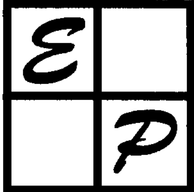

THE CORPORATE COUNSEL

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HIGHLIGHTS AND PITFALLS

Deep (1933 Act) Thoughts on Google's TSO Program

Google's transferable employee stock option program (featured in the May-June 2007 issue of *The Corporate Executive*) is fertile with 1933 Act detours and forks in the road. For those who may have missed that discussion, Google is providing employees a program to sell their options to institutions via an online auction managed by Morgan Stanley. New grants will also be TSOs; executives and directors are not participating. The option buyers will hedge their position immediately by selling short an equal number of shares, then adjusting their position to a desired "delta."

Registration of Short Sales, But Not the Exercise of Sold TSOs—
The 2003 Goldman Sachs II Interpretive Letter

The option buyers' short sales involve the public sale of shares that is equivalent to advance sale of the option shares that the option buyers ultimately will purchase from the company. Thus, Google has included those short sales in its S-3 (File No. 333-142243) that also includes its stock plan (replacing its S-8s, which Google de-registered and transferred the unused fees—see our January-February 2001 issue at pg 4).

In a letter issued to Goldman Sachs & Co. dated October 9, 2003 (see the January-February 2004 issue of *The Corporate Counsel* at pg 1), the Staff essentially memorialized the 1933 Act registration requirements of Microsoft's 2003 program (similar to Google's TSO program), where J.P. Morgan bought (underwater) Microsoft employee stock options and immediately hedged its position via short sales in the public market. The Staff had required Microsoft to register the short sales upfront (a Rule 415(a)(1)(x) shelf offering), treating the (public) buyers of the shares sold in the short sale as the "real purchasers," and concurred that the ultimate exercise of the sold options (by J.P. Morgan just prior to expiration of the options) needn't be registered. In essence, registration of the short sales rendered the ultimate exercise of the options (including delivery of the option shares to close out share borrowings) a 1933 Act non-event.

The Microsoft situation was a one-shot transaction so, there, the Staff's position freed the company from maintaining the registration (for three years until expiration when the options would be exercised) and, more importantly, freed Morgan from any concerns that a registration statement would still be in effect at the time of exercise. In the Google situation, because the auction program is ongoing, the S-3 covering short sales will need to be maintained in effect throughout the duration of the TSO program.

Welcome Aboard, David Lynn

We are honored to welcome David Lynn to our team, for all of our publications. Dave has decided to leave one aspect of the public service sector for another. In his second tour of duty at the SEC, Dave served as Chief Counsel of the Division of Corporation Finance for the past four years.

In addition to helping implement the record amount of rulemaking that occurred in the wake of Sarbanes-Oxley, Dave has been one of the key point persons on the SEC's proxy disclosure rules and, most recently, was responsible for the overhaul of the SEC's Telephone Interpretations Manual and other interpretive guidance. In addition to being on top of all the "bread and butter" practice issues that many of us grapple with daily, Dave has worked closely on many novel issues. Dave loves to teach and has spent countless hours bringing younger Staffers up-to-speed on all aspects of the securities laws.

We look forward to Dave sharing his knowledge and insights with all of us for many years to come through our publications and websites. —*JMB*

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But, the Staff's position that registration is required upfront (at the time of the short sales), *not down the road at the time of exercise,* is still vital here, in that it wouldn't be acceptable to the option buyers in the Google program for there to be any uncertainty (or conditions, *e.g.,* continuing S-3 registration) for the free tradability of the stock they acquire upon ultimate exercise of the options they purchase. So long as the S-3 is in effect when an option is purchased (and all the shares are sold short simultaneously), the option buyers are assured of liquidity for all of the option shares. In fact, Google's S-3 doesn't even cover exercise of the transferred TSOs.

Theoretically, a buyer might not wish to sell short 100% of the shares immediately. (Google points out that the TSO buyers might borrow shares from "securities lenders" in order to effect the short sales.) However, by selling short all shares immediately per the S-3 that is in effect at the time of their purchase of an option, they not only cleanse the option stock of 1933 Act restriction but they become free thereafter to subsequently buy back shares in the market (with proceeds from the short sales) in order to arrive at, and adjust up or down later, their net hedge position.

Traded Call, Etc. Options—No Issuer Registration. Normally, the exercise of options issued by a company must be registered (unless non-public or otherwise exempt), even where the original sale/issuance of the options was registered, *e.g.,* following the registered sale of common stock purchase warrants an S-3 must be maintained to cover exercises (per Rule 415(a)(1)(iii)). In this context, we got to thinking about how traded/standardized options (calls, puts, etc.) in a company's stock fit in here. Those options aren't issued by the company, but are packaged by the applicable stock exchange, and technically are "issued" by the Options Clearing Corporation. Thus, no *company* registration is implicated, for either the issuance or exercise of those options (see Rule 238, adopted in Rel. No. 33-8171 (December 23, 2002)); but, an options disclosure document is required to be filed with the Commission by the options market (OCC) and furnished to customers (see Rule 9b-1). Another way to look at it is that these options are just a vehicle for everyday trading in a company's stock (with leverage).

The Staff's Net Exercise Alternative Apparently Not Available (or Needed). We wonder whether Google, in its pre-filing conference, asked the Staff to concur that exercise of the purchased options also would not require registration if the options were subject to SAR-type net exercise, *i.e.,* issuance on exercise of only the net number of shares representing the spread. Might the Staff's position that net exercise of investment warrants does not require registration (see our September-October 1998 issue at pg 5), *i.e.,* because an investment is made (only) at the time of purchase of the warrants (and the exercise is exempt under Section3(a)(9)), be applicable here? We assume the Staff was not willing to extend this position to the Google TSO context, because of the Staff's longstanding refusal to apply it in the employee stock option context, even though here there is an actual investment in a warrant-like security at the time a TSO is purchased.

Primary vs Secondary S-3?

Google's S-3 Hedging Prospectus (there is also a Stock Plan Prospectus) says that the subject shares "may be offered and sold from time to time by Morgan Stanley," and the option buyers (Morgan Stanley, Citigroup, et al.) are named as underwriters. We would think, however, that Google is the real seller here in a "primary" offering (of the option stock); thus, there is no selling shareholder section with S-K 507 information. That Morgan Stanley rather than Google is stated to be selling isn't really dispositive, in that the S-3ASR obviously wasn't reviewed (although Microsoft's S-3, which contains similar language, likely was). [Compare *Goldman Sachs I* (see our January-February 2000 issue at pg 4), where affiliates sold forward-sale contracts on shares they already owned and the broker-counterparties hedged; there, Rule 144 was implicated, not 1933 Act registration, because the affiliates were the deemed public sellers.] S-3 is available to any listed company to register sales by a shareholder, but primary S-3 eligibility is required for an issuer shelf.

Why Not Register the TSO Sales?

Google also has not registered the employees' TSO sales. Grant of the TSOs is registered, just as grants of *non-transferable* options typically are registered. [Non-transferable options might not be a security separate from the underlying stock, but grant of the option is nevertheless an offer of the underlying stock, requiring (unless exempt, *e.g.,* §4(2)) registration under Section 5(c). We suspect the Staff's accommodating employee stock option positions (see the *Telephone Interpretations Manual* (July 1997), at G.61), *i.e.,* that there is no "offer" pre-vesting and that late registration is tolerated until (just prior to) exercise (see our July-August 2005 issue at pg 1), wouldn't apply to *transferable* employee stock options, especially where (as here) the options can morph into warrants.]

The TSOs are being sold only to a few institutional investors; thus, Section 4(2) should be applicable (or "§4(1-1/2"), because these are resales by the employees—see our May-June 1981 issue at pg 7). (As discussed above, any look through to the resulting public short sales of Google stock that are triggered by the TSO sales is addressed by the S-3 registration.) And, the sold TSOs are not further transferable, so there is no liquidity/resale concern that registration of the TSO sales might assuage. Moreover, gratuitously registering every transaction in sight (*e.g.,* the TSO sales and exercises) might increase exposure to the 1933 Act's non-scienter antifraud liabilities, *e.g.,* Section 11 (§12(a)(2) is not limited to *registered* offerings).

Technically, there might be a private offering problem even with sale of the TSOs to only a few investors, arguing for registration of the option sales, in that (pending implementation of the Commission's May 23 general solicitation interpretation/proposals), there may be a theoretical general solicitation problem here, *i.e.,* any institutional investor can seek to become a bidder. Fortunately, the SEC finally is putting this one to bed.

Might Google's Short-Sale S-3 Be Usable During the Pendency of Undisclosed Information?

Google says it will suspend TSO sales at any time that material information is undisclosed, *i.e.,* during any imposed (or even regular quarterly) blackout period. In Q&As for its beta TSO program (see FWP filed February 22, 2007), Google says that its S-3 registering the short sales "may not" be used while material information regarding Google is undisclosed. We think what they mean is not that the registration statement/ prospectus is inadequate for 1933 Act purposes (see our March-April 2005 issue at pg 9), but that Google deems it prudent not to allow the registration statement to be used, especially since Google is registering sales of the option stock, and is indemnifying the underwriters from 1933 Act liabilities. Note that we are not talking here about undisclosed information resulting from a 1934 Act filing delinquency, which subject we featured in our March-April 2007 issue.

Suspending All S-3s? The logical extension of Google's approach here might be to suspend any ongoing S-3s (S-8s, too?) during any blackout period, *i.e.,* allowing S-3 sales (and even stock-option exercises) only during window periods. We don't think most issuers would go that far. Moreover, suspending all S-3s during an imposed blackout would be walking right into the problem of the marketplace becoming aware that something is astir (which Google takes pains to address in the context of its blackout of TSO sales/short sales by the TSO buyers—see our *The Corporate Executive* discussion at pg 6).

Rule 10b5-1 Plans. As we discussed, Google (despite encouraging 10b5-1 plans for all employees) is not permitting any TSO sales during blackout periods, even where there is a 10b5-1 plan specifying TSO sale dates. While a plan may protect the optionee/seller, here, neither Google (as registrant for the triggered short sales) nor the short sellers/underwriters would be protected by a 10b5-1 plan, in that 10b5-1(c) provides a defense only to 10b-5 liability, not 1933 Act Sections 11, 12(a)(2) or 17(a).

Form S-8 vs. S-3ASR

We wonder whether Google switched its stock plan registration to S-3(ASR) (i) because of concern that the grant of options that, upon sale, automatically morph into warrants couldn't be registered on S-8, or (ii) because there may actually be a benefit to using S-3ASR rather than S-8. More on this in our upcoming issue. [Even non-primary S-3 issuers can use S-3 to register the exercise of stock options (instead of S-8), *i.e.,* by employees pre-sale or by the option buyers post-sale (see S-3 General Instruction I.B.4(a)(3)); although, as discussed above, Google did not register exercise of the sold options.]

NEW DEVELOPMENTS

The CDI—The Staff's New Guidance Format

In our May-June 2006 issue (at pg 5) we mentioned the Staff's plan to update the *Telephone Interpretations Manual* on a section-by-section basis, and to ultimately incorporate other Staff interpretive vehicles (*e.g.*, FAQs, the Current Issues Outline, and SLABs). Now, the Staff has actually begun to replace sections of the *TIM*.

The New Compliance and Disclosure Interpretations

Earlier this year, the Staff updated Corp Fin's homepage. A part of that reorganization was to create a new home and name for the *TIM* and most other interpretive guidance (not including, *e.g.*, no-action letters or accounting guidance), called "Compliance and Disclosure Interpretations." To date, the Staff has replaced portions of the *TIM* with eight new interpretive "sections": Rule 144; S-K Items 201, 402, 403, 404 and 407; 1934 Act Section 16; and 1939 (the Trust Indenture) Act.

Two Parts. Each CDI section is broken down into two parts: (1) Questions and Answers of General Applicability (reminiscent of the FAQs) and (2) Interpretive Responses Regarding Particular Situations (more like the old *TIM*). Each part is further broken down and is numbered 101, 102, etc. for part (1) and 201, 202, etc. for part (2). (Some of the earlier CDI sections are simply numbered 1, 2, 3, etc., but we suspect future CDIs will have the decimal numbering system.) In both parts, the first sub-part is "General Guidance" with each question/interpretation separately numbered (*e.g.*, Question 101.01, Question 101.02, etc.). The remaining sub-parts depend upon the particular item. *E.g.*, the Rule 144 Compliance and Disclosure Interpretations' Sections 102 and 202 discuss Rule 144(a)(1), Sections 103 and 203 discuss Rule 144(a)(2), and so on. [Going forward, we will refer to part (1) sections as "Question" and part (2) sections as "Interpretation." *E.g.*, 1939 Act CDI Question 101.03, or Rule 144 CDI Interpretation 225.04. Prior to being moved to the CDI, we will continue to refer to sections of the old telephone interpretations as the "*TIM*."]

Archives. One nice feature of the new format is the inclusion of a date (in brackets) at the end of each Question or Interpretation, indicating the last time it was published or revised. Another nice feature of the revised website is the ability to access the old *TIM* (as well as other interpretations) by clicking "Archives" in the left-hand column of Corp Fin's homepage. Interestingly, there is a note on the archive page stating that information is "for historical reference purposes," but its placement on this page is "not meant to imply that all the information is outdated or superseded." We assume this means that many of the archived interpretations are in the CDI, and still in effect.

The Coming Internal Control Disclosures by Non-Accelerated Filers— Staff Clarifies Scope and Effective Date of 10-Q Temporary Item 4T

As our readers may recall, non-accelerated filers (*i.e.*, filers that are neither accelerated filers nor large accelerated filers as defined in Rule 12b-2), which comprise 44% of domestic filers, are required to "furnish" (but, permitted to "file") the SOX Section 404 management assessment in their 10-K for 2007, and to "file" both the management assessment and auditor's attestation beginning in their 10-K for 2008. (See our January-February 2007 issue at pg 11.)

Item 4T of Form 10-Q

Item 4 of Part I of Form 10-Q requires disclosure of material internal control *changes* during the quarter (Item 9A of Part II of Form 10-K applies to the fourth quarter). Because of the one-year transition to full 404 status, non-accelerated filers temporarily are subject to Item 4T instead of Item 4 (and Item 9A(T) instead of Item 9A). There appears to be some confusion, however, regarding when, and perhaps even to what extent, Item 4T applies.

Modified S-K Item 308 Requirements. Management's annual internal control assessment (in the 10-K) is governed by S-K Item 308(a), which calls for *inter alia* a (i) description of the framework used to evaluate the effectiveness of internal control, (ii) statement whether the company's internal control was effective as of the end of the most recent fiscal year, and (iii) discussion of any material weaknesses in internal control. Management's Item 308(a) report (like the Item 308(b) auditors' attestation report) goes in the 10-K, but is not required to be included in the 10-Q. Both the 10-Q and 10-K, however, require Item 308(c) disclosures relating to material internal control changes during the quarter.

The Commission adopted S-K Temporary Item 308T, consistent with the phase-in of the Section 404 requirements for non-AFs. See Rel. No. 33-8760 (December 15, 2006). Item 308T applies only to non-AFs' first, transition year. 308T(a) temporarily revises 308(a) to allow the issuer to "furnish" management's annual assessment and most of the other information called for by Item 308(a). Item 308T(b) is simply "old" Item 308(c) (*i.e.,* changes), renumbered because the auditor's attestation (Item 308(b)), is inapplicable during the transition.

Source of the Confusion. Item 4T calls for the information required by Item 308T (not just Item 308T(b)). Item 4T's apparent call for 10-Q compliance with all of Item 308T, *i.e.,* both management's (annual) assessment and quarterly changes, raises two questions. First, an introductory note to 308T says that 308T applies only to annual reports, suggesting that nothing in 308T needs to be addressed in Form 10-Q. Second, the requirement to comply with all of 308T, as opposed to the 10-Q requirement to comply only with Item 308(c) (*i.e.,* changes), suggests that, during the temporary period, non-AFs must also include in each 10-Q the 308T(a) disclosure relating to management's internal control assessment.

There is no cause for alarm, however. The Staff has confirmed to us that, notwithstanding the introductory note, Item 308T does apply to Form 10-Q, and also has confirmed that the 10-Q does not need to include the management assessment required by Item 308T(a), and instead must address only Item 308T(b).

Item 4T Effective For 10-Qs Filed in 2008 (not 2007)

Item 4T calls for Item 308T disclosure "with respect to a quarterly report that the registrant is required to file for a fiscal year ending on or after December 15, 2007," *i.e.,* the transition year. Apparently, some counsel are reading this to mean that Item 4T displaces old Item 4 for the 10-Qs for Q1, Q2 and Q3 of 2007 and for the 10-K that covers Q4, and we have already seen several non-AFs include Item 4T in their 2007 Q1 Form 10-Q. The Staff tells us, however, that new Item 4T doesn't become applicable until *after* the issuer files a 10-K for the transition year (*i.e.*, for calendar year issuers, the first quarter of 2008); it would be premature to disclose changes in the internal control framework prior to furnishing/filing the first management assessment.

The changes disclosure requirement similarly didn't kick in for accelerated filers either, until their second year under 404. (See FAQs on Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Q.9 (October 6, 2004).) Non-AFs therefore may continue to include only S-K 307 information (disclosures controls and procedures) under Item 4 in their 10-Qs this year.

Small Business Issuers. SBIs are subject to the same 404 requirements as non-AFs (pending any further relief that may be coming, *e.g.,* in methodology from COSO). Small business issuers are subject to temporary Item 308T of Regulation S-B, which is applicable under Part I, Item 3A(T) of Form 10-QSB and Part II, Item 8A(T) of Form 10-KSB.

Issuer Private Placement While There is Undisclosed Material Information— Rule 10b-5 Concerns (Waiver?)

More than once lately we've encountered an issuer with an urgent need for capital proposing to sell securities in a private placement while (potentially) material information had not been publicly disclosed (*e.g.*, an issuer in the *midst* of an internal accounting investigation, or negotiating an acquisition).

Disclosure Via Confidentiality Agreement

Where the undisclosed information is identifiable and can readily be disclosed to a private investor (*e.g.*, the issuer is proposing to announce a new product, or plans to sell a subsidiary), the solution to the problem ordinarily is to provide the disclosure to the investor but to require that the investor enter into an agreement to keep the information confidential (and not to trade in the issuer's stock) until the information has been made public. Disclosure obviously protects the issuer from potential antifraud liability to the investor under 1933 Act Section 12(a)(2) and 1934 Act Rule 10b-5.

This approach allows the issuer to control the timing and content of information that is not yet ripe for public disclosure, while assuaging the antifraud concerns. Where the investor is an FD-covered person (*e.g.*, an existing shareholder), a confidentiality agreement also addresses FD's selective disclosure concern (FD allows selective disclosure if the recipient agrees to keep the information confidential—see our September-October 2000 issue at pg 7). FD does not require that the recipient of the information also agree not to trade on the information (see Q.10 in the *TIM*, Fourth Supplement (October 2000)), but issuers usually try to include a no-trading clause in the confidentiality agreement in order to make clear that the investor was on notice and contractually bound not to defraud other investors.

No Disclosure to the Investor

Sometimes, the confidential information is not readily amenable to drafting or disclosure. Say, for example, an issuer has filed an 8-K Item 4.02 announcing that its financial statements should no longer be relied upon due to recently discovered accounting irregularities. The issuer has decided not to allow sales under its extant registration statements on Form S-3 (or even S-8). (See our March-April 2007 issue at pg 3.) While an internal accounting investigation is underway, the issuer is approached by one or more potential acquirors, and the issuer decides to explore the possibility.

Both the internal investigation and the merger discussions may be fluid, rapidly developing situations, not easily described in a disclosure document that might become stale even before it is delivered. Where the issuer needs to raise capital during this period (*e.g.*, by selling preferred stock to an institutional investor), we've seen issuers include in the stock purchase agreement (or require the investor to sign) an acknowledgment that the issuer is undertaking an internal investigation and/or is involved in discussions that might lead to a merger, and that the issuer is (or may be) in possession of material non-public information of which the investor has not been made aware.

Implicit Waiver? We think acknowledgments of this type might, in the event of a dispute between the parties (or an SEC investigation), help the issuer establish that the investor was aware of the risks of the

investment, which is essentially the equivalent of arguing that the information withheld was immaterial in view of the disclosures that were in fact made. We are not confident, though, that obtaining an acknowledgment of this nature (or, *e.g.,* providing a price discount in recognition of the uncertainties) would protect an issuer from antifraud liability where material, adverse information was known at the time the securities were sold but was knowingly withheld by the issuer (or even just negligently withheld, in the case of a Section 12(a)(2) allegation).

We think the acknowledgment might be considered the equivalent of the investor waiving compliance with the disclosure requirements, which presumably would run afoul of 1934 Act Section 29(a) (which provides that any waiver of compliance with the federal securities laws is void). (After-the-fact releases in the litigation context, in contrast, can be enforceable.) Nevertheless, we think an acknowledgment of this type can, in appropriate circumstances, help establish the circumstances that existed at the time of the transaction and therefore may help (and can't hurt). (A price discount might be offered as consideration for the waiver; even if the waiver ultimately is not enforced, the discount should reduce any 10b-5 actual damages to that extent.)

Sophisticated Traders. A recent Enforcement action against Barclays Bank PLC and one of its bond traders suggests that the SEC would not agree that a seller (or purchaser) of securities can avoid antifraud liability by disclosing to its counterparty that it is (or may be) in possession of material non-public information that is not provided to the counterparty. In Lit. Rel. No. 20132 (May 30, 2007), the Commission filed (and simultaneously settled) an injunctive action alleging that Barclays traded in debt securities of bankruptcy debtors based on material non-public information obtained by the bond trader through representation of Barclays on creditors committees.

Barclays defended some of its trades by producing "big boy letters," signed by counterparties, acknowledging that Barclays might be in possession of material non-public information regarding the issuer-debtor. Perhaps Barclays thought the sophistication of the counterparties was enough to permit a knowing waiver of the "disclose or abstain" rule (which goes all the way back to the original insider trading case, *SEC v. Texas Gulf Sulfur*), but it appears that the SEC didn't agree. In the release, the Commission noted that Barclays obtained big boy letters but added that "in no instance did Barclays or [the trader] disclose the material non-public information received from creditors committees." This lesson was expensive for Barclays and the trader, who agreed to pay disgorgement and penalties of $10.94 million and $750,000, respectively.

Stock Option Exercises

We think most issuers don't blackout employee stock option exercises just because there is material non-public information; that might restrict option exercises to insider trading window periods. But, we think option grant agreements should be drafted to enable the issuer to do so, circumstantially, based on compliance with applicable securities laws. [Even positive undisclosed information can be material here, in that optionees typically sell contemporaneously at least a portion of their option stock.]

Where an executive delivers notice of exercise of an expiring stock option, assuming the executive is not otherwise aware of material information, if the issuer has suspended use of its S-8, the issuer may have little choice other than to sell securities in a private placement, and to provide the best disclosure it can (or is willing to make). But, that technique may not be suitable for non-executives. Google initially considered banning all exercises during quarterly and imposed blackouts (consistent with its ban on TSO sales—see pg 3), probably for symmetry reasons, but backed off doing so. (See the May-June 2007 issue of *The Corporate Executive* at pg 6.)

Goldman Sachs Belatedly Adds Shareholder Proposal to Annual Meeting

We noticed that Goldman Sachs Group, Inc. recently supplemented its February 21 proxy statement (for its March 27 shareholder meeting) to add a shareholder proposal (from gadfly Evelyn Y. Davis), calling for no further stock options to be awarded by the company. On March 19, without delving into the reasons that the shareholder proposal didn't make it into the proxy statement (presumably, an oversight, or maybe they had thought they would receive a favorable exclusion letter from the Staff), Goldman supplemented its meeting notice and proxy statement and included a revised proxy card, adding the new item and allowing 15 days (beyond the meeting date) to respond, but only for voting on that item (at a "reconvened" meeting).

Supplemental Disclosure of Litigation

Interestingly, the supplemental proxy statement also discloses a shareholder derivative lawsuit challenging Goldman's compensation practices, including stock option methodology, as well as the sufficiency of the February 21 proxy disclosures in that regard. Goldman points out that Mrs. Davis is not involved in the

litigation. The litigation is not directly related to any of the other meeting agenda items (*e.g.,* there is no stock plan proposal), so it appears that Davis' proposal triggered the new disclosure (the lawsuit was filed on March 16). Even if there had been a management stock option proposal, we doubt Goldman would have supplemented the proxy statement absent the Davis proposal glitch; the plaintiffs theoretically were free to mount an opposition campaign. Keep in mind that even shareholder proposals don't trigger a preliminary proxy filing. (See Rule 14a-6(a)(3).)

Why So Many Forms 4 Cluttering Edgar?

Ever wondered why, when accessing Edgar filings at sec.gov, without (inadvertently or on purpose) checking the box to bypass Section 16 filings, there often are pages and pages of Forms 4 in the way? We have (and, we now routinely check that box).

Multiple Transactions. Alan Dye tells us that the main culprit may be the requirement to report each transaction (*e.g.,* sale or purchase) on a separate line, even multiple transactions occurring on the same day. Thus, insiders often sell a large number of shares that, when effected in the market (rather than in a negotiated block transaction), may well involve many transactions (*e.g.,* 100 shares at $90, 100 at $90.01, etc.). Even though one method of reporting here would be to add additional pages to the same Form 4, the Staff for some reason prefers multiple forms once the 30 transaction lines on the standard form are used up (labeling each Form 4 "one of X," "two of X," etc.). (See Model Form 19 in Romeo & Dye's *Section 16 Forms and Filings Handbook* (2005).)

The Staff has taken the position that aggregate reporting of transactions that occur on a single day (at the weighted average price) isn't permitted, apparently because of the need to know the highest sale price/lowest buy price for Section 16(b) matching purposes (see Section 16 CDI Question 133.08). Alan would like to see the Commission adopt a rule permitting (or the Staff interpret the Form 4/5 instructions to permit) aggregate reporting (with the range of prices in a footnote). This change may take some getting used to by the Section 16 plaintiffs' bar, but overall there would be significant savings here.

RSU Vesting. Another reason for the high volume of Forms 4 may be the increasing use of restricted stock units (as opposed to outright grants of restricted stock) as long-term equity compensation. While restricted stock grants are reportable only once, at the time of grant (see Model Form 116), RSUs, if reported in Table II at the time of grant (either voluntarily, or because the award may settle in cash), must be reported again upon vesting, as the exercise or conversion of a derivative security (see Model Form 119). We understand that some issuers coordinate the vesting dates of successive years' RSUs grants, to enable vestings from several years' grants to be reported in the same Form 4.

Internet Proxy Solicitation—State Law Compliance?

In our January-February 2007 issue (at pg 9) we discuss the ability of issuers to deliver proxy materials via the Internet beginning July 1, and the Commission's intention to soon require universal availability of Internet access (for delivery purposes). The April 5, 2007 proxy solicitation of Cadbury Schweppes plc includes a management proposal that reminds us of the possible role here of both (i) non-federal law and (ii) shareholder relations: Cadbury seeks shareholder authorization to send notices, etc. to its shareholders via the company's "website or by using other electronic means."

State Law Pre-emption?

Cadbury obviously is a foreign company, so there is no question here of whether, or to what extent, the federal proxy rules pre-empt state corporate law. While the Commission's proxy solicitation rules do pre-empt state laws regarding proxy solicitation (see, *e.g., Fidelity Federal Savings & Loan Ass'n v. De La Cuesta*, 458 U.S. 141 (1982)), the Commission's authorization of the use of I-proxy (which some are still calling "e-proxy") isn't intended to override a state law requiring, *e.g.,* that notice of a meeting include more information than the notice that I-proxy contemplates. (See Rel. No. 34-55146, January 22, 2007, at II.A.5.) While state laws ultimately may be conformed to I-proxy, that obviously won't happen all at once. Moreover, shareholder approval, alone, generally wouldn't be sufficient to change state corporate law requirements.

S-K Item 403 Follow-Up—Staff Now Says Deceased NEO May Be Excluded Completely From Beneficial Ownership Table

In our March-April 2005 issue (at pg 11) we parsed some of the proxy statement disclosure issues raised by death of an NEO (or director) after the end of the fiscal year. One aspect we addressed was whether to include in the S-K Item 403 beneficial ownership table an NEO who died after the end of the fiscal year

but before the (latest practicable) date used for the table. The uncertainty arises because Item 403(b) requires that each NEO be included in the beneficial ownership table, but also calls for beneficial ownership as of the "latest practicable date." Where that date is after the end of the fiscal year (which usually is the case), the NEO's death before that date means that the decedent (whose NEO's status for the past fiscal year under S-K 402 is not affected) cannot beneficially own any issuer securities as of the date of the table. (Ownership by heirs, legatees, or the NEO's estate is not ownership by the NEO, who obviously no longer has the power to vote or the power to dispose of any securities owned at the time of death.)

Based on Staff input we got at the time, we advised issuers to include the deceased NEO in the beneficial ownership table but show "0" as the number of shares beneficially owned as of the date of the table. Since the deceased executive would still be an NEO in the Item 402 compensation tables, including the NEO in the beneficial ownership table would maintain symmetry with the executive compensation tables, and showing "0" as the number of securities owned would accurately reflect the NEO's beneficial ownership as of the date of the table.

New CDI Input

In S-K 403 CDI Question 2.03, the Staff has re-examined the need to include a deceased NEO in the beneficial ownership table. The Staff now says that an NEO who dies after the end of the fiscal year (or who died during the fiscal year, but still ended up an NEO—see our March-April 2005 issue at pg 11) does not need to be named/included in the beneficial ownership table at all. [Ditto, even where death occurs after the as of date of the beneficial ownership table (but before the date of the proxy statement). Because, in this circumstance, the NEO would have beneficially owned a determinable number of securities on the as of date of the table, the Staff must have concluded that beneficial ownership information regarding a deceased NEO (as a line item or as part of the holdings of all directors and executive officers as a group) is simply immaterial.]

Reporting Standalone Stock Appreciation Rights in the Beneficial Ownership Table—What Number of Shares?

With many issuers now granting standalone (instead of tandem) SARs, issuers are having to determine how to report, in the beneficial ownership table, standalone SARs held by their executive officers or directors. Because "beneficial ownership" for purposes of S-K Item 403 is determined using the standards applicable under 1934 Act Section 13(d) (see Instruction 2 to Item 403), the relevant inquiry (as with stock options) is whether (and, if so, to what extent) the SARs confer on the holder a right to acquire issuer securities (*i.e.,* are vested at, or will vest within 60 days after, the as of date of the table); see Rule 13d-3(d)(1).

As our readers may recall, an SAR is a right to receive the amount by which a specified ("notional") number of shares of the issuer's common stock increases in value over the "exercise price" between the date the SAR is granted and the date on which it is exercised. In effect, a standalone SAR is a stock option that entitles the grantee to receive the "spread" value of the option on the date of exercise. An SAR might be exercisable for cash (but, not often these days, given the adverse accounting for cash, but not stock, SARs) and/or stock. The number of shares delivered upon exercise of a stock SAR is determined by dividing the aggregate option spread by the market price of the stock on the date of exercise.

Gross vs. Net Shares

Until recently, most SARs were granted in tandem with a stock option, so the gross number of shares subject to the award simply was included in the table, without parsing the lesser number that might actually be acquired if the SAR were exercised rather than the stock option, with footnote explanation of the SAR terms. When reporting shares underlying standalone SARs, we think the beneficial ownership table should not include the notional/gross number of shares, but rather the shares the holder could acquire if, on the "latest practicable date" used for purposes of the table, the holder exercised all SARs that are then exercisable (*i.e.*, vested) or that will become exercisable within 60 days.

The notional number describes the terms of the compensation arrangement appropriate for S-K Item 402 disclosure (*i.e.,* with a 10,000-share SAR, the holder stands to earn $10,000 for every dollar the stock price increases). (See S-K 402 CDI Question 8.01, January 24, 2007.) But, the 403 table shows the number of shares an SAR holder has the right to acquire.

So, for example, if an NEO holds 10,000 vested SARs having an exercise price of $20 a share, and the market price of the issuer's stock on the as of date of the beneficial ownership table is $40 a share, the beneficial ownership table should include 5,000 shares ((10,000 shares x $40 = $400,000) – (10,000 shares x $20 =

$200,000) ÷ $40 = 5,000 shares). (The number included in the table would be 10,000 (with an explanatory footnote) if the SARs were issued in tandem with a stock option permitting the NEO to acquire all of the underlying shares for cash.) As required by Item 403, the table should include a footnote disclosing that the NEO's reported holdings include 5,000 shares issuable upon the NEO's exercise of SARs within 60 days of the date of the table; the footnote might also describe the terms of the SARs, including the notional number of shares and strike price.

We note that the Staff hasn't specifically confirmed the net approach here, but see our discussion below of the new S-K 201 interpretation.

Cash-Only SARs. If exercisable only for cash, a standalone SAR does not represent a right to acquire issuer securities and therefore should not be included in the beneficial ownership table, even if vested. [This conclusion is consistent with the Staff's position that cash-settled phantom stock held under a non-qualified deferred compensation plan should not be included in the table. See our March-April 2003 issue at pg 6.] If, on the other hand, SARs may be exercised for stock (even if the grantee may elect to receive either cash or stock), the SARs represent a right to acquire stock and, therefore, to the extent vested, represent beneficial ownership of stock. (If SARs may be settled in cash or stock, but the issuer rather than the holder determines the form of payment, then the holder doesn't have the "right" to acquire common stock and, therefore, the SARs need not be included in the beneficial ownership table; albeit, a footnote noting the exclusion may be advisable.)

New S-K Item 201 Interpretation—Net Shares

In S-K 201 CDI Interpretation 4.04, the Staff takes a net-share position for SARs under S-K Item 201(d)(2)(i), which requires disclosure, in column (a) of the Equity Compensation Plan Information table, of the number of shares issuable upon the exercise of outstanding options, warrants and rights. There, the Staff says to include in the table the net number of shares that would be issuable under outstanding SARs based on the market price of the issuer's stock on the last day of the fiscal year, and explain the calculation in a footnote. Thus, the current Staff scoreboard for SARs is 402, gross; 201(d), net; and 403, no guidance.

We think 201(d) is indicative how the Staff would come out on 403. In fact, we can make a case for gross treatment under 201(d), in that, pending exercise, an outstanding SAR utilizes the gross number of shares from a stock plan's authorization (even though, where the plan specifically authorizes net counting, an undetermined number of shares would be returned to the plan upon exercise). The purpose of the 201(d) table is to show, in column (a), the number of shares utilized and, in column (c), the number of shares available for future grants; Interpretation 4.04 results in overstating (c), it seems to us.

Post-Termination Rule 144 Cutoff for Control Stock—Waiting Period!@#$%

We were pleased to see that the Staff has already updated its Rule 144 interpretations (in the new CDI). The new interpretations, which were posted on April 2, not only update (and supersede) Section C. of the *TIM* but address a few new topics.

One new interpretation that caught us by surprise, however, is Interpretation 201.06, addressing the applicability of Rule 144 to a former affiliate's sale of unrestricted securities, *i.e.*, "control stock." This situation usually comes up when a recently terminated director or executive officer exercises a stock option (per S-8) during the permitted post-termination exercise period (usually three months or 90 days) and immediately sells at least some the underlying stock, *e.g.*, to pay the exercise price. Our advice has always been that, where affiliate status is based on service as an officer or director, affiliate status terminates upon termination of that service; thus, the seller is considered free to sell the option stock without complying with Rule 144. (See our May-June 1989 issue at pg 3.)

Interpretation 201.06 adds a new wrinkle to this analysis. While the Staff acknowledges that a former affiliate may sell unrestricted securities without complying with Rule 144, the Staff goes on to say that "[t]he cessation of affiliate status is a facts-and-circumstances determination and counsel should not assume that it ceases instantly" upon the affiliate's termination of service. We don't have a problem with that observation, at least in principle, but we do think the Staff may have created confusion when it added that "the former affiliate should wait some amount of time–-either the three month period of Rule 144(k), by analogy, or until the issuer files its next periodic report," before selling outside of Rule 144.

Rule 144's Definition of "Affiliate"

As our readers may recall, Rule 144(a)(1) defines "affiliate" as any person who controls, is controlled by or is under common control with, the issuer. (For some reason, Rule 144 doesn't utilize the definition of affiliate in Rule 405, but there is no substantive difference.) Directors and executive officers ordinarily are

considered to be affiliates by virtue of being members of a "control group." (The Commission once proposed, in 1997, to limit Rule 144 affiliate status to Section 16 insiders, *i.e.*, executive officers, directors and ten percent owners. See Rel. No. 33-7391 (February 20, 1997) and our January-February 1997 issue at pg 1.)

Relevant Facts and Circumstances. The determination of a former director's or officer's status as an affiliate should be based on the whether the person remains a member of the "control group" by continuing to participate in policy-making or management functions. While some former directors or officers may continue to participate in board or management decisions for a period of time following termination of service, and therefore might remain affiliates under a facts and circumstances analysis, that isn't usually the case. We think the continuation of affiliate status post-termination of service is the exception rather than the rule.

We question in particular the Staff's suggestion that the determination of affiliate status should be based on the issuer's filing of its next periodic report or the mere passage of time. Tying affiliate status to the filing of the issuer's next periodic report suggests that affiliate status should be based on awareness of material non-public information, which we think is a Rule 10b-5 insider trading concern, not a Section 5 concern. (Insider trading policies usually address this concern by directing departing insiders not to trade in issuer securities if material information is undisclosed at the time of termination.)

Imposing a three-month wait may resurrect the confusion that surrounded Rule 144(k) when it was first adopted in 1981, when many practitioners thought (mistakenly) that Rule 144(k)'s three-month non-affiliate status requirement might apply to sales of *control* stock as well as to sales of restricted securities. (As our readers may recall, 144(k) frees up restricted securities that satisfy a two-year ownership cut-off, so long as the seller has not been an affiliate at any time during the three months preceding the sale.) As we said then (and have repeated since), former affiliates can sell unrestricted securities immediately upon termination of affiliate status, without waiting the three-month period applicable to a former affiliate's sales of restricted securities. (See, *e.g.,* our March-April 1976 issue at pg 4 and our September-October 1983 issue at pg 4.)

Where to Go From Here

Former directors and executive officers (and their brokers) now should not automatically assume that affiliate status terminates simultaneously with termination of service, and instead must analyze their circumstances to determine whether they have continuing responsibilities that may extend their affiliate status. In a typical termination scenario, however, we expect that most seasoned counsel will have little difficulty concluding that a former director or officer ceases to be an affiliate immediately upon termination.

What's the Harm in Complying with the Rule for Up to Three Months? In many situations, we would think that the continuation of affiliate status would mean little more than, *e.g.*, filing Form 144 incident to exercise of a stock option. But, that signals a sale that otherwise may not be reportable. Moreover, continuation of affiliate status might result in continued applicability of all of the company's insider trading restrictions applicable to affiliates (*e.g.*, pre-clearance); we would think that, in any event, policies should specifically limit the extent that former insiders are covered.

No Effect on Section 16 Insider Status. The Staff's suggestion that a terminated officer or director may remain an affiliate after termination should not have any effect on the person's status as a Section 16 insider. Peter Romeo and Alan Dye tell us that, while persons who are not serving as "elected" directors have been deemed directors for purposes of Section 16 where they are *currently* involved in policy-making or other director-like activities (*e.g.*, as directors by deputization or directors emeritus), no court has ever held that a former director remained a director after stepping down from the board. Similarly, while a person who does not have an officer's title can nevertheless be subject to Section 16 as an officer if he or she performs the functions of an officer, a functional analysis ordinarily would not lead to the conclusion that a former officer remains an officer after termination of service (and the attendant policy-making function).

Of course, even though a terminated officer or director is no longer a Section 16 insider, Section 16 reporting may continue to apply to a former insider's transactions for up to six months following termination of service, but only to transactions that are not exempt from Section 16(b) (*e.g.,* sale of shares incident to exercise of stock option) that occur within six months after a non-exempt, opposite-way transaction that occurred prior to termination of service. See Romeo & Dye, *Section 16 Treatise and Reporting Guide* §6.02[10] (2d ed. 2004). [Query whether, if and when Form 144 is supplanted by Form 4 (see below), a former officer or director who effects a same-day sale but is not required to file a Form 4 (because there is no potentially matchable transaction within the prior six months) could end up being required to file Form 144 because still deemed an affiliate.]

Staff No Longer Allows Adding Shares to Form 144 by Amendment—Ramifications

In our March-April 2004 issue (at pg 9) we reported that the Staff appeared to be backing away from its longstanding position (reflected in the *TIM*, at C.93) allowing a Rule 144 seller to amend a previously filed Form 144 to increase the number of shares to be sold, up to the volume limit applicable at the time of the original filing. Now, it's official. In the CDI, the Staff not only drops C.93 but adds Rule 144 Interpretation 222.03, to the effect that a seller (of either control stock or restricted securities) who files a Form 144 covering less than the full amount that may be sold under Rule 144(e)'s three-month volume limitation (*i.e.*, the greater of one percent of the class outstanding or the average weekly trading volume over the four calendar weeks preceding the filing of the Form 144) may not later amend the Form 144 (within the three-month period) to increase the number of shares to be sold up to the limit calculated as of the original filing date (which sellers did sometimes, rather than file a new Rule 144, where the volume limit under Rule 144(e) has decreased since the time the original Form 144 was filed, due, *e.g.,* to a decrease in the average weekly trading volume). Instead, the seller now *must* file a new Form 144 to cover any additional sales, and will be subject to the volume limitation applicable as of the date of the new filing.

The Staff's position is based on the deemed absence, at the time of the original filing, of a *bona fide* intention to sell the additional securities, which is a prerequisite to reliance on the rule. (See Rule 144(i).) It seems likely, therefore, that Interpretation 222.03 also sounds the death knell for the Staff's no-action position in *Permian Basin Royalty Trust* (March 5, 1986), where the Staff allowed a holder of restricted securities to add shares to a previously filed Form 144 where the seller represented having a "general intent" at the time of the original filing to sell up to the maximum number of shares that could be sold during the following three months. Now, in the absence of an intent to sell a specific (and larger) number of securities (*e.g.*, where an incorrect number was inadvertently included in the Form 144), we doubt a seller could add securities by amendment.

Anything to Do Different Now?—Impact if Form 144 and 4 Combined

There are changes looming that may, in effect, moot the major impact of this new interpretation, *i.e.,* loss of flexibility to lock-in high volume upfront. The Commission is seeking comment on limiting the Form 144 requirement to the sale of control stock (*i.e.,* by affiliates) and providing that Form 4 (filed after the fact) would satisfy the Form 144 requirement. (See the Commission's press release announcing the proposals—Rel. No. 2007-102 (May 23, 2007).) The result would be no upfront filing (except where a former insider is still considered an affiliate—see above), so no locking in any *bona fide* amount.

In the meantime, however, we don't see "highballing" the number of shares in the original filing; there is still the *bona fide* intention requirement to sell all the shares listed in the Form and, although Forms 144 are still filed mostly in paper and are not widely followed, Yahoo and maybe others post them, so overstating can be a market negative. (In fact, there is pressure sometimes for a seller to hold shares back from the initial filing, to avoid alarming the market; now, there may be a liquidity cost to doing so.)

We are pleased that the Commission is seriously considering eliminating the separate Form 144 filing. Brokers, presumably, will no longer file Forms 144 (but, underwriter liability concerns might make brokers want to take over the Form 4 instead, *i.e.,* for market sales—see our May-June 2005 issue at pg 8).

New Backdating Investigation Numbers

Our friend Bruce Brumberg of myStockOptions.com reports that David Bergers, head of the SEC's Boston Regional office, told the local NASPP chapter on June 6 that Enforcement has now completed 40 of 180 backdating investigations. He says they are notifying issuers as investigations terminate (presumably, sometimes happily and sometimes with the substantial penalties that have been reported recently, *e.g.,* Mercury Interactive ($28 million) and Brocade Communications Systems ($7 million)).

The Ongoing Costs of Backdating—One Issuer's 10-K Disclosure

We were intrigued with this year's (very complete) proxy and 10-K disclosures of American Tower Corporation (which first announced backdating problems in May 2006). Even though apparently able to avoid the more extreme remediation of multiple 10-Q/K amendments, the company discloses (in MD&A) $16.2 million costs in 2006 alone for review, etc., and $3.9 million cash bonuses to replace the discount that employees forgave in an exchange/tender offer designed to reprice backdated options upward in order to avoid Section 409A discounted option/NQDC consequences. (Officers and directors weren't offered a cash bonus, fortunately; eliminating the discount affords the company no offsetting relief from accounting charges

incurred over the vesting period by reason of the discount—see the May-June 2006 issue of *The Corporate Executive* at pg 10.)

Moreover, the terms of severance of a top executive in February 2007 (there is no mention in this disclosure whether or not the termination was connected to backdating) include acceleration of vesting of stock options (presumably, not with backdated prices), resulting in stock option expense of approximately $5.0 million. (For discussion of the accounting treatment of discretionary acceleration of vesting, see the January-February 2007 issue of *The Corporate Executive* at pg 11.)

The company's Contingencies financial statement footnote describes, in addition to pending SEC Enforcement and DOJ investigations, a securities law class action and five shareholder derivative lawsuits relating to backdating (which "could result in a material adverse effect on the Company's … ").

Three 'Must' Conferences—In One!

We have just posted the agendas for the three major Conferences that we will be holding in San Francisco during our "October Conference Week for Counsel". Because of their importance, we will be televising the conferences via Live Nationwide Video Webcast. We are looking forward to seeing many of our loyal readers in San Francisco. (If you can make it, there will also be two post-conference Gala Events, with big name entertainment). But, for all those that can't make it out here in October (the best time of the year in San Francisco), see the special 'Member Appreciation Package' below.

"Tackling Your 2008 Compensation Disclosures"

Our "2nd Annual Proxy Disclosure Conference" will be big. As all those who attended last year's conference can attest, this is the definitive conference for everyone involved in preparing, drafting, reviewing—or providing advice regarding—your proxy compensation disclosures. The new requirements and higher expectations for the 2008 disclosures may, in many respects, be more demanding than this past year—with greater potential consequences.

You will want to make sure that all your people hear each and every one of the panels. Last year, over 5,000 people attended this conference in person and via the Nationwide Live Video Webcast. This year's audience will be even larger.

The 4th Annual Executive Compensation Conference: "Lessons Learned"

Everyone attending the "2nd Annual Proxy Disclosure Conference" will need to also attend this key conference. This major one-day conference has taken on *heightened importance* under the SEC's new executive compensation rules. The regulators and the critics are not happy with the failure of many companies to provide meaningful "Analysis" in their 2007 CD&As (*e.g.,* see John White's recent speech). For 2008, all eyes will be focused on the "Analysis" section of the CD&A and the need to address the *tools* that compensation committees are utilizing—and the resulting findings and actions. As a result, this Conference will be a "must" for anyone who has any role in the preparation or review of proxy statements. A glance at the enclosed agenda will give you a hint at why this Conference will be so critical for each of us.

Our 1st Annual "*The Corporate Counsel* Speaks" Conference

Yes, for years, our loyal readers of *The Corporate Counsel* have asked us to provide the type of practical guidance we have become known for—in a Conference format. We have listened! At this Conference, our readers will be brought up-to-speed on the latest innovations and developments that you are grappling with (*e.g.,* Google's transferable options program). And, you will get the latest thinking from the foremost experts on "bread and butter" daily practice topics. This conference will also cover the latest proxy season challenges, such as the implications of e-Proxy and how solicitation strategies need to change, as well as a lightning "nuggets" round on avoiding costly executive compensation disclosure mistakes. And, Alan Dye and yours truly are putting together a "Ten Preventive Nuggets in 15 Minutes" session that will be designed for our readers to play over and over (for your executives and anyone involved with insiders' transactions).

"Member Appreciation Package"—Early Bird Rates

As you will see in the enclosed, because it is important to us that every person involved in the process gets the benefit of these important Conferences, and as a way of saying "thank you," we are providing very special rates for those attending all three conferences via the Nationwide Live Video Webcast. Note that we have provided the steepest discounts for those who will be taking advantage of the "unlimited" and "firmwide" categories to ensure that everyone at companies and firms will have ongoing access to the archives and the materials, even after the conferences. Also, don't overlook the Early Bird special rates (which expire on June 30).

—J.M.B.

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