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August 2, 1991

VIA FACSIMILE
202-272-2677

Mr. Brian J. Lane
Office of Chief Counsel
Division of Corporation Finance
Securities & Exchange Commission
450 Fifth Street N.W.
Washington, D.C. 20549

Dear Mr. Lane:

In accordance with our telephone conversation last week, this will supplement our letter of May 28, 1991 requesting an interpretation of the Commission's Rule 16(b)-3(c)(1) in connection with the acceleration of the vesting period for a derivative security. You have requested further information regarding the acceleration of the vesting period under the stock option plan.

As we previously noted, the Plan Administrator agreed to accelerate the vesting provisions for an employee in connection with the termination of the employment relationship of the employee. The provisions of the Stock Option Plan which are relevant are as follows:

a. Plan Administration. The Plan Administrator is the Board of Directors or a committee of the Board of Directors, in either case, consisting of a majority of disinterested directors. The Plan Administrator has the authority, in its discretion, to determine all matters relating to the derivative securities.

b. Term and Maturity. The Plan provides that the term of each non-qualified stock option shall be as established by the Plan Administrator. The Plan then provides that "unless the condition of this sentence is waived or modified in the agreement evidencing the option or by resolution adopted by the

Plan Administrator" the option will be exercisable 20% after one year continuous relationship with the company from the date the option was granted and an additional 1.666% each month completed thereafter.

c. Termination of Relationship. The Plan provides that if an employee's relationship with the Company ceases, the employee may exercise that portion of the option "which is exercisable at the time of such cessation". The option shall terminate at the end of a three month period unless "such provision is waived in the agreement evidencing the option or by resolution adopted by the Plan Administrator within 30 days of such cessation".

The actual option issued to the ex-employee incorporates the Plan and states that the option "shall vest and become exercisable according to the terms and conditions of the (Plan) and as follows:" and repeats the normal vesting schedule set forth in the Plan under Term and Maturity.

As our letter of May 28, 1991 noted, in connection with the termination of the employment relationship, the acceleration of the vesting period for a certain number of options was done by a unanimous resolution of the Board of Directors and consequently was made in accordance with the Plan. The corporate resolution provided that "the stock option grants for (employee) shall be accelerated to allow for the immediate vesting of (additional) options". We do not believe that this acceleration of the options vested by a resolution of the Plan Administrator in accordance with the Plan constitutes a new grant of the derivative security. We would appreciate receiving confirmation from the staff in this regard.

Please call the undersigned if you need any further information.

Very truly yours,

Robert J. Diercks

Robert J. Diercks

RJD:ce
Enclosure

RJD-122*

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May 28, 1991

Office of Chief Counsel
Division of Corporation Finance
Securities & Exchange Commission
450 Fifth Street N.W.
Washington, D.C. 20549

Dear Sir or Madam:

Interpretative Advice With Respect
to Amended Section 16 Rules

In accordance with conversations with the Staff of the Division of Corporation Finance, the following interpretative question is submitted with respect to the recently adopted amendments to the Commission's rules under Section 16 of the Securities Exchange Act of 1934.

Rule 16(b)-3(c)(1) provides that in order for a grant of an equity security, including a derivative security, to be exempt from Section 16(b), a total of six months must elapse between the grant of the derivative security and the sale of the security underlying the derivative security. If a former employee received the grant of a stock option more than six months before the date of a proposed sale, but in connection with the termination of the employment relationship the Plan Administrator agreed to accelerate the vesting provisions of the stock option, does the change of the vesting period create a "new" derivative security which must be held for six months from the date the vesting provisions are changed? The acceleration of the vesting period was done in accordance with the existing Plan.

Thank you for your assistance in connection with this inquiry.

Sincerely,

Robert J. Diercks

Robert J. Diercks

RJD:cw
RJD-122*

December 9, 1991

RECEIVED
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OFFICE OF CHIEF COUNSEL
CORPORATION FINANCE

VIA FACSIMILE AND
FEDERAL EXPRESS

Emanuel D. Strauss
Office of the Chief Counsel
Securities and Exchange Commission
450 Fifth Street
Judiciary Plaza
Washington, D.C. 20549

Re: SEC Staff Position Relating to Assumption or Substitution of Options in Corporate Acquisitions

Dear Mr. Strauss:

The undersigned would like to express our views to the SEC Staff on what we understand to be the Staff's preliminary position on the treatment of the assumption or substitution of options under the new Section 16 rules promulgated in Release Number 34-28869 dated February 8, 1991 (the "Release").

This subject is of widespread interest to the corporate community. We believe that a typical fact pattern involves options of an acquired company that are outstanding on the date of acquisition where (1) such options (and the plan under which the options were granted) are assumed by the acquiring company, or (2) equivalent options are substituted by the acquiring company for the options of the acquired company. In both situations, (i) the exercise price and the number of shares subject to options are adjusted to reflect the exchange ratio of the acquisition and (ii) there is no acceleration of vesting of the assumed or substituted options. In the case of the assumption of options and an option plan, there are no other changes in the terms of the options assumed. In the case of the substitution of options, all of the other terms of the substituted options are substantially the same as the terms of the old options. It is our understanding that the Staff's preliminary position on this fact pattern is that the assumption or substitution of an option is deemed to be the disposition of the old option and the grant of a new option with a new six-month holding period.

Recommendation. We recommend that the Staff issue an Interpretive Letter stating that the assumption or substitution of options under the conditions described above will be a non-event for purposes of Section 16. More specifically, we urge the Staff to adopt the position that the assumption or substitution of an option by an acquiring company would not be deemed a redemption, cancellation or other disposition of the old option and the grant of a new option, and would not start a new six-month holding period. Rather, the six-month holding period for the shares purchasable under the assumed or substituted option would relate back to the original date the option was granted by the acquired company.

If the Staff were to adopt what we understand to be its preliminary position on the assumption or substitution of options, the result would be to encourage insiders to cash out their long-term options prior to an acquisition, rather than to accept assumed or substituted options with a new six-month holding period and the resulting market risk. We believe that this result was not intended by the Release and would be inconsistent with the goals and reasonable expectations of the parties to an acquisition.

Discussion. The policy considerations underlying former Rule 16b-6(c) are an appropriate starting point for our analysis. These policy considerations remain relevant even though Rule 16b-6(c) has been repealed because option exercises are no longer "purchases." Under former Rule 16b-6(c), the disposition of a security purchased upon exercise of an option, where the option was acquired more than six months before its exercise, was exempt from Section 16(b) if the disposition was pursuant to a merger, consolidation or reclassification of the issuer's securities or in connection with the purchase of assets.1/ Examples of the manner in which this exemption was applied under the former rules are contained in Questions 137 and 141 of SEC Release Number 34-18114 dated September 24, 1981.

The importance of this exemption is referred to on page 60 of the Release:

> "The former rule was promulgated in response to concern that profit recovery under such circumstances would negate the accrued value of long-term options.

1/ We acknowledge that former Rule 16b-6(c) imposed a six-month holding period requirement designed to limit speculative abuse. The six-month holding period requirement of new Rule 16b-3(c)(1) will similarly limit speculative abuse in a manner consistent with the former Rule.

> An insider would be required to exercise the option, which was deemed a purchase under the former scheme, before surrendering the underlying securities into the merger. Without the exemption, the combination of the exercise and the surrender of the underlying securities would result automatically in a short-swing transaction subject to Section 16(b)."

On page 60 of the Release, the SEC suggests that the former exemption is no longer necessary "because the exercise of the option is exempt if it is not out-of-the money." Reference is also made to page 114 of the Release, which rescinds Questions 137 through 141 as no longer necessary. To this end, footnote 154 of the Release concludes that:

> "While the new rules would not provide an exemption for the disposition of the underlying securities, the exemption adopted for exercises should protect long-term accretion in the value of options from short-swing profit recovery as a result of a merger by providing an exemption for the acquisition of the underlying stock."

We believe that, in adopting the new rules, the Commission did not intend to change the policy underlying former Rule 16b-6(c) that long-term appreciation of stock options should not be adversely affected by an acquisition. However, if the Staff adopts its preliminary position on the assumption or substitution of options, the accrued value of long-term options that are assumed or substituted in an acquisition will be unfairly impaired by the imposition of a new six-month holding period. The effect of the Staff's preliminary position would be to encourage insiders with vested options to exercise their options prior to the acquisition, rather than to accept the market risk of assumed or substituted options with a new six-month holding period.

The following example illustrates the inconsistent treatment that would result under the Staff's preliminary position for insiders that cash out options in such a case compared with insiders that have such options assumed or replaced with substituted options:

Assume that each of Insiders A and B has an option to purchase 50,000 shares of stock that is immediately exercisable and that was granted more than six months ago. Insider A exercises his option immediately prior to the merger. Insider B does not exercise her option, and the option is assumed (or substituted for) in the merger. Insider A, by exercising his option, can sell the shares before the acquisition without being subject to Section 16. Insider A bears no additional market risk because he has elected to cash out his option. By contrast, Insider B does not exercise her option prior to the merger, but instead has her option assumed or substituted. Insider B is treated as having received a new option and would be subject to a new six-month holding period (and the associated market risk) merely because she did not cash out her option. This result is inequitable. There is no reason to force Insider B to exercise, or to impose a new six-month holding period (and the resulting market risk) on Insider B if she does not exercise, simply because an acquisition happens to take place during the term of the option.

If the SEC's intended approach toward assumed and substituted options is adopted, it will not only unnecessarily encourage insiders to cash out their option holdings prior to a merger, but it also may create unexpected and unnecessarily harsh results in other situations that frequently arise in the context of an acquisition.

First, in many acquisition transactions, an insider of the acquired company becomes an insider of the acquiring company immediately after the merger. Not infrequently, such an insider may be fired or otherwise terminate employment with the acquiring company shortly after the acquisition. Because most options (including assumed or substituted options) must be exercised within three months or less of termination of employment, a terminated insider may be required to come up with the cash to exercise the option shortly following termination, and then be subject to a market risk until the six-month holding period has expired and the shares can be sold. This is a risk that would not have occurred if the insider had exercised the option prior to the acquisition. (As some of us noted in our discussion with you on November 20, 1991 with respect to _Foster Pepper_, this six-month holding period requirement significantly increases the risk of litigation for an issuer that wishes to terminate an insider shortly after an acquisition.)

Second, if an assumed option would by its terms expire within six months after the acquisition, the imposition of a new six-month holding period would mean that an insider who exercises an option prior to its expiration would be required to hold the shares for six months after the acquisition, and assume a market risk during that period, simply because the acquisition happened to occur during the term of the option. This obviously is not the result intended by the Release.

Third, where an assumed option was not originally granted pursuant to a Rule 16b-3 plan, treating the assumption as the disposition of the old option and the grant of a new option means that an insider who had a prior purchase within six months of the assumption would have a matching purchase and sale at the time of the assumption; the cancellation of the old option would be treated as a sale and matched with the prior purchase.[2/] This is an unfair result for insiders who would not have encountered this problem under the former rules (which did not distinguish between 16b-3 and non-16b-3 options) and who would not encounter this problem if they had cashed out their options prior to the acquisition.

From a policy perspective, the Staff's contemplated position is neither required by nor consistent with the underlying purpose of the statute. The Supreme Court itself has repeatedly observed that it is "reluctant to exceed a literal, 'mechanical' application of the statutory text" in part because Section 16(b) imposes "liability without fault..." <u>Gollust v. Mendell</u>, ___ U.S. ___, 111 S.Ct. 2173, 115 L.Ed. 2d. 109, 118 (1991), quoting <u>Foremost McKesson, Inc. v. Provident Securities Co.</u>, 423 U.S. 232, 251 (1976). Nothing in the legislative history of Section 16(b) and nothing in the language of the statute itself compels the result the Staff is considering. <u>See, e.g.</u> S. Rep. No. 792, 73d Cong., 2d Sess. (1934).

When there is an assumption or substitution of options in connection with an acquisition under circumstances in which the new options are substantially equivalent to their predecessors, there is no new investment decision being made that gives rise to the danger that Congress sought to prevent through the adoption of Section 16(b). Indeed, in the classic situation, an option for shares of the acquired company is simply replaced with an identical option for shares of the acquiring company under terms and conditions that reflect precisely the same conversion ratio offered to public shareholders. Whatever change results to the economic value of

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2/ A similar result would occur under a literal interpretation of new Rule 16b-3(c)(1) with respect to options granted pursuant to a Rule 16b-3 plan if the Staff were to view the cancellation of the old option as an event that results in the loss of the exemption for the grant.

the option and to the economic value of the underlying shares is caused solely by the acquisition at the associated conversion ratio. There is no change in value that results from a grant or exercise of any option or from any decision made by any option holder independent of the acquisition itself. Accordingly, the danger of insider trading that Congress sought to prevent through the strict liability provisions of Section 16(b) simply does not arise.

We respectfully request your reconsideration of what we understand to be your preliminary position on the issue of assumption or substitution of options in the context of an acquisition. We would welcome an opportunity to discuss this issue in person or in a conference telephone call. We also would be happy to submit a formal request for an Interpretive Letter if that would be appropriate.

Thank you for your permitting us to foward our views to you.

Very truly yours,

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November 22, 1991

Elisse B. Walter, Esq.
Deputy Director, Division
of Market Regulation
Securities and Exchange Commission
Room 3009, Mail Stop 3-1
450 5th Street, N.W.
Washington, D.C. 20549

Re: Foster Pepper & Shefelman (August 30, 1991)

Dear Elisse:

Thank you for the opportunity to meet with the members of the Staff handling implementation of the Section 16 Rules. I think that the meeting was highly beneficial to the members of the private bar in their perception of the substantive processes the Staff undergoes in interpreting the Rules.

I would like to take you up on the opportunity to submit informally my own thoughts about the Foster Pepper letter. I believe you heard enough at Wednesday's meeting regarding the practical difficulties arising from the Staff's interpretation. I therefore will confine myself to the analytical issues the interpretive letter raises.

As I mentioned at the meeting on Wednesday, the analysis for whether an amendment to a derivative security should be treated under Rule 16b-3 as a cancellation and regrant, it seems to me, should be whether the change in terms affects the potential for the type of abuse that Section 16 is designed to prevent, i.e., profiting from a purchase and sale within six months. The provisions of Rule 16b-3 are designed to establish conditions under which an option grant will be protected against the opportunity for abuse. Thus, the amendment should only be treated as a new grant if it presents the same risks of abuse as the original grant. To employ a subjective test on whether an amendment makes the option "look" different, without analyzing whether the differences have any significance in this regard, could lead to what might be perceived by the public as arbitrary distinctions between different types of amendments (and to a flood of interpretive letter requests on this issue). The standard I suggest for analyzing the effect of amendments to options upon the exemptive conditions of Rule 16b-3 is narrower and, I believe appropriately, distinct from the "comparability" standard for determining whether a plan's features have been approved by shareholders.

The Rules reflect that whether or not an option is exercisable does not affect the opportunity for the type of abuse that Section 16 was designed to prevent. For example, Rule 16a-1(a)(2)(ii)(F) provides that an option's exercisability (and, of necessity, the option's becoming exercisable) does not affect a person's beneficial ownership of the underlying equity. Exchange Act Release No. 28869 (the "Adopting Release") also addresses those factors which do and which do not affect the ability to realize short swing profits. The Adopting Release states, in the text at footnote 104, "When an insider acquires a typical call option, the insider acquires the right to receive the underlying equity security at a fixed price for a fixed duration." Footnote 104 states, "Although the timing of the exercise of European style options is fixed in advance, the opportunity to profit from acquiring stock at a fixed price is the same." Further, the text of the Adopting Release at footnote 143 states that the exercisability of an option does not affect the opportunity to realize short-swing profits.

These statements help to provide the analysis that demonstrates that the discretionary acceleration of exercisability of an option does not present any opportunity for abuse, and therefore should not be treated as a cancellation and regrant that requires the protection of a new six month holding period under Rule 16b-3(c)(1). As the Adopting Release notes and the Rules reflect, the opportunity for abuse commences when the insider acquires (1) the right to receive a fixed number of the underlying equity securities, (2) at a fixed price, and (3) for a fixed duration of time. Because these events occur upon the grant of an option, Rule 16b-3(c) sets up certain criteria that the grant must satisfy in order to be exempt, one of which is the commencement of a six month holding period.

A discretionary acceleration of exercisability does not alter the option holder's position, because it creates no more opportunity for abuse than the actual exercise does. While the exercisability of an option naturally may affect the timing of an exercise (and thus, of a subsequent sale), it does not affect the ability to lock in a profit. Again, the Adopting Release reflects this, in the text at note 105: "When the price of the underlying equity security exceeds sufficiently the price at which the derivative security can be exercised, the profit can be locked in as there is no uncertainty about the insider's ability to realize the profit, whether by selling the derivative security, selling the underlying securities received upon exercise, or selling other holdings of the underlying securities or other derivative securities related to the underlying security." To borrow a concept from the tax laws, timing of exercisability affects only the recognition of profit, not its realization. Or, as the Adopting Release phrases it in the text preceding note 102, "While the amount of the profit may vary given factors such as the time value of money . . . the exercise does not change the opportunity to realize a profit."

For example, if an insider with a deep in-the-money long-term stock option that is not presently exercisable knows that the stock's price is going to decline, the insider may sell other securities she holds or she may sell the stock short, carry the short position through the price decline and for more than six months until the option becomes exercisable, exercise the option at its fixed price, and realize the profits locked in at the time the insider established her short position. This may be fraudulent under Rule 10b-5, but because the insider held the stock underlying the option for more than six months from the date the option was granted and received the option under other circumstances satisfying Rule 16b-3, the transactions are not deemed to be the type to which Section 16 is addressed. The profit arose from the price change between the date of the option grant and the date of the short sale, which was greater than six months; the abuse arose from selling on inside information. However, the abuse was not short swing and, to borrow Judge Tenney's memorable quote from Duke Ellington, "It don't mean a thing if it ain't got that swing." Portnoy v. Seligman & Lutz, 516 F.Supp. 1188, 1200.

If the exercisability of the option in the foregoing example had been accelerated so that the insider could have exercised and sold prior to the price decline instead of having to rely on previously owned shares, the structure of her transactions may have differed, but again the important point is that she is not acting contrary to Section 16(b)'s intention provided that at the time of the sale at least six months had lapsed since the option had been granted. Although the foregoing example at first may seem counterintuitive, since it "looks like" the accelerated exercisability and sale creates an abusive situation and thus that the accelerated exercisability should be treated as a new grant requiring a new six month holding period, the analysis focusing upon the elements essential to a derivative security -- a right to acquire (or sell) a number of shares for a fixed price and for a fixed duration -- demonstrates that in fact there is no Section 16 abuse in the situation posited but "only" Rule 10b-5 abuse arising from the sale on inside information.

Focusing upon the elements essential to a derivative security also demonstrates why a discretionary acceleration of exercisability is a different issue from a discretionary repricing or a discretionary extension of the term of an option (and thus why footnote 35 of the Shareholder Approval Release is correct). Because an option is treated as beneficial ownership of the underlying equity with a fixed acquisition price, the profit potential exists only so long as that beneficial ownership exists. Obviously, when the option expires, beneficial ownership ceases. However, if the beneficial ownership is discretionarily extended, there is a continuing ability to lock in profits, and thus that extension should be subject to all the safeguards of Rule 16b-3(c), including a new six month holding period (assuming another provision is not relied upon to exempt the extension).

I hope that my musings are of some help to the Staff in its further consideration of _Foster Pepper_. Please do not hesitate to call if you would like to discuss this or any other issue.

Sincerely,

Ron

Ronald O. Mueller

cc (to be hand delivered):
Mauri L. Osheroff, Esq.
Abagail Arms, Esq.
Ann Devenny Wallace, Esq.
Brian J. Lane, Esq.
Mark W. Green, Esq.
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