



## HIGHLIGHTS AND PITFALLS

### Ten Compensation Disclosure Fixes

We now have the benefit of a completed proxy season under the new executive compensation rules, as well as the SEC Staff's initial observations from the comment letters sent last month. (See the September-October 2007 issue of *The Corporate Executive* for analysis and guidance of the Staff's initial round of comments.) In light of this information, the following are ten key compensation disclosure fixes that issuers need to consider now for their upcoming 2008 proxy statements.

#### **Focus on Analysis**

The analysis in the CD&A must be the focal point of compensation disclosure—not just an afterthought. Based on the comments raised in the first wave of the Staff's targeted review of executive compensation disclosures, the CD&A must include an analysis of why the issuer paid each element of compensation. In particular, the CD&A must specifically focus on the factors considered by the compensation committee in approving elements of compensation for each of the NEOs, and explain the reasons why the compensation committee believes that the total amounts paid are appropriate in light of these factors considered.

Issuers should not wait until the first draft of the proxy statement to focus on its analysis for the CD&A. The compensation committee needs to understand the necessity of articulating a rationale for compensation policies and individual compensation decisions—before decisions are made—and issuers must ensure that disclosure controls and procedures are in place to capture the rationale behind the decisions in order to facilitate the analysis in the CD&A. Compensation committees should have tally sheets, including a wealth accumulation analysis, in hand when making decisions, and—consistent with the Staff's recent comments—issuers should describe the committee's use of this important tool and the extent to which the committee increased or decreased compensation based on the tally sheets.

#### **Highlight the CD&A Analysis under its Own Caption**

While we would like to see the SEC require a separately-captioned "Analysis" section in the CD&A, no rule changes are likely for next year's proxy season. But that doesn't mean there shouldn't be a separately-captioned section. The plain English rules (1934 Act Rules 13a-20 and 15d-20) contemplate the use of descriptive headings and subheadings. By providing the analysis under its own caption in a manner consistent with these plain English rules, readers (including the SEC Staff) can easily identify and refer back to the analysis underlying the rest of the compensation disclosure. By contrast, "burying" the analysis—or dispersing it throughout the CD&A—will likely frustrate the reader and make it difficult for the issuer to communicate its compensation story.

#### **Concentrate on the Individual**

Through its review process the Staff has expressed concern with disclosure that glosses over the individual differences—and internal relationships—of compensation for the CEO and each of the NEOs. Aggregating the discussion and analysis of individual NEO compensation can obscure how the compensation committee evaluates the internal pay relationship among its executives and others in setting compensation, including the extent to which the committee analyzes the multiple by which a CEO's compensation is greater than that of other specified employees. As we noted in our September-October 2005 issue (at pg 4), internal pay equity is a critical consideration for compensation committees when considering and setting executive pay, and is essential to providing perspective whenever benchmarking against other companies is considered or presented.

Based on these concerns, a discussion and analysis is necessary as to the ways in which the issuer structures and implements specific forms of compensation to reflect any quantitative and qualitative elements of

individual performance—as well as internal pay equity considerations—that were analyzed by the compensation committee when determining the total amount of each NEO’s compensation.

### **Disclose Performance Target Levels Whenever Possible**

Issuers should disclose incentive plan performance target levels (preferably using a comparative table), rather than seeking to rely on the competitive harm exception. The use of Instruction 4 to S-K Item 402(b) needs to be limited to those situations where the target levels or other factors are, in fact, competitively sensitive. For example, performance target levels tied to short-term business plans or tied to a potential merger may satisfy the competitive harm test and warrant withholding the information. By contrast, it is difficult to justify competitive harm when a target level is based simply on earnings per share or total shareholder return.

Disclosure of target levels facilitates the analysis required in the CD&A. A lack of quantitative information about target levels makes it much more difficult to understand the relationship between the levels of compensation and company or individual performance. Moreover, the “degree of difficulty” disclosure required when target levels are withheld typically does little to explain the extent to which a target is “real”—unless the disclosure analyzes historical data and explains specific past experience with the particular target.

### **Make Benchmarking Disclosure Meaningful**

A complete description of the issuer’s benchmarking process (including details of the selected comparator groups) is necessary for an understanding of this element of compensation decision-making. The relative importance of the benchmark data and the targeted percentiles (including targeted percentiles pegged to individual elements of compensation) in the overall compensation-setting process needs to be fully discussed.

But the real issue here is the over-reliance on benchmarking. There needs to be other meaningful analysis—like internal pay equity—to see if the issuer is getting away from its own philosophies and values. If all a board does is look to surveys and no other analysis, it needs to say so. (For a discussion of what’s wrong with surveys and what compensation committees should be doing, see the “Benchmarking and Survey Use” section on CompensationStandards.com.)

### **Address the “Real” Tax and Accounting Implications**

In many cases this past proxy season, issuers included in their CD&A only the same general references to Code Section 162(m) compliance that were a staple of the old Compensation Committee Reports. A description and analysis of the actual tax and accounting consequences and implications driving executive compensation policies, practices and decisions is often difficult to find.

The CD&A should include a discussion of the extent to which performance targets are established to meet Section 162(m) requirements, but then negative discretion is routinely exercised (or specifically contemplated) in determining the actual incentive compensation. In addition, the CD&A should describe how Section 162(m) has influenced the allocation of compensation among the various elements.

More discussion of accounting implications is also warranted, including how accounting concerns (*i.e.*, expensing of equity awards) may influence the allocation of individual elements of compensation.

### **Provide the Whole Termination and Change-in-Control Picture**

While S-K Item 402(j) provides some flexibility for presenting the termination and change-in-control disclosure, a tabular presentation appears to be preferred by the Staff and seems to work best for providing the disclosure in an understandable manner.

A complete analysis of the “why” behind the termination and change-in-control arrangements is necessary in the CD&A. This analysis needs to address how the arrangements fit into the issuer’s overall compensation objectives and affect decisions made as to other compensation elements, the rationale for decisions about the terms of the arrangements (including why particular multiples were selected and why benefits are provided for the identified triggering events), and the extent to which any benchmarking is used in determining the benefits. While in many cases termination and change-in-control provisions may be very similar among different NEOs, the Staff has indicated through the comment process that significant differences across these arrangements must be identified and discussed.

An important component of the compensation committee’s analysis—which needs to be reflected in the disclosure—is the extent to which other elements of pay are factored into determining the contemplated termination or change-in-control compensation. Such consideration of *wealth accumulation* should be

critical to the overall determination of elements and levels of compensation and thus needs to be fully described in the CD&A.

### **Provide the “Walk-Away” Number**

Item 402(j) may not literally require that the amounts payable under termination and change-in-control arrangements be totaled. But under the SEC’s “principles-based” disclosure framework, if an issuer does not provide an aggregate figure, it is providing only part of the story. Focusing the disclosure on an expected total walk-away number that the NEO is entitled to upon a termination or change-in-control event is the best means for avoiding any unwanted “surprises” down the road if any of these provisions are ultimately triggered. This disclosure approach should parallel the considerations of the compensation committee, which needs to be equipped with “walk-away” numbers—including all vested amounts—when making any decisions about whether to establish, modify or keep any termination or change-in-control arrangements.

### **Maximize the Utility of the Compensation Tables**

Making permissible modifications to the tables and providing additional narrative disclosure can facilitate a better understanding of the information. Based on our observations from the last proxy season and suggestions from our readers, some of these changes should include:

- Text leading up to the table providing a “tutorial” on how to interpret the data presented in the table. For instance, accounting concepts that are relevant to understanding the amounts reported for equity awards and their impact on the numbers are best reported in the lead-up to the Summary Compensation Table. (See Citigroup’s 2007 proxy statement.)
- In presenting information about equity awards in the SCT, visual aids (such as different fonts or offsetting colors) can be used to help investors understand the differences between the amounts that are actually earned and received in the last completed fiscal year and the amounts that the executive officer has an opportunity to earn in the future. (See Schering-Plough’s 2007 proxy statement.)
- In the Outstanding Equity Awards Table, additional disclosure showing the unrealized value of outstanding stock options (calculated by determining the difference, at fiscal year-end, between the market price of the underlying securities and the exercise price). While the SEC eliminated this requirement under the new rules, the information presented in the table is much more useful if the unrealized value is separately presented, rather than requiring the reader to compute the number.
- A “grant date” column in the Outstanding Equity Awards Table, in order to facilitate the presentation of the vesting date information following the table. The same concept may also be applied to identify the performance period for each performance share award as a way of relating these awards back to the CD&A.
- An “annual benefits” column or other supplemental disclosure in the Pension Benefits Table in order to explain the annual benefits that NEOs could receive upon retirement or upon termination. This disclosure can then facilitate the discussion of pension benefits in the termination and change-in-control section.

### **Fully Describe NEO and Consultant Involvement**

Disclosure about the role of the CEO (or other executive officers, as applicable) in the compensation process needs to include a discussion of the ability of the CEO to call or attend compensation committee meetings, whether the CEO met with the compensation consultant used by the compensation committee, whether the CEO had access to any other compensation consultant who influenced executive compensation and the degree of input the CEO had in developing compensation packages.

Individualized disclosure about the engagement of each compensation consultant is necessary for any consultants involved in setting executive and director pay (not just the consultant engaged by the compensation committee). While not specifically contemplated by the rules, disclosure should also be included about actual or potential conflicts of interest or any other independence concerns about the compensation consultant, as this is an area that some investors have focused on.

### **The Need for Action Now**

Expectations will be even higher this coming proxy season—therefore, issuers need to be preparing today for these potentially significant changes to their disclosure. Even if an issuer has not yet received a comment letter, it still needs to determine what fixes must be made now, so that the compensation committee and others can be fully prepared as the proxy season approaches.

—JMB/DL

**The October 9 and 11 Conferences.** In view of the SEC’s heightened focus on this coming year’s proxy disclosures, we would urge all our readers to attend—via the Nationwide Webcast—the October 9<sup>th</sup> Conference—“Tackling Your 2008 Compensation Disclosures.” And—with the SEC targeting every company’s CD&A—be sure to register for the October 11<sup>th</sup> Conference: “Lessons Learned” Necessary Compensation Fixes—Impacting Your Proxy Disclosures.

## NEW DEVELOPMENTS

### Staff Affirms “No-Sale” for Restricted Stock

In the lead item in our July-August 2005 issue, we wondered whether the Staff was maybe backing away from the application of its bonus stock/no-sale position to restricted stock/RUs. Thus, we were pleased to see the Staff’s apparent affirmation of no-sale in this context, in *Verint Systems Inc.* (May 24, 2007).

The *Verint* facts strain the no-sale paradigm (see below), but the requestor’s starting point is reliance on the Staff’s *Goldman Sachs Group, Inc.* (August 24, 1998), *MCA Inc.* (May 26, 1992) and *Farmers Group, Inc.* (December 1, 1995) no-action letters, *i.e.*, that neither the grant of restricted stock, etc. nor the time-vesting requirement of continuing service involves a surrender of value invoking a “sale” or “offer to sell” under 1933 Act Section 2(a)(3). (See also *Goldman Sachs Group, Inc.* (February 22, 2000), discussed in our March-April 2000 issue at pg 4.) *Verint* doesn’t address performance-vesting stock, but see our July-August 2005 discussion (at pg 2).

### Disclosure, Etc. Concerns

The Staff seemed to have no problem with the basic, no-sale premise. Rather, the drill here involved fitting *Verint’s extremis* situation into the no-sale bottle, *i.e.*, the three standard conditions: 1934 Act reporting company, stock actively traded, and relatively small number of shares (see our January-February 1980 issue at pg 6).

In our March-April 2007 comprehensive discussion of the impact of 1934 Act reporting delinquency on 1933 Act registration, we point out that, even during the pre-§10(a)(3) deadline period when eligibility to use a registration statement isn’t affected, disclosure concerns may well lead counsel to determine that an S-8, etc. shouldn’t be used. Disclosure concerns may also need to be addressed when registration isn’t required, *e.g.*, where there is an exemption and possibly even where there is deemed to be no offer or sale.

### Satisfying the Three Conditions Even Though in Extremis

*Verint* had been delinquent in its 1934 Act filings since not filing its 2006 Form 10-K (resulting from *Verint’s* ongoing investigation of options backdating and other accounting problems) and, when it submitted its no-action request, was about to not file its 2007 Form 10-K filing. Thus, because *Verint* was ineligible to use S-8, etc., “no-sale” was key (Rule 701 not being available, because *Verint* was still subject to reporting requirements). *Verint’s* stock had also been de-listed by Nasdaq, so trading was limited to the pink sheets.

*Verint’s* proposed restricted stock grants were to be broad-based and from its broad-based plan, and (to assuage any negotiation/“sale” concerns—see *Guinness PLC* (April 9, 1993) and our September-October 1993 issue at pg 5) would be made only to employees hired before *Verint* became delinquent and not to executive officers; no value would be “paid” for the grants, or any special agreements or covenants. The total number of shares equaled approximately 1.7% of the outstanding stock.

*Verint’s extremis* posed questions, however, with both the 1934 Act reporting and actively-traded “no-sale” conditions: Is a materially delinquent issuer (here, two 10-Ks) still a 1934 Act reporting company in this context? Can a de-listed stock be actively traded? *Verint* ended up addressing these concerns, apparently to the Staff’s satisfaction, by conditioning vesting not only on continuing service but also on (i) *Verint* becoming “current with its 1934 Act reporting obligations” (presumably, 12-month currency) and (ii) the re-listing of its common stock.

Moreover, even though the classic no-sale doctrine would allow (re)sales without restriction, *Verint* acceded to an additional burden/bone to the Staff by conditioning employees’ (re)sales of the stock on an effective registration statement relating to the underlying shares (presumably, a resale registration). Thus, *Verint* undertook to treat all the shares as “restricted securities” under Rule 144, apparently without even a (k) cutoff.

We don’t know whether the Staff ended up requesting this resale restriction/registration requirement in the dialogue that followed *Verint’s* initial request letter, or whether *Verint* proposed it upfront. Request letters are still submitted non-publicly, whether in original and seven copies per Rel. No. 33-6269 (December 5, 1980) or, these days, via e-mail to the Staff at [cflatters@sec.gov](mailto:cflatters@sec.gov); unfortunately, the public never gets to see the earlier iterations of request letters, which would provide insight as to counsel’s “negotiations” with the Staff.

### Could Verint Have Made Option Grants?

Presumably, *Verint* also could have granted *stock options* without having an effective S-8, per the Staff’s accommodating position that allows grants prior to filing/effecting an S-8 so long as an S-8 is effected prior to exercise. (See the *Telephone Interpretations Manual* (July 1997) at G.61, and our July-August 2005

discussion.) The difference with restricted stock is that, with no-sale, there is no registration required at exercise (or grant).

### Does Anyone S-8 Eligible Not Register RS/RUs?

Verint needed to rely on “no-sale.” We would like to hear from any readers who actually rely on “no-sale” for restricted stock even though eligible to register.

### Accounting and Section 16(a) Impacts of Verint’s Unusual Vesting Conditions

Verint’s conditional grants should be treated like any other performance grants under FAS 123(R), even though the conditions here seem so company-specific (*i.e.*, 1934 Act reporting currency and re-listing) and the likelihood of vesting may be low. A typical EPS condition, too, is essentially beyond employees’ control, and sometimes may also be unlikely to be met. Under 123(R), the measurement date is the grant date and the fair value is the stock price on the grant date. A low degree of likelihood would be reflected by the expense being recorded (over an estimated vesting period) based on the likelihood (from time to time) of the conditions being satisfied.

If Verint had included executive officers in its grants (whether as non-negotiated no-sales or per, *e.g.*, Section 4(2)), when would the grant occur for Section 16 reporting purposes? Alan Dye tells us that, where conditions are not substantially likely to occur, and beyond the control of the insider, the grant doesn’t occur until the conditions are (or become likely to be) met. But where, instead of RUs, shares of restricted stock actually are issued upfront (with dividends, voting, etc.), there are arguments both ways.

### Use of S-3ASR instead of S-8 to Register Stock Plan?

We featured the 1933 Act aspects of Google’s transferable stock option program in our May-June 2007 issue. As mentioned, we don’t know whether Google switched their stock plan registration to S-3ASR (i) because of concern that the grant of options that, upon sale, become warrants might not be registrable on S-8 (as we discussed, Google isn’t even registering *exercise* of the warrants), or (ii) because counsel may actually have perceived a benefit to using S-3ASR rather than S-8.

### Availability of S-3 for Options, Etc.

S-3 General Instruction I.B.4 specifically allows even non-primary S-3 issuers to use S-3 to register the exercise of *outstanding* warrants or options, provided the issuer delivers certain information to participants (*e.g.*, annual report to security holders). But, because I.B.4 applies only to outstanding securities, it doesn’t seem to fit the bill for a stock plan, *e.g.*, for grants not yet made. Moreover, I.B.4’s information delivery requirements could be onerous compared to S-8.

### Automatic Effectiveness

Thus, we think only issuers that meet the requirements for a primary S-3 offering per General Instruction I.B.1 would consider registering their stock plan on S-3. In fact, only WKSIs would consider doing so, because only the S-3ASR matches S-8’s automatic effectiveness on filing. In addition to automatic effectiveness, both S-8 and S-3ASR are updated automatically by post-effective date 10-Ks (as well as by forward incorporation of other 1934 Act reports). [Note that S-3 General Instruction I.B.1’s limitation to securities offered “for cash” does not pose an impediment here. TIM H.42 instructs that this S-3 requirement should not be read literally, but is intended only to make it clear that S-3 is not available for exchange offers or other business combination transactions.]

### S-3 Negatives

Filing of Prospectus. Perhaps the most significant S-3 detriment/S-8 benefit is S-8’s non-filing of “prospectus” material (which, for some reason, hasn’t deterred Google from using S-3 despite Google’s well-known proprietary proclivities; one needs to look no further than some of the information in Google’s stock plan prospectus filings to see the kind of detail that using the S-3 causes to be filed). Section 11 liability does, however, apply to the S-8 “prospectus.” [A “free-writing prospectus” (for an S-3, etc.), even though filed, is not subject to §11 liability (because, per Rule 433(a), it is a Section 10(b) prospectus, not §10(a)). See Rel. No. 33-8591 (July 19, 2005) at III.D.3.b.iii.(G). In a sense, an S-8 involves a collection of FWPs which, even though not filed, are collectively deemed to be a §10(a) prospectus subject to §11 liability.]

1934 Act Delinquency Results in Ineligibility to File or Renew S-3 at the Section 10(a)(3) Deadline. As discussed in our March-April 2007 issue (at pg 3), having filed a 1934 Act report late does not affect an issuer’s eligibility to continue an S-8 offering after the Section 10(a)(3) update. Even if the late report in

question is the 10-K and it is filed after the Section 10(a)(3) deadline, the S-8 can be resurrected once the 10-K is filed. With S-3, however, a late 1934 Act report (if no Staff waiver is forthcoming) results in the issuer no longer being able to use S-3 at the next §10(a)(3) update time, requiring the stock plan to be re-registered on a form for which it is then eligible. (There should be no difference in the effect of a disclosure gap, resulting from the pendency of a 1934 Act delinquency, on the use of an extant S-8 or S-3 prior to the §10(a)(3) deadline.)

Impact of Loss of WKSI Status. The issuer may lose WKSI status from, among other things, a 1934 Act delinquency, or if its public float falls below \$700 million. In the event of a loss of WKSI status, a stock plan S-3 ASR would have to be amended onto a 1933 Act form for which the issuer is then eligible.

S-3 Not Available for Registration of Plan Interests. Where plan interests need to be registered (e.g., 401(k) plans with an issuer stock fund alternative—see our November-December 1999 issue at pg 7), the plan cannot use S-3 because the plan does not meet the registrant requirements. Instead, the plan must use S-8. This is not usually a concern for stock plans, however, which typically don't involve the registration of "plan interests."

ERISA. If a plan is subject to ERISA, ERISA imposes information delivery requirements (a "summary plan description") in addition to those of the 1933 Act. In the S-3 context, that ERISA information would be additional prospectus material (required to be filed).

### A Few S-3 Positives

S-3ASR Registers an Unlimited Amount of Securities. While the S-3ASR can register an unlimited amount of securities (although Google does specify the number of securities), the only way to add securities to an already effective S-8 is to file a new S-8. We understand the Staff often hears *mea culpas* from issuers who oversold their S-8, or mistakenly tried to increase shares by a post-effective amendment. Even though it must be re-filed every three years, an S-3ASR may be more convenient.

Pay-As-You-Go. Moreover, with an S-3ASR, the issuer can pay registration fees on an as-needed basis, per Rule 456(b). With S-8, the issuer must pay a registration fee for the entire amount of securities registered at the time of filing (although unused fees can be re-used).

Electronic Prospectus Delivery. Rules 172 and 173, which facilitate "electronic access (*i.e.*, Edgar filing) equals delivery," are applicable to S-3 (but, not S-8) prospectuses. Per the Commission's electronic delivery interpretive releases (Rel. Nos. 33-7233 (October 6, 1995) and 33-7288 (May 9, 1996)), which releases haven't (yet) been superseded (E-proxy is a 1934 Act delivery), issuers have the ability to deliver electronically to their employees (e.g., via e-mail). But, for those issuers where some employees don't have access to the company's intranet, etc., S-3 delivery (per Rules 172 and 173) actually may be easier than S-8 delivery. (Generally, the exercise of a stock option, etc. doesn't trigger an additional prospectus delivery requirement under either S-8 or S-3.)

Bottomline, we don't expect a wave of WKSI's using S-3ASRs to replace their S-8 stock plan registration. Maybe we will know more after hearing from Google at the October 10 "Google and Transferable Options—The Next 'Big' Thing?" session at the NASPP Conference in San Francisco, October 9-12.

### **Rule 14a-8 Proof of "Record" Ownership—Staff Says No to Investment Advisor Affirmation**

Hard to believe, but the 2008 shareholder proposal season will soon be upon us. One purpose of Rule 14a-8 (the rule governing inclusion of shareholder proposals in management's proxy statement) is to provide shareholders a role in setting the agenda for shareholder meetings, and for that reason we understand why the Staff often seems to tilt toward allowing shareholder proposals to be included in the proxy statement. Most of the 13 substantive bases on which an issuer may exclude a shareholder proposal (in Rule 14a-8(i)) require, or allow, the Staff to make a reasoned judgment whether to allow exclusion, and the subjectivity factor may justify the Staff's apparent favoring of proponents these days in close (and even some not so close) cases.

We think it's another matter entirely, however, for the Staff to "interpret" objective, bright-line procedural requirements of the rule in a way that ignores the clear language of the rule. We were, therefore, pleased to see the Staff take the position that a proponent may not satisfy the rule's requirement to provide proof of "record" ownership of securities by delivering a statement from the proponent's "investment advisor" "verifying" the proponent's stock ownership. (See *CIGNA Corporation*, February 21, 2006.)

### Broker Affirmation of Street Name Holding Still OK

As our readers may recall (see our November-December 2001 issue at pg 6), Rule 14a-8(b) provides that, to be eligible to submit a shareholder proposal, a proponent must have continuously held a minimum of \$2,000 in market value of the issuer's securities entitled to be voted on the proposal for a minimum of one year prior to submission. If a proponent holds issuer securities in street name, the rule requires the proponent to establish compliance with the stock ownership requirement by submitting to the issuer written proof of ownership from the "record" holder of the securities.

"Record" holder is not defined in Rule 14a-8 (the term is defined in Rule 12g-5, only for purposes of applying the Section 12(g) shareholder threshold), but the term generally is understood to refer to a person registered in the issuer's stock ledger, etc. as an owner of the issuer's securities. At one time, a street name holder's securities actually were owned of record by the broker or bank with which the holder maintained an account. Nowadays, however, most brokers and banks hold customer securities through CEDE & Co., which technically is the record holder of the securities. (See *In re Appraisal of Transkaryotic Therapies, Inc.*, Civ. Act. No. 1554-CC, Del. Ch., May 2, 2007.) Nevertheless, the Staff has allowed proponents to establish compliance with Rule 14a-8's stock ownership requirement by submitting a written statement from the broker or bank, apparently on the theory that CEDE & Co. is the "agent" of the broker or bank, making the broker or bank the "record" holder. (See *Dillard Department Stores, Inc.*, March 4, 1999.)

### Investment Advisors

While we are sympathetic to the exigencies that may have led the Staff to *Dillard* (it would be burdensome to require CEDE & Co. to trace its holdings to individual proponents), we would not want to see the "record" holder requirement completely read out of the rule (*i.e.*, by Staff interpretation). Otherwise, a proponent's statement of eligibility (many of which prove to be wrong, even when made in good faith) could not be verified, by either the issuer or the proponent.

A broker owns or has custody of securities held for a customer's account, and therefore is in a position to verify a proponent's ownership of issuer securities. An investment advisor, in contrast, ordinarily doesn't have custody of its clients' securities. The Staff seemed to recognize that distinction several years ago when it concluded that an "investment manager" is not a record owner (see *Coca-Cola Co.*, January 10, 2001), a position the Staff appears to have reaffirmed in *CIGNA*, despite the fact that the underlying shareholder proposal in question (*i.e.*, whether the issuer should publish a list of its charitable donees) is politically popular today.

### Other Bright-Line 14a-8 Requirements Previously Upheld By the Staff

The *CIGNA* letter should come as no surprise, of course. The Staff generally seems to recognize the need to provide some certainty (and fairness to both sides) to the shareholder proposal process (not to mention the limitations on the Staff's authority), by enforcing the unambiguous procedural requirements of the rule even where the proponent barely misses. The Staff has, for example, allowed exclusion of proposals where (1) the proposal arrived one day after Rule 14a-8(e)'s deadline for submission (*Hewlett-Packard Co.*, November 9, 1999), (2) the proponent misdirected the proposal to the issuer's transfer agent, which forwarded it to the issuer two weeks later for arrival one day late (*Coca Cola Co.*, January 10, 2001), (3) the value of the proponent's holdings of issuer securities was slightly less than \$2,000 (*Sabre Holdings Corporation*, January 28, 2004), (4) the proponent held non-voting instead of voting common stock (*McCormick & Co.*, November 14, 2005), and (5) the proponent owned the required number or value of voting securities for only 359 days prior to submitting the proposal (see *Sizeler Property Investors, Inc.*, September 16, 2005). We don't expect to see any erosion in this aspect of the Staff's administration of Rule 14a-8.

### Posting (Next Year) of Shareholder Proposal No-Action Letters, Finally

From time to time, we have wondered why the Staff doesn't post its responses to 14a-8 issuer requests for no-action letters that seek to exclude a shareholder proposal from the annual proxy statement, along with the other no-action letter responses that Corp Fin helpfully now posts on sec.gov (Investment Management and Market Reg also post their no-action letters). One reason for not posting the shareholder proposal letters appears to have been that at least one portion of the related correspondence (*i.e.*, the proponent's response to the exclusion request by issuer's counsel) is almost never submitted electronically and sometimes is handwritten. Another reason, we suppose, was the sheer volume of these letters.

Former Corp Fin Deputy Director Marty Dunn, who oversaw the 14a-8(i) process, also pointed out that Staff responses (and the issuer's underlying request, as well as the proponent's letter) are published in paper at

the SEC's Public Reference Room in DC (no longer at any regional office) immediately after the Staff issues its response (until 1988, there was a general 30-day publication delay for all no-action letters), and that the publication services (e.g., Lexis and LivEdgar) immediately scan and post them electronically. Note that Rule 82 requires that materials filed with the SEC (and related written communications) regarding shareholder proposal no-action letters, and the Staff's response thereto, be made available upon request (Rule 81 governs other no-action letters). There is no longer any confidentiality request/delay process here.

The SEC Inspector General's March 28, 2007 report on the Staff's interpretive guidance criticized Corp Fin for not posting its 14a-8 letters on sec.gov. See Audit of Full Disclosure Program's Staff Interpretive Guidance Process (March 28, 2007). Not coincidentally, Corp Fin Director John White announced at the ABA's Spring Meeting in March that the Staff will begin posting the Rule 14a-8 letters next year. In the meantime, last season's "big" 14a-8 letters (e.g., *HP*, *Reliant* and *UnitedHealth Group*) can be found on Corp Fin's Frequently Requested Materials webpage.

### **Filing Form T-1 After S-3 Effectiveness—Don't Use Form 8-K**

The Staff's new 1939 Trust Indenture Act Compliance and Disclosure Interpretations suggest that some issuers may need to change the way they file a Form T-1 in connection with a shelf takedown of debt securities.

#### **Background—The Form T-1 Filing Requirement**

1939 Act Section 310 sets forth eligibility requirements that must be met by the trustee under the trust indenture that governs a registered offering of debt securities. To assure the trustee's eligibility, Section 305 requires the issuer to file a statement of the trustee's eligibility as part of the 1933 Act registration statement registering the debt securities (Form S-3, in the shelf registration context). In 1940, the Commission adopted Form T-1, to be completed and signed by the trustee, as the statement of eligibility required by Section 305 (see 1939 Act Rule 5a-1). S-K Item 601(b)(25) requires the issuer to file the T-1 as an exhibit to the registration statement.

#### **Delayed Offerings—When/How to File the T-1**

When an issuer includes debt securities in a universal or automatically effective shelf registration statement, the issuer might not have selected the indenture trustee at the time the S-3 is made effective, planning instead to retain a trustee only when and if the issuer takes debt off the shelf. In those cases, the issuer must file the Form T-1 as an exhibit to the registration statement, when the trustee is later identified (see 1939 Act Rule 5b-1). This sequence of events is contemplated by 1939 Act Section 305(b)(2), which provides that, in a "delayed offering," the indenture trustee's statement of eligibility does not have to be filed with the registration statement, but instead may be filed later "in accordance with such rules and regulations as may be prescribed by the Commission."

We have seen issuers file the Form T-1 by including it as an 8-K exhibit in advance of the closing of a debt takedown, which has the effect of adding the T-1 as an exhibit to the Form S-3 through incorporation by reference (see Item 12 of Form S-3). Presumably, counsel for those issuers have assumed that a T-1 can be filed via an 8-K because that procedure works for other S-3 exhibits (e.g., S-K Item 601(b)(1) expressly allows the underwriting agreement to be filed by Form 8-K, and 1939 Act CDI Question 102.01 and Interpretation 201.04 extend the same treatment to supplemental indentures).

The Commission's rules do not, however, expressly contemplate the filing of Form T-1 as an 8-K exhibit. Instead, as provided in Volume II of the EDGAR Filer Manual, the T-1 should be a standalone filing, under the electronic form type "305b2" (adopted in Rel. No. 33-7122 (December 19, 1994)). Mindful that some issuers have not complied with this requirement, the Staff has driven it home in two new interpretations, along with an admonition that the T-1 should not be filed by Form 8-K. (See 1939 Act CDI Question 103.01 and Interpretation 220.01.)

#### **Effective Date of Form T-1—Ten-Day Wait?**

Section 305(b)(2) provides that a T-1 becomes effective automatically ten days after filing, unless the Staff accelerates the effective date (which it never does) or enters an order refusing effectiveness. We understand that the Staff takes the position (which we think is supported by the language of Section 305(b)(2)) that the ten-day waiting period applies whether the T-1 is filed (correctly) as a 305b2 submission or (incorrectly) as an 8-K exhibit. However, while issuers often do not file the T-1 in time for it to be effective prior to the closing of the offering, it has been the Staff's longstanding position that, so long as the trustee is in fact eligible to serve as trustee (which is virtually always the case), the issuer may close the offering before the ten-day period has run.



## **Updating the Exhibit 5 Legality Opinion at Each Shelf Takedown**

While on the subject of updating S-3 exhibits via Form 8-K, we learned recently that some counsel consider it unnecessary to update the Exhibit 5 legality opinion for each takedown under a shelf S-3. We don't agree, at least where the opinion filed with the S-3 at the time of effectiveness was based on assumptions regarding the board of director's approval (down the road at the time of each takedown) of the issuance, price or terms of the registered securities. While the Commission allows issuers to satisfy the S-K Item 601(b)(5) exhibit requirement upfront, at the time of effectiveness (or, with an S-3ASR, at the time an additional class of securities is added by post-effective amendment—see the Securities Offering Reform FAQs (November 30, 2005) at Q.20, which also requires a signed opinion covering the specific securities “no later than the time of offering the securities”), by filing a qualified opinion (*i.e.*, one that assumes, *e.g.*, board approval of takedown and offering price), the Staff requires that the issuer file an updated (*i.e.*, offering-specific) opinion in connection with each takedown. (See Rel. No. 33-6714, n.47, June 5, 1987, and the TIM, at D.11, both of which were highlighted in an ABA Special Report published in the August 2004 issue of *The Business Lawyer*, at pg 1511-12.) As these authorities make clear, however, the updated legality opinion may be filed as an 8-K exhibit.

## **Disclosure of Short Positions on Form 13F?**

In our July-August 2007 issue (at pg 6) we discussed Schedules 13D and 13G in the context of a question raised at the June 26 Congressional hearing with the five SEC Commissioners, *i.e.*, whether hedge funds, etc. are required to report short positions. We noted that a hedge fund (or any other 5% owner) usually can avoid disclosing any short position, by reporting its beneficial ownership on Schedule 13G rather than Schedule 13D (*i.e.*, where the hedge fund has no control purpose or effect and, therefore, is not required to file on 13D).

Several readers pointed out that 1934 Act Section 13(f) was also mentioned at the hearing as possibly being relevant here. We don't think §13(f) requires “short” disclosure either.

### Who Must File Form 13F?

Form 13F is a quarterly filing required of (i) institutional investment managers that have (ii) “investment discretion” over publicly traded equity securities having a value of \$100 million or more. The filing obligation is imposed by Section 13(f) (as implemented by Rule 13f-1), which defines “institutional investment manager” to include any entity that buys and sells securities for its own account (*e.g.*, a hedge fund) as well as any entity that has investment discretion over another person's account (*e.g.*, an investment adviser to a hedge fund). Thus, all hedge funds with over \$100 million under management (and their managers) must file Form 13F (although the rules allow only one to file, naming the other as a co-filer), reporting all their holdings of publicly traded equity securities (with no ownership threshold).

Report “Holdings.” Form 13F must be filed within 45 days after the end of each calendar quarter, listing “holdings” of all 13(f) securities over which the institutional investment manager has “investment discretion.” The term “13(f) securities” is defined in Rule 13f-1 to include any equity security of a class described in Section 13(d)(1) (generally, any class registered under Section 12) that is admitted to trading on a national securities exchange (*e.g.*, the NYSE or Nasdaq) or is quoted on the automated quotation system of a registered securities association. The SEC makes it easy, by publishing on sec.gov a comprehensive list of 13(f) securities each quarter, as mandated by Section 13(f)(3).

A short position in an issuer's stock is not a “holding” (see the related 13D discussion in our July-August 2007 issue), and therefore Form 13F does not call for information regarding short positions (but does call for holdings of put and call options). So, an issuer looking for information about a hedge fund's short position in its securities is not likely to find the hedge fund's quarterly Form 13F any more enlightening than its Schedules 13G.

### 13F Holdings Not Necessarily Beneficially Owned—Investment Discretion vs. Investment Power

While on the subject of Form 13F, we are often asked whether, when an institutional investment manager discloses on Form 13F a holding of more than five percent of an issuer's stock, the issuer should identify the investment manager as a greater than five percent owner in the S-K 403 beneficial ownership table. Our answer has always been “no,” unless the investment manager also files a report on Schedule 13D/G reporting “beneficial ownership” of more than five percent of the class.

For purposes of Item 403, beneficial ownership is based on the §13(d) (and §13(g)) standards of beneficial ownership, *i.e.*, voting or investment power (see Instruction 2 to Item 403). Form 13F, in contrast, calls for

securities over which the filer has “investment discretion.” While “beneficial ownership” for purposes of Schedules 13D/G includes securities subject to the filer’s “investment power” (see Rule 13d-3(a)), investment power does not necessarily have the same meaning as “investment discretion” as used in Section 13(f). (Section 13(f) was not part of the 1968 amendments that added Section 13(d) to the 1934 Act, but was added in 1975.)

1934 Act Section 3(a)(35) (see also Q.6 of the Division of Investment Management’s May 2005 FAQs on Form 13F) provides that a person has “investment discretion” over an account if the person (i) is authorized to determine what securities will be purchased or sold for the account or (ii) makes decisions as to what securities will be purchased or sold for the account, even if some other person has responsibility for investment decisions. In our experience, some institutional investment managers consider themselves to have investment discretion over securities of which they are not “beneficial owners” under Section 13(d) or 13(g) (e.g., where the manager buys, sells and holds issuer securities pursuant to a rabbi trust that dictates voting and investment decisions). [Our readers may recall that a rabbi trust is a trust set up by an issuer to hold issuer assets (subject to creditor claims) for distribution to participants in an unfunded, non-qualified deferred compensation plan.] Accordingly, issuers are not required to, and should not, look to Forms 13F for beneficial ownership information. That’s why Instruction 3 to Item 403 says that issuers may rely on Schedules 13D and 13G for beneficial ownership information, but makes no mention of Form 13F.

### **When Does a Reporting Delinquency Occur?—Clarification**

A sharp-eyed reader recently asked us to parse a statement in our March-April 2007 discussion of the impact of 1934 Act delinquency on 1933 Act registration, in light of the discussion in our July-August 2007 issue (at pg 11) where we aver that, for S-3 eligibility purposes, a 1934 Act delinquency occurs (allowing a new timeliness clock to start) on the day after the date the filing is missed, and not continuously until the delinquent report ultimately is filed.

In pointing out (in our March-April discussion at pg 3) that a missed 8-K has the same effect on S-3 (and S-8) eligibility as a missed 10-K or 10-Q, we noted that, a late 8-K usually can be filed “soon enough” (*i.e.*, before a takedown) to assuage disclosure concerns. In doing so, we may have suggested that the timeliness clock for an 8-K delinquency doesn’t restart until the 8-K is filed.

What we meant to say is that, for disclosure concerns, the delinquency continues until the 8-K is filed. But, as discussed in our July-August follow-up, we believe the delinquency occurs on day one for S-3 timeliness purposes. Thus, irrespective of when the 8-K ultimately is filed, S-3 timeliness eligibility can be restored 12-plus months after the missed 8-K deadline. (But, “currency” cannot be re-established until the filing is made, or 12 months have passed.)

### **California’s Listed Issuers/Securities Exemptions Updated**

California’s blanket exemption for securities listed on an exchange certified by the Commissioner of Corporations, and its non-issuer transaction exemption for all securities of issuers with a security listed on an exchange certified by the Commission, have long been in need of some fine tuning, despite NSMIA’s purported pre-emption of state law qualification for “covered securities” (see our July-August 1997 issue at pg 5).

#### **Background**

California’s Section 25100(o) exempts from its issuer, non-issuer and reorganization transaction qualification requirements securities listed on any “national securities exchange” certified by the Commissioner of Corporations, and any warrant or right to purchase such a security. [Section 25100(o) does not apply to other securities of the issuer. However, by its Reg 260.105.33, the Commissioner has exempted any security “senior” to exempt listed securities of an issuer.] The Commissioner originally certified the NYSE and AMEX in the 1970s in Rel. No. 27-C, and in 1993 “temporarily” (but, indefinitely) certified the Nasdaq NMS (see our September-October 1993 issue at pg 8) as authorized by a 1989 amendment of §25100(o) that was necessary because Nasdaq was not (then) a “national securities exchange” (see our January-February 1989 issue at pg 7). In 2000, the legislature added authority to certify NMS successors.

Section 25101(a) provides for a similar certification, exempting any securities of exempt listed issuers from California’s peculiar Section 25130 requirement for issuers to file an annual notice in order to exempt “non-issuer” transactions in their securities occurring in the state. The history here is similar to that of Section 25100(o).

### Recent Certification of Nasdaq Global Select Market and Nasdaq Global Market

Nasdaq became a national securities exchange on August 1, 2006, with new tiers (see our May-June 2006 issue at pg 6). In its Rel. No. 87-C (August 9, 2007), the Commissioner certified under §25100(o) both the Nasdaq Global Market (the obvious successor to NMS) and the Nasdaq Global Select Market (an elite tier above the Global Market), but chose not to certify the Nasdaq Capital Market (formerly, SmallCap)). At the same time, in Rel. No. 88-C, the Commissioner certified both the Nasdaq Global Market and Global Select Market under Section 25101(a). Even though NSMIA's 1996 federal pre-emption includes the Nasdaq NMS (and successors), the §25100(o) certification removes the prior uncertainty for rights, etc. to purchase these securities, which some have worried are not included in NSMIA's pre-emption (see our May-June 2006 discussion at pg 8 and our September-October 1993 issue at pg 8); another uncertainty had been that Global Select might not be deemed a successor to NMS per the 1993 certification or under California's 2000 legislation (see our May-June 2006 discussion at pg 8).

Note that §25100(o) applies to securities approved for listing (e.g., in an upcoming IPO), whereas §25101(a) only applies after listing has occurred. And, §25101(a) is not available to non-issuer transactions registered under the 1933 Act (e.g., a secondary offering).

Section 25100(o) certification also gains, e.g., exclusion from dissenting share status under California Corporations Code Section 1300(b)(1) in a merger, etc., clarifies application of the exemption from California's usury law in Section 25117(a), and facilitates investment of reserves by pension funds, insurance companies, etc. Keith Bishop of Buchhalter Nemer in Irvine points out, however, that California law still contains references to the Nasdaq NMS that need to be cleaned up, e.g., Corporations Code Section 301.5 (allowing board classification and elimination of cumulative voting; includes "any successor") and Corporate Securities Law Section 25219 (Commissioner's authority to suspend trading; no mention of successor).

### How the Nasdaq Capital Market (formerly, SmallCap) Fits In Here

Effective May 24, 2007, SEC Rule 146(b) was amended to add securities listed on the Nasdaq Capital Market to the list of "covered securities" pre-empted by 1934 Act Section 18 from state securities regulation (NSMIA) and state anti-fraud claims (SLUSA). (See Rel. No. 33-8791, April 18, 2007.) This essentially renders moot California's non-certification of the Nasdaq Capital Market, except for those (e.g., Keith Bishop) still concerned that NSMIA's pre-emption might not extend to rights to purchase, etc. The Commission did not pick up on the recommendation of the 2006 Advisory Committee on Smaller Public Companies to also add the OTCBB to 146(b). (See our May-June 2006 discussion at pg 8.) [In the 146(b) adopting release, the SEC does appear to "confirm" Nasdaq's position that the GSM is a segment of the GM and, therefore, that both are considered successors to the NMS within the meaning of Section 18.]

### **Rule 144—Acting in Concert Under a 401(k) Plan**

As our readers know, affiliates of an issuer (which most counsel take to include all executive officers—see Release No. 33-7391, § III.B, February 20, 1997) are subject to Rule 144 in connection with their market sales of issuer securities.

Rule 144 applies to market sales by the administrator of the issuer's 401(k) plan where the sales result from an affiliate's election to transfer or withdraw funds from the plan's issuer stock fund, *i.e.*, the sales are for the account of the affiliate. (See *Rohr Industries*, August 27, 1985.) Ordinarily, though, when an affiliate elects to transfer or withdraw funds from an issuer stock fund, the plan administrator avoids having to comply with Rule 144 by (i) matching (or "netting") the affiliate's sales with issuer stock fund purchases for the account of other plan participants, on a book-entry basis, and (ii) allowing any net sales into the market to be allocated to non-affiliates. (See our November-December 1993 issue at pg 1.)

Where, however, the aggregate number of issuer securities sold for the account of all affiliates exceeds the number of shares purchased by other plan participants, resulting in excess market sales for the account of one or more affiliates, the plan administrator must comply with Rule 144 in connection with those sales (each affiliate, and not the plan itself, is considered a seller). This generally means that each affiliate who wasn't netted out through matching may sell shares under Rule 144, subject to 144(e)'s three-month volume limit without regard for the number of shares sold for the account of other plan participants, including other affiliates.

If selling affiliates were deemed to be "acting in concert," however, their sales would be subject to aggregation (see Rule 144(e)(3)(vi)), meaning that the total number of securities sold for all affiliates could not exceed the volume limit. At its 2004 meeting with the Staff, the ABA's Joint Committee on Employee

Benefits asked the Staff whether affiliates would be deemed to be acting in concert where the plan (i) placed a limit on the aggregate number of shares of issuer stock that could be sold in the market at one time (to maintain an orderly market for a thinly traded stock), and (ii) provided for a pro rata cutback if total proposed sales would exceed the plan limit.

Generally, the Staff is reluctant to address “acting in concert,” because the question depends primarily on whether there is an “agreement” relating to the sale of issuer securities, which is inherently a factual question as to which the Staff generally defers. (See, e.g., *Gap, Inc.*, September 16, 1992.) Here, however, where the JCEB asked the Staff to assume that no seller would have any information about other selling participants (including their names or the number of shares they wanted to sell), the Staff was willing to advise that no express or implied agreement among the sellers would exist and, therefore, the sellers would not need to aggregate their sales for purposes of Rule 144.

### Existence of Agreement

Although the JCEB’s question posited that none of the plan participants would enter into an agreement with any other plan participant, the Staff’s favorable response was not a foregone conclusion. Way back when Rule 144 was a newborn, the Staff declined to grant no-action relief where an issuer proposed to get 20 holders of restricted securities to agree not to sell more than a specified number of shares each month, “to preserve an orderly market for everyone’s benefit.” (*Damson Oil Corp.*, April 13, 1972). There, too, the sellers were to become subject to an agreement *with the issuer*, and not with each other, although it was clear that the purpose of the proposed agreement was to benefit all parties to the agreement (as well as all other shareholders).

### Aggregation Even with Non-Affiliates

Rule 144(e)(3)(vi) calls for aggregation of sales by all “affiliates or other persons” who agree to act in concert. The rule’s reference to “other persons” means that even sales by non-affiliates that are not otherwise subject to 144 could be aggregated with affiliate sales for purposes of the volume limit. See Release No. 33-5223 (January 11, 1972) and *SEC v. Drucker*, Fed. Sec. L. Rep. (CCH) ¶99,529 (S.D.N.Y. 1983). In the JCEB’s example, therefore, if the plan’s limit on sales were deemed to give rise to acting in concert, market sales by the administrator for any plan participant within the prior three months, or other sales directly by a participant, would have to be aggregated not only with all other plan participants who are affiliates but with all other plan participants(!), when calculating the volume limit.

### The Upcoming Issue of *The Corporate Executive*

Because our readers will not want to wait two months between issues, and because most of our readers already subscribe to both *The Corporate Counsel* and *The Corporate Executive*, we will blur the lines and continue our proxy disclosure guidance from one issue to the next.

Any readers (or colleagues) who do not subscribe to both newsletters are encouraged to enter no-risk trials to keep abreast of the ongoing proxy disclosure developments and our guidance. (Right now, you can receive the newsletters free for the rest of the year when you try a 2008 No-Risk Trial.)

### It’s Renewal Time

As all subscriptions are on a calendar year basis, renewal time is upon us. Please return the enclosed renewal form (or renew at [TheCorporateCounsel.net](http://TheCorporateCounsel.net)) ASAP. And, don’t forget that this year, in particular, you will also need *The Corporate Executive*.

### The October 9 and 11 Conferences

In view of the SEC’s heightened focus on this coming year’s proxy disclosures, we would urge *all* our readers to attend—at least via the Nationwide Webcast—the October 9<sup>th</sup> Conference—“Tackling Your 2008 Compensation Disclosures.” Just as critical now—with the SEC targeting every company’s CD&A—be sure to register for the October 11<sup>th</sup> Conference: “Lessons Learned” *Necessary Compensation Fixes—Impacting Your Proxy Disclosures* (also in San Francisco and via Nationwide Live Video Webcast).

See you there!

—JMB/MG

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