American Bar Association
Section of Business Law
Committee on Federal Regulation of Securities
Subcommittee on Employee Benefits, Executive Compensation and Section 16

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Catherine T. Dixon, 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 Ms. Dixon:

On behalf of the Subcommittee on Employee Benefits, Executive Compensation and Section 16 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 rules under Section 16 of the Securities Exchange Act of 1934 ("1934 Act").

1. Availability of Rule 16b-3 for Transactions Involving Subsidiaries

Rule 16b-3 provides a series of exemptions for transactions "between the issuer (including an employee benefit plan sponsored by the issuer)" and its directors and officers. The term "issuer" is not defined in the rules under Section 16, and Rule 16b-3 is silent on whether the rule is broad enough to include transactions effected through subsidiaries of the issuer.

Many issuers conduct all or a part of their business through subsidiaries. For a variety of operating and tax reasons, issuers often choose to maintain employee benefit plans at the subsidiary level. As Rule 16a-1(f) makes clear, officers of subsidiaries can be officers of the issuer if they exercise significant policy making functions. The employee benefit plans in which they participate often make awards that involve an "equity security of such issuer" within the meaning of Rule 16a-1(d). Several examples include:

- A deferred compensation plan maintained by a subsidiary that permits participants to defer amounts into phantom stock of the issuer-parent;
- A 401(k) plan sponsored by the subsidiary that permits participants to invest in common stock of the issuer-parent; and
- A stock option plan maintained by a subsidiary in which common stock of the issuer-parent is made available to the subsidiary to satisfy the exercise of options.

The above examples are not meant to be exhaustive. Other situations raising the same considerations include acquisitions or dispositions of issuer stock by a subsidiary from or to an officer or director of the issuer.

We are seeking interpretive advice that the term "issuer" in Rule 16b-3 includes subsidiaries of which the issuer is a greater than 50% owner. Although it appears that the staff has not addressed the availability of Rule 16b-3 for transactions through any type of subsidiary under either the current or former versions of Rule 16b-3, we believe that where the issuer has a majority ownership interest, it effectively controls the subsidiary and can treat it as its alter ego. In such situations, we are not aware of any policy reason why Rule 16b-3 should not be available. Moreover, such an interpretation would be consistent with the staff's position in *Chadbourne & Parke* (January 10, 1992), in which it was held that the term "issuer" encompasses direct or indirect majority owned subsidiaries for purposes of the exclusion from the definition of derivative securities provided in Rule 16a-1(c)(5) for interests in employee benefit plans.

We believe that the manner in which an issuer elects to structure its operations should not be relevant to the availability of the Rule 16b-3 exemption. If majority-owned subsidiaries were included within the term "issuer" for purposes of the Rule 16b-3 exemption, the transactions effected through such subsidiaries for which an exemption is sought would still (i) involve issuer securities, (ii) be subject to the issuer's ultimate control, (iii) not involve any market participants on the other side of the transaction, and (iv) need to meet the transaction-specific requirements *(e.g.,* approval by the board of directors or a committee) of the rule. Accordingly, we ask that you confirm that transactions with a subsidiary that is more than 50% owned by the issuer, or a benefit plan sponsored by such a subsidiary, are eligible for exemption under Rule 16b-3.

2. Excess Benefit Plans Under Rule 16b-3

a. Benefits Lost due to Code Section 401(a)(17) Limit

Rule 16b-3(b)(2) defines an "excess benefit plan" as a plan that is operated in conjunction with a qualified plan and provides only the benefits or contributions that would be provided under the qualified plan but for "any benefit or contribution limitations" set forth in the Internal Revenue Code (the "Code"). Section 401(a)(17) of the Code provides that a qualified plan may not take into account compensation in excess of $150,000 as adjusted for inflation (which limit has to date been adjusted to $160,000).

A common type of supplemental non-qualified benefit plan applies the benefit formula of the qualified plan to compensation in excess of the Section 401(a)(17) limit. For example, if the qualified plan provides for an employer contribution of 10% of compensation, an employee making $260,000 would receive a contribution of $16,000 (10% of $160,000) in the qualified plan and a credit of $10,000 (10% of the compensation in excess of $160,000) in the supplemental plan.

Most qualified plans express the Section 401(a)(17) limit as part of the plan's definition of "compensation." As a result, the question has arisen whether this method of expressing the limit constitutes a "benefit or contribution limitation" for purposes of Rule 16b-3. Most practitioners have assumed that it does, and that any supplemental nonqualified plan making up for this limit is an "excess benefit plan" within the meaning of Rule 16b-3(b)(2). In our view, the fact that the limit is expressed as a definition of compensation rather than in some other way should not negate the fact that the definition is intended to, and does, operate as an effective limit on the amount of contributions which can be made to the qualified plan.

Please confirm that a plan operated in conjunction with a qualified plan that makes up for contributions that cannot be made to the qualified plan by virtue of Code Section 401(a)(17) as reflected in the plan's definition of compensation would constitute an Excess Benefit Plan for purposes of Rule 16b-3.

b. Benefits Lost due to Salary Deferrals into Non-Qualified Plans

Another common type of supplemental plan makes up for benefits that would otherwise have been contributed to a qualified plan but for the deferral of salary into a different non-qualified plan. One example would be a qualified profit sharing plan in which the company makes an annual contribution of 3% of compensation, with compensation defined as gross income for federal income tax purposes. For an individual earning $160,000 per year, the contribution would be $4,800. If that individual, however, deferred $10,000 of salary into a deferred compensation plan, the profit sharing plan would disregard the deferred amount (because it would not be part of gross income) and only $4,500 ($150,000 times 3%) would be credited to the participant under the plan. The supplemental plan would therefore make up for the $300 that the participant lost as a result of the manner in which compensation was defined under the qualified plan.

There is no question that such a plan operates "in conjunction with a Qualified Plan." However, to qualify as an "Excess Benefit Plan," the plan must provide only the benefits or contributions that would be provided under the qualified plan but for any benefit or contribution limit set forth in the Internal Revenue Code. The benefit provided by this type of supplemental plan arguably is not a result of a benefit or contribution limitation in the Code, but rather a result of the definition of the term "compensation" in the related qualified plan, which, because it limits compensation to gross income, excludes non-qualified deferrals. The staff appears to have taken this position in the *American Express* letter (February 25, 1997). Yet a definition of compensation which is limited to gross income typically is used in a qualified plan to assure compliance with the Code's nondiscrimination requirements.

Treasury Regulation § 1.401(a)(4)-2(b) provides a "safe harbor" method of complying with the Code's nondiscrimination requirements. In order to fall within the "safe harbor," contributions to a defined contribution plan (such as a profit sharing plan) must be either a fixed dollar amount or a uniform percentage of compensation. In addition, the definition of compensation that can be used for this purpose must be one of the definitions set forth in Code Section 414(s) and the regulations thereunder. All of these definitions of compensation cross-refer to the definition of compensation set forth in the regulations under Code Section 415 (and permit various adjustments to that definition which are not relevant here). The regulations under Section 415 in turn expressly exclude from the definition of compensation amounts not currently includible in the employee's gross income (such as contributions to a deferred compensation plan).[1] Thus, in order to come within the "safe harbor," a defined contribution plan must exclude from its definition of compensation amounts contributed to a non-qualified deferred compensation plan.

A plan that does not satisfy the conditions for the "safe harbor" could instead satisfy the Code's nondiscrimination requirements under the so-called "general test." While a plan that satisfies the "safe harbor" is deemed to satisfy the nondiscrimination requirements on an ongoing basis until the plan formula is changed, a plan that uses the "general test" is required to demonstrate on a recurring basis, which may require complex and costly actuarial testing, that the plan satisfies the nondiscrimination rules. Moreover, a plan's ability to satisfy these rules may vary with changes in the age and relative compensation levels of the company's workforce.

A company that has chosen to operate under the "safe harbor" rules so as to avoid the cost and complexity of the "general test" should be entitled to treat the limitations imposed by those rules (including the limitation on the permissible definitions of compensation) as a limitation under the Code for purposes of the Rule 16b-3 definition of Excess Benefit Plan. The exclusion of non-qualified deferrals from "compensation" under the qualified plan in order to satisfy the "safe harbor" rules

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1 *See* Treas. Reg. §§ 1.415-2(d)(3), (10), and (11).

effectively acts as a benefit or contribution limit under the Code, and the fact that the supplemental plan makes up for the application of this limit should cause it to come within the definition of Excess Benefit Plan within the meaning of Rule 16b-3(b)(2).

The safeguards in Rule 16b-3(b)(2) would be preserved if such a supplemental plan were treated as an Excess Benefit Plan because the supplemental plan must operate in conjunction with the qualified plan. In addition, the fact that a participant must actually give up for a definable period of time the right to receive amounts deferred into a non-qualified plan provides additional assurance that an insider would not use this strategy as a device to evade the effects of Section 16(b).

We request that the staff reconsider the position in the *American Express* letter and interpret Rule 16b-3(b)(2) to include supplemental plans that make up for benefits that would be provided under a qualified plan because of compensation that was deferred into a non-qualified plan. We expressly exclude from this request any non-qualified plan (whether or not operated in conjunction with a qualified plan) that accepts employee deferrals or that provides matching contributions on amounts that an employee defers into a non-qualified plan.

3. Aggregate Reporting for Deferred Compensation and Supplemental Plans

We believe it would be appropriate for the staff to accord limited reporting relief under Section 16(a) to non-qualified deferred compensation plans and non-qualified supplemental plans or arrangements that involve periodic acquisitions of phantom stock but that do not qualify as Excess Benefit Plans. Currently, each acquisition under such plans, with the exception of the relatively small number of plans that qualify for aggregate reporting under the *American Express* letter, must be reported individually by each insider-participant. This requirement can often be highly burdensome, particularly where there are many acquisitions during a year. (In some cases involving bi-weekly payroll deduction deferred compensation plans, there may be as many as 26 separate acquisitions.) Many of these acquisitions are identical to each other. Given the identical or similar nature of most of these acquisitions and the fact that all typically are exempt under Rule 16b-3(d), we do not perceive any benefit in requiring each acquisition to be reported individually. In our view, aggregate reporting on Form 5 of all exempt acquisitions (including dividend reinvestments to the extent reportable) would be sufficient to satisfy the need of the investing public for information about these transactions. This approach would be consistent with aggregate reporting of dividend equivalent rights ("DERs"),[2] which are similar in substance to the phantom stock transactions under the above types of plans.

4. Availability of Rule 16b-3 for Transactions With Other Parties in Which An Insider Has an Indirect Pecuniary Interest

Partnerships and other parties often engage in transactions with the issuer in which an officer or director has an indirect beneficial interest. For example, a venture capital fund organized as a partnership, in which a director of the issuer is a general partner, may acquire shares of stock directly from the issuer in a transaction approved by the issuer's board of directors. In such circumstances, the director is deemed under Rule 16a-1(a)(2)(ii)(B) to have an indirect pecuniary interest in the transaction that is reportable under Section 16(a) to the extent of the greater of the director's share of the partnership's profits or capital. Similarly, the issuer may engage in transactions with other parties, such as a corporation, trust, or the spouse of an insider, which are reportable by the insider because the insider has an indirect pecuniary interest in such transactions under Rule 16a-1.

Rule 16b-3 provides an exemption for transactions between an issuer and an officer or director. It does not directly address the question whether the rule may be relied upon to exempt an insider's indirect pecuniary interest in transactions with the issuer conducted through other parties. We are not aware of any policy or other reason why the rule should not also be available to exempt transactions meeting its requirements that are conducted indirectly through other entities or persons. So long as the availability of the rule is limited solely to the portion of a transaction consisting of the insider's interest, it would seem that the purposes of the rule would be satisfied. Accordingly, we request that the staff, at the least, confirm that the rule may be relied upon to exempt the following transactions in which an officer or director has an indirect interest:

- A transaction with a partnership or corporation in which beneficial ownership of the securities is reportable by the insider pursuant to Rule 16a-1(a)(2);
- A transaction with a member of the insider's immediate family that the insider is required to report under Rule 16a-1(a)(2)(ii)(A);

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2 *See, e.g.*, Release No. 34-34514 n. 75 (1994); *Skadden, Arps, Slate, Meagher & Flom* (June 23, 1992); *Palmer & Dodge* (January 31, 1992).

- A transaction with a trust, the holdings and transactions in which are required to be reported under Rule 16a-8(b).

In each of these transactions, it can be assumed that (i) the board of directors or the committee acting to approve the transaction will be specifically aware of the indirect relationship, and (ii) the document evidencing the approval will specifically mention the indirect relationship and the understanding of the board or committee that such approval constitutes approval for purposes of Rule 16b-3.

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In accordance with Release No. 33-6269, we are including seven copies of this request with the original letter. Members of the Subcommittee are available to discuss any aspect of this letter at the staff's convenience, and we would appreciate the opportunity to do so before you issue any response.

Sincerely,

Louis Rorimer /KFH

Louis Rorimer
Chairman

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