SECTION OF BUSINESS LAW

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Martin P. Dunn, Esq.
Chief Counsel
Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Section 16 of the Securities Exchange Act of 1934

Dear Mr. Dunn:

On behalf of the Task Force on Section 16 Developments of the American Bar Association Section of Business Law's Federal Regulation of Securities Committee, we are writing to request the Staff's views on several questions of general applicability relating to the new rules under Section 16 of the Securities Exchange Act of 1934.

1. Non-Employee Directors

Rule 16b-3(b)(3) defines a non-employee director as, in addition to certain other requirements, a director (i) who does not receive for services in any capacity other than as a director compensation in excess of the dollar amount for which disclosure would be required under Item 404(a) of Regulation S-K and (ii) who does not possess an interest in any transaction and is not engaged in a business relationship for which disclosure would be required pursuant to Item 404(a) or 404(b) of Regulation S-K. The test under Item 404 is whether any of the described transactions or relationships have occurred since the beginning of the last fiscal year or are currently proposed. By contrast, the language of Rule 16b-3(b)(3) speaks only in the present tense.

Rule 16b-3(b)(3) raises two concerns. First, at the time a director takes action it may be impossible to know whether a relationship will ultimately become one that is disclosable under Item 404. Suppose, for example, a non-employee director is an executive officer of an entity that is doing business with the issuer but at the time the action is taken it is not known whether the 5% threshold in Item 404(b) has already been met or whether it will be met during the current fiscal year. Second, a director who has had a disclosable relationship during the prior year may have terminated it and it is not entirely clear that he or she would qualify as a non-employee director following such termination. The resulting uncertainty makes it difficult for companies to administer their benefit plans.

As to the first concern, we would prefer an interpretive position that tested non-employee status by looking to the last day of the fiscal year immediately prior to the time the action is being taken. If the staff is unable to concur in that approach, however, we believe that an appropriate interpretive approach is to treat a director as a non-employee director if the most recent filing with the Commission that required disclosure of Item 404 information included no Item 404(a) or (b) disclosure about the director and the issuer reasonably believes that no such transactions or relationships are likely during the current fiscal year based on information available to it at the time the action is taken. As to the second concern, even if the most recent filing with the Commission disclosed Item 404(a) or (b) relationships or transactions as to a particular director, if those relationships and transactions have been terminated prior to the time that the action for which exemption is sought is taken, the director would qualify as a non-employee director. Please confirm that these interpretations are consistent with the language of the Rule.

2. **Scope of Discretionary Transaction Definition - Cash Distributions**

Paragraphs (c), (d) and (e) of Rule 16b-3 exclude from their exemptive coverage "Discretionary Transactions". A Discretionary Transaction is defined in Rule 16b-3(b)(1) and includes, among other things, a "cash distribution funded by a volitional disposition of an issuer equity security . . . ." We assume that this requirement must involve a fund established by the issuer or an employee benefit plan of the issuer that holds issuer equity securities. Please confirm that the following are <u>not</u> Discretionary Transactions:

- Cash settlement of an option, SAR or phantom stock right.

Discretionary Transactions occur pursuant to employee benefit plans and involve either intra-plan transfers involving an issuer securities fund or a cash distribution from a plan that is funded by the disposition of an equity security. Thus, the definition should not by its terms apply to options, SARs or phantom stock rights that are stand-alone equity instruments because

they are issued under plans that do not have investment funds and their disposition does not "fund" the payment.

The same analysis should hold true for phantom stock units in a deferred compensation plan where issuer equity securities are the only investment medium. By their nature, these units must be held in a plan. However, the cash settlement of these units is no more a Discretionary Transaction than is the cash settlement of a stand-alone SAR or phantom stock right.

- An election to take a stock bonus award in cash rather than stock.

This transaction should be analyzed as an award of the stock followed by a disposition to the issuer similar to the exercise of an SAR or phantom stock right, both of which would be exempt if the requisite approvals were received under Rule 16b-3.

- Withdrawal of cash from an employee stock purchase plan prior to the end of the purchase period.

In an employee stock purchase plan, participants generally accumulate funds through payroll deductions during a purchase period, which funds are used to acquire securities at an exercise price that is generally not fixed until the end of the period. Because no derivative security is created until the end of the period, there is no disposition of an equity security that can be characterized as a Discretionary Transaction. Even if the exercise price were fixed at the beginning of the period, a cash withdrawal should not be considered a Discretionary Transaction: it is simply an election not to participate in the plan. The cash accumulated bears no relationship to the value of an equity security and a distribution of that cash in no way should be considered to be funded by a disposition of the option.

3. **Scope of Discretionary Transaction Definition: Qualified Plans - The "Required to be Made Available" Requirement**

The definition of discretionary transaction excludes transactions "required to be made available" by the Code. For many such elections, the Code sets minimum standards for plans that are qualified under the Code. Many plans elect to comply with these minimum standards by allowing more generous elections. This question relates to the scope of the phrase "required to be made available" for transactions pursuant to Section 401(a)(9) of the Code.

Section 401(a)(9) requires qualified plan distributions to "commence" no later than April 1 after the year in which the participant reaches age 70-1/2, even if the participant is still employed. (This provision would be eased under the new Pension Simplification legislation, by not requiring distributions until termination of employment, regardless of age, unless the

employee is a 5% shareholder. However, the effective date is several years off.) Once distributions commence, at least a minimum amount must be distributed each year in order to avoid a 50% excise tax. However, the minimum distributions apply beginning in the year the individual reaches age 70-1/2, even though the first distribution is not required to be made until April 1 of the following year. Thus, if the commencement of the distribution is postponed until April 1 of the year after the individual reaches age 70-1/2, the April 1 distribution is deemed to be on account of the prior year (i.e., the year the individual reached age 70-1/2), and a second minimum distribution is required for the current year. To avoid doubling up on the tax in the year in which distributions are required to commence, many plans permit a participant to commence distributions in the year they reach age 70-1/2 (instead of the next April 1). However, this earlier election is not required under the Code.

Similarly, once distributions commence under Section 401(a)(9), minimum distributions must be made. The minimum required distribution is such that the entire interest of the employee will be distributed "over the life of such employee or over the lives of such employee and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary)". (Section 401(a)(9)(A)(ii).) Thus, the minimum required distribution is generally determined by a formula applying the remaining applicable life expectancy to the participant's account balance. Complex regulations apply to these calculations. To simplify plan administration, many plans do not permit participants to string out distributions as long as possible under these minimum distribution rules. They either require all distributions to be made in a lump sum, or they permit installments over no longer than a set period (e.g., 10 years) which will always comply with the minimum distribution rules.

Rule 16b-3(b)(1)(ii) defines "Discretionary Transaction" as excluding transactions pursuant to an election "required to be made available to plan participant pursuant to a provision of the Internal Revenue Code." In a case where the plan's provisions permit the required distributions to begin at age 70-1/2 (instead of the next April 1) and permit (or require) employees to select a shorter distribution period than the maximum period permitted under the Code, the tax-qualified plan complied with the Code requirement by requiring the election to be made as to the commencement and length of the distribution period, but the distributions made pursuant to the plan's provisions may be in excess of (or slightly earlier than) the minimum "required to be made available." Plan provisions exceed the minimums in order to make plan administration less complex or in order to permit employees to avoid bunching of taxable income or to permit smoother transition to retirement. The provisions apply uniformly to all employees, and, since Section 16 has not historically been of concern to qualified plans, they have not been designed or implemented in order to favor Section 16 insiders.

Plan administration (which is already very complex in this area) would be made much more complex if distributions to Section 16 insiders were "Discretionary Transactions" only to the extent they comply with the minimum required rules. You may assume that any election in excess of the minimum standards would apply equally to all plan participants. Please confirm that any transaction pursuant to Section 401(a)(9) of the Code that is designed to comply with the Code requirement is not a discretionary transaction.

4. **Approval of Subsequent Transactions**

Note (3) to Rule 16b-3 states that the required approvals must relate to each specific transaction, not the plan in its entirety, unless the terms and conditions of the transaction are fixed in advance. However, where the terms of a subsequent transaction are provided in the transaction as initially approved, no further approval is necessary. Consider a plan, approved by the board of directors, that defines the class of participants (e.g., all non-employee directors or all employees above a certain salary grade) and permits these participants to elect to defer a specified portion (which could be up to 100%) of their cash compensation in phantom stock units. The election is made prior to the year in which the compensation to be deferred will be paid. At the time or times the compensation would otherwise be paid, the participant instead receives a number of phantom stock units that is based on the then fair market value of the stock. The units will be paid in cash or stock at the participant's election on a later date more than six months after the election (as specified by the participant in the election) or upon death, disability, retirement or termination of service.

Please confirm that (i) the election to participate in the plan is not an event subject to Section 16 and that (ii) approval of the plan itself is sufficient for purposes of Rule 16b-3(d) and (e) to exempt (A) the acquisition of the phantom stock units, (B) the subsequent payout and, if the plan so provides, (C) the crediting of dividends into additional phantom stock units.

Please also confirm that the same treatment would be accorded the payout of phantom stock units in cash where the timing is left to the discretion of the holder. The second and third paragraphs of Section II.E. of the adopting release indicate that the delivery or withholding of securities in payment of the exercise price or to satisfy tax withholding obligations upon exercise of an option and the exercise of a stock appreciation right for cash will be exempt if pursuant to the terms of the award as initially approved in accordance with Rule 16b-3(d)(1) or (2). Stock options and stock appreciation rights are typically exercisable at the discretion of the holder, and there is no apparent reason to treat other employee plan derivatives, such as phantom stock units, differently. Although similar restrictions were contained in prior Rule 16a-1(c)(3)(ii), they have not been included in new Rule 16b-3(e). The transaction is solely with the issuer in either case and has no market impact. To impose a subsequent exercise-by-exercise approval requirement on these instruments unless exercise is restricted to fixed dates or incident to death, disability, retirement or other termination would

impose on plan committees the necessity of arranging cumbersome approval procedures solely for Section 16 purposes under circumstances where the committee has no interest in exercising such oversight and no corporate purpose is served.

In addition, as to the appropriate reporting of the foregoing transactions, please confirm that:

- No Section 16(a) reporting is required upon the election to participate in the plan.

- The acquisition date for the units would be the date the price is fixed and the units are allocated to the participant's account and are not subject to any performance criteria (other than continued employment). We understand that the transactions, if exempt, would be reportable on a Form 5 based on the account statement of the plan administrator and that the transactions may not be reported on an aggregate basis.

- If the units were payable solely in stock, they would be reportable on Table I. The payout would not be reportable if made in stock because it would be a change in the form of beneficial ownership exempt under Rule 16a-13. A payout in cash would be a disposition reportable on Form 5 if exempt.

- If the units were not payable solely in stock, they would be reportable on Table II. A payout in stock would be a disposition of the unit reportable on Table II and a corresponding acquisition of stock reportable on Table I. A payout in cash would be reportable solely on Table II as a disposition of a phantom stock unit, rather than as the exercise of a derivative security and a deemed sale of the underlying securities reportable on both Table I and Table II.

Finally, assume the same facts as above, except that the plan permits participants to choose the deferred amounts to be invested in various phantom mutual funds in addition to issuer stock and to make intra-plan transfers between such funds. Please confirm that the approval of the plan is sufficient to exempt the acquisition of phantom stock units upon the initial crediting of amounts under the plan and to exempt the disposition represented by the payout at the date specified in the election or upon death, disability, retirement or termination of employment.

5. **Domestic Relations Orders**

Rule 16a-12 exempts the acquisition or disposition of equity securities pursuant to a domestic relations order as defined in the Code or Title I of ERISA. The adopting release, at

note 159, suggests that in order to qualify as a "domestic relations order" under these provisions, an order must, among other things, "create or recognize an alternate payee's right to receive all or a portion of the benefits payable to a participant under a plan." This feature is an attribute of a "qualified domestic relations order" under both the Code and ERISA, but this feature is not necessary for a "domestic relations order." The latter term includes any judgment, decree or order, including approval of a property settlement agreement, made pursuant to a state domestic relations or community property law that relates to the provision of child support, alimony payment or marital property rights to a spouse, former spouse, child or other dependent. Please confirm that Rule 16a-12 exempts acquisitions and dispositions of all equity securities pursuant to a domestic relations order, not only securities acquired under employee benefit plans.

In accordance with Release No. 33-6269, seven copies of this request are included with the original letter. Members of the task force are available to discuss any particular aspect of this request and we would appreciate the opportunity to do so before you issue any response.

Very truly yours,

Peter J. Romeo/KFH

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