders, or *later* ratification by shareholders (no later than the next annual meeting), provide a direct exemption both for the grant itself and any subsequent acquisition of the underlying shares. Alternatively, if at least six months lapse between the grant and disposition of the award or the underlying shares, the grant and the acquisition of the underlying shares is also exempt.

An exercise of a stock option or stock appreciation right remains automatically exempt under Rule 16b-6(b), provided that the stock option is not underwater, regardless of whether or not the grant was an exempt acquisition. Under the New Rule, the exercise, i.e., actual acquisition of the underlying shares, can also be exempted, even if the option is underwater[7], through proper approval of the exercise terms at grant or some later time prior to the transaction.

3. Dispositions to the Company[8]

A disposition of stock by an insider to the company, unless deemed a "discretionary transaction," is exempt provided that the transaction is approved *in advance* by the full board, a committee of non-employee directors, or shareholders. This provision covers inherent "sales" such as the cash settlement of an SAR, shares withheld to cover taxes, or a stock-for-stock exercise, if such a transaction was contemplated in the original approved grant or is approved as additional terms subsequent to the grant, but prior to the disposition itself. Likewise, a sale of a stock option back to the company can only be exempted through proper approval and *not* by having held the option for at least six months.

4. Discretionary Transactions[9]

The fourth avenue of exemptive relief is limited to transactions in which (1) monies are switched into or out of a company stock-based fund or (2) there is a cashout from a company stock-based fund, within the parameters of any plan maintained by the company that contains such funds. Exceptions would be intra-plan transfers effected to comply with the Internal Revenue Code diversification criteria, cash withdrawals made pursuant to termination of employment, or "sales" such as pre-established cash payments, i.e., dispositions to the company, of deferred compensation denominated in stock under a plan or arrangement having complying approval. Discretionary transactions are exempt only if effected pursuant to an *election* that was made at least six months after a prior *election* triggering an opposite-way discretionary transaction made under any plan or arrangement. For example, moving monies from one fund into the company

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[5] Rule 16b-3(d).

[6] See discussion below for more information on the "non-employee" definition.

[7] Exercise of an underwater option could rationally occur if the exercise triggers bonus or premium shares or the payment of accumulated dividend equivalents.

[8] Rule 16b-3(e).

[9] Rule 16b-3(f).

stock fund under a 401(k) plan would not be exempt if *within* six months before the election another election had been made, for example, to move money out of any company plan stock fund or to make a hardship withdrawal from a stock unit account under a deferred compensation plan. However, the original transaction, the earlier disposition in our example, does not lose its exemption, i.e., once a discretionary transaction is deemed exempt, the exemption cannot be lost. The New Rule does not include any exemptions for discretionary transactions that take place during a window period after the release of financial and other information. While this exemption, which existed in prior 16b-3 rules, allowed less flexibility in the timing of such transactions, it was a relatively easy alternative avenue for insiders to obtain exemptive relief.

Transition and Effective Date

Companies must rely on the New Rule for exemptive relief of all transactions with insiders by November 1, 1996. Earlier adoption is permitted after August 14, but such adoption must be for all insider transactions under plans. However, for cash-only grants or for individual transactions under arrangements outside of a plan, exemptive relief may be obtained under the New Rule without necessitating adoption for all other plans and transactions.

Section 16(a) Reporting Requirements

Exemptions and Timing

Along with the Rule 16b-3 changes, Section 16(a) reporting requirements have been generally simplified. The major purposes of these filings are to monitor compliance with Section 16 and to provide market investors with information on how insiders view the prospects for their company's stock. Some compensatory transactions, the SEC has theorized, do not provide information useful to market participants and so have been eliminated from the reporting requirements. Among these are transactions exempted under the New Rule as tax-conditioned, transactions that occur once the individual is no longer an insider (so long as there was no opposite-way non-exempt transaction within the prior six months while the individual was an insider), and exempt cancellations or expiration of a derivative security where no value is received (such as the expiration of an underwater stock option at the end of its term).

Under the new reporting rules, most transactions exempted under the New Rule need not be reported until a Form 5 is filed at the end of the year (i.e., within 45 days of the close of the issuer's fiscal year). The exception is exempt exercises or conversions of derivative securities, e.g., stock options and SARs, which must be reported on Form 4 within 10 days of the end of the month during which the reportable transaction occurred. Any Form 5 reportable transaction may also be voluntarily reported earlier on Form 4. Reliance on the new reporting rules for Rule 16b-3 exempt transactions can only happen once the company has adopted the New Rule. (The Attachment includes a summary of the reporting requirements for the compensatory transactions listed.)

Proxy Statement Disclosure of Delinquent Filings

Under Item 405 of Regulation S-K, a company is required to disclose in its annual meeting proxy statement any instance of late filings or failures to file under Section 16(a). Currently, there is no specific guidance on where and how this disclosure is to be made. Some companies have used this unspecificity to bury such disclosure in footnotes to the beneficial ownership table or in the back of the proxy statement. The SEC has amended Item 405, effective for proxy statement filed after August 14, 1996, to require that all Section 16(a) filing delinquencies be reported under the following caption: "Section 16(a) Beneficial Ownership Compliance."

Practical Implications

Non-Employee Board Committee Approval

We believe most companies will rely on approval by a non-employee committee to secure exemptions for most acquisitions. This approach is simple, consistent with current practice, and will enable companies to avoid some of the pitfalls inherent in the New Rule as discussed below.

-- For Transferable Stock Options

Reliance on the six-month holding period exemption could be a problem for transferable stock options. The greatest benefit from transfer can occur when the stock option is at its lowest value, i.e., generally at grant before the stock price appreciates. However, the transfer (which if in the form of a gift would be an exempt disposition under Rule 16b-5) within six months of grant would cause the original acquisition of the option by the insider to be non-exempt and matchable with a non-exempt sale or other disposition of company stock. Thus, approval of the stock option grant, including the transferability provision, will be the most prudent avenue for relief.

-- For the $1 Million Compensation Deduction Limit

Complying committee approval is necessary for deductibility of compensation in excess of $1 million under IRC §162(m). Note that the definition of "non-employee" directors for purposes of the New Rule is somewhat different from the definition of "outside" directors for purposes of §162(m). For example, for New Rule purposes a former officer of the company qualifies as a "non-employee" director but does not qualify as an "outside" director for purposes of §162(m). On the other hand, disclosure of certain relationships under Items 404(a) or (b) of Regulation S-K may not taint §162(m) qualification but will preclude committee service for purposes of the New Rule. Therefore, a simple way to reconcile the committee make-up is to first ensure §162(m) qualification and then check for any interrelationship disclosure required by Item 404(a) or (b) of Regulation S-K. This will exclude from the committee, for example, consultants and others earning greater than $60,000 from the company in a capacity other than as a director, any lawyer or investment banker whose firm has received fees from the company, and any person employed by an entity that receives more than 5% of its gross revenue from the company.

-- For a Broad Group of Executives

At some companies, grants made to non-insiders are approved by the CEO under broad delegation authority granted by the compensation committee. If an executive later becomes an insider, this could create a problem for certain transactions such as a stock-for-stock exercise. Without proper prior approval of the transaction, the disposition of the tendered shares would not be exempt and could be matched with any non-exempt acquisition within a six-month period (on either side of the disposition). One remedy for such a situation would be to obtain committee approval for a broader group of executives than those subject to Section 16 at the time of grant. Alternatively the board could ratify the features of the executive's outstanding awards at the same time the executive is elected to the position that makes him/her subject to Section 16.

Six-Month Holding Period

In addition to relying on committee approval, companies should consider imposing a six-month or longer holding period on certain grants even if it is not the avenue selected to provide the exemption. This will avoid possible bad press and shareholder ire resulting from the appearance or possibility of short-swing profit-taking, while also providing a back-up exemptive avenue.

Re-Approval of Prior Conditions

In public forums, the SEC staff has stated that transactions which occur once the New Rule is adopted will need to rely on the exemptive conditions of that Rule and will not be grandfathered exemptive relief simply because they would have been exempt under one of the prior 16b-3 rules in effect at the time of grant[10]. For example, foregoing the delivery of a portion of shares acquired upon the exercise of a stock option to settle tax withholding requirements constitutes a "sale." While this disposition may occur in a way which met prior rule requirements, e.g., election to use stock withholding made in a window period, the disposition still has to meet the New Rule requirements to be exempt. Prior compensation committee approval of stock-for-tax withholding in the option agreement or the plan will suffice *provided* the committee, at the time the option was granted, met the new non-employee director standard. Since this may not be the case in some situations, companies should consider having features in outstanding grants, such as stock-for-stock, stock-for-tax and reload option rights, re-approved or ratified by a proper committee or the full board before adopting the New Rule.

Grants to Directors

Because the "disinterested" director concept has been dropped, awards to, and other transactions with, directors are easily exempted so long as the applicable conditions discussed earlier are met. For example, under the New Rule, grants approved by the board of directors or the complying committee of directors would be exempt even if individual directors received different amounts and types of awards. And, of course, these awards would not have to be made under a shareholder approved plan. However, given the increasing amount of corporate governance and director compensation scrutiny by shareholders and the media, it is unlikely that many companies

[10] 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 had excluded these grant types from the definition of derivative security.

will differentiate among awards to directors. Nor are they likely to grant stock options or restricted stock awards without having a shareholder-approved plan. Accordingly, we would expect many companies to continue to utilize "formula-type" plans approved by shareholders since such approval is sufficient to exempt both acquisitions and dispositions by directors.

Future Shareholder Approval

There is no longer any requirement for shareholder approval of plans or arrangements. However, this probably will not result in companies abandoning shareholder approval. Each company must consider the laws of the state in which it is incorporated, its policy with regard to the million dollar limit, rules governing the listing of shares on any stock exchanges where its shares are traded, and the relationship between management and shareholders. State incorporation laws requiring shareholder approval of shares issued to officers and directors and stock exchange rules for shareholder approval of newly listed shares will have crucial impact on decisions regarding whether future shareholder approval should be obtained. Those companies desiring to grant "incentive stock options" (or to have the ability to do so) will continue to seek shareholder approval as required by IRC §422. And all companies, especially those whose shares are largely held by institutional investors, will have to weigh how much input into compensation practices shareholders should have and how much they expect, particularly with regard to potential shareholder dilution.

"Cashless" Exercises

There are some seeming inconsistencies under the New Rule. For example, an insider garners the same economic benefit from a cash SAR settlement as from a third party "cashless" exercise. Yet the former is exempt while the latter is not, even if it is specifically provided for under the plan or option agreement. Dispositions under cashless exercise programs, in which exercise of the option and sale of the underlying shares are transacted through a third party, are *not* exempt since the disposition would not be to the issuer but rather to a market participant. Note, however, that the SAR results in compensation expense to the company, whereas the cashless exercise does not.

Non-Stock-Price-Based Performance Vesting

The SEC has made, and has indicated that it will continue to make, a distinction between grants with performance vesting based on stock price versus vesting based on some other measure of performance. The former are considered derivative securities at the time of grant, and therefore the acquisition occurs at the time of grant. The latter, for example, stock options or performance share units that vest based on EPS achievement, are not considered derivative securities, and therefore are not deemed to be acquired, until vesting or earnout. For example, stock appreciation rights with EPS performance vesting would not be considered acquired until the EPS targets had been met and the SAR vested. Unless there has been proper approval or ratification, the exercise, if the settlement is in cash, must occur at least six months *after vesting* for the acquisition to be exempt. Without approval, the cash settlement of the SAR would be a non-exempt disposition which could be matched against a non-exempt acquisition[11]. If the payment to the insider was made in shares there is no need for approval by the compensation committee, board or shareholders for exemptive relief so long as the shares are held six months or longer after exercise. However, prior approval would be needed if the transaction involved stock-for-tax withholding.

Stock In Lieu of Cash Payments

Because an election to receive stock-based compensation in lieu of a cash payment, e.g., stock option in lieu of a cash bonus, effectively results in a volitional purchase of company stock by an insider, exemptive relief from Section 16(b) is crucial. Under the New Rule such a transaction would appear, at first blush, to be a discretionary transaction which would have to result from an election made six or more months after the most recent election effecting a sale. However, the SEC staff has made it clear at public forums that such a transaction is not a discretionary transaction since it does not involve fund switching. Therefore, since the grant of a stock option is not an acquisition pursuant to a tax-conditioned plan, the only available avenue of exemptive relief is under Rule 16b-3(d), "Grants awards and other acquisitions from the issuer."

Accordingly, if the option were not transferable (and the underlying shares could not be sold) until six months following the grant date, the acquisition of the option and the shares eventually acquired upon exercise would be exempt from Section 16(b). However, for purposes of IRC §162(m), approval of the option grant by a proper committee would be needed to ensure the deductibility of the option gain at exercise by the granting corporation. If the company has a plan or resolution approved by a committee that met both §162(m) and Rule 16b-3 standards, and the plan or resolution included the optionees' unqualified eligibility to elect to take future bonuses in the form of stock options under a pre-established formula with the other terms and conditions of the options also prescribed, such approval should also suffice to exempt the grant of the option for both IRC §162(m) and Section 16(b) purposes even though the grant could be considered "volitional."

Cash-Only Stock-Based Awards

As noted under the "highlights," the blanket exemption from Section 16 for stock-based awards payable only in cash will be eliminated as part of the SEC's changes in the Section 16 rules. Thus, any cash-only awards granted after August 14, 1996, will be derivative securities subject to both Section 16(a) reporting and Section 16(b) short-swing profit recovery. However, given the simplicity of the New Rule, Section 16(b) exemptive relief should be readily available for both the grant and the cash-out of such future awards.

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11 Under the SEC's theory, articulated in adopting a new Section 16 framework in 1990, the acquisition of the SAR and its cash settlement would presumably not be matchable if vesting and exercise were simultaneous since the transactions would constitute the delivery of compensation earned by performance other than stock price appreciation, i.e., EPS target achievement. Only appreciation in stock price following vesting would be recoverable profits if matched against the acquisition of the SAR, i.e., additional gain realized from a cash settlement exercise occurring within six months of vesting.

Since the blanket exemption of such awards will no longer be available and because of the variable expense treatment required for computing company earnings, companies should seriously consider using grants of actual shares or at least making payments for phantom grants solely in shares. Grants of cash-only awards made prior to August 15, 1996, will continue to be exempt from Section 16 under the current blanket exemptive relief, unless the terms of the grants are materially changed.

Non-Complying "Excess Benefit Plans"

For purposes of the Rule, an "Excess Benefit Plan" is defined as one that not only works in conjunction with a "Qualified Plan" but which also limits the benefits to those that would be provided under the Qualified Plan if there were no ERISA-imposed limits. Some companies have adopted 401(k) "look-alike" plans for their executives which not only overcome the ERISA limits on individual and company contributions but which also provide greater benefits. For example, some companies credit amounts to an executive officer's stock unit account as a "matching contribution" but do not require that the executive make a "contribution" by deferring payment of the compensation being matched. Contributions to and withdrawals from company stock accounts under these plans cannot be exempted as transactions under a tax-conditioned plan and accordingly will need exemptive relief under another section of the Rule.

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The information presented in this letter represents our understanding of the New Rule. Specific company situations should be reviewed with legal counsel. Questions of a general nature can be directed to Larry Bickford or Leslie Winograd in our firm’s New York office at (212) 986-6330.