AVOIDING SECURITIES PITFALLS IN EMPLOYEE PLANS

Eleanor Banister
Christine B. LaFollette
Tana Pool

December 9, 2003

If you haven’t downloaded the program materials, please do so now at -

www.kslaw.com/e-lunch/handout
To connect to the audio part of the program please call:
1-888-291-5971
A customer service representative will connect you to the seminar.

For technical assistance at any time during the presentation please call:
1-888-865-7469

Biographies

**Eleanor Banister** is a partner in King & Spalding’s Employee Benefits & Executive Compensation Group. She advises clients on all aspects of the design, implementation and administration of employee benefit plans, executive compensation plans and the related funding vehicles. A significant part of her practice is devoted to counseling with and negotiating on behalf of clients in connection with business transactions, including initial public offerings, mergers, acquisitions, divestitures and restructurings.

Ms. Banister has considerable experience representing institutional trustees in connection with their provision of trust and other services to sponsors of employee plans, financial institutions in connection with retail prototype plan services and lenders in the benefit aspects of loan transactions, including leveraged ESOPs.

**Chris LaFollette** practices corporate and securities law in King & Spalding’s Houston office as a Partner in the Energy, Corporate Finance and Mergers & Acquisitions Practice Groups. She has more than 20 years experience representing issuers and underwriters in public offerings and private placements of equity and debt securities, restructurings and financings as well as federal and state securities laws matters, including with respect to employee matters. Ms. LaFollette also focuses her practice in representing clients in public and private merger acquisition and disposition transactions. Her practice also includes representation of public companies, board of directors and special committees with respect to compliance with corporate governance matters, including the Sarbanes-Oxley Act, periodic reporting, proxy solicitation, audit committee standards and insider trading requirements of the federal securities laws.
Biographies cont’d

Tana Pool is Counsel in King & Spalding’s Mergers and Acquisition Practice Group. Her experience includes a variety of merger, acquisition and disposition transactions, as well as corporate and securities matters. Her corporate and securities practice includes public offerings of securities, periodic reporting and disclosure requirements, and matters relating to compliance with securities laws. She also has significant experience advising clients with respect to the application of securities laws to employment plans.

For several years prior to joining King & Spalding, Ms. Pool served as in-house counsel with significant responsibility for active acquisition and business development programs and securities compliance matters. Her industry knowledge includes companies in the energy and technology sectors and companies focused on the consolidation of fragmented industries.

AVOIDING SECURITIES PITFALLS IN EMPLOYEE PLANS

Eleanor Banister
Christine B. LaFollette
Tana Pool

December 9, 2003
What is an Employee Plan?

A plan, program or other arrangement designed to provide compensation to employees during employment or after termination of employment

Most plans are written

May cover only one person

Types of Employee Plans

Qualified Retirement Plans
- 401(k) Plan
- Employee Stock Ownership Plan (ESOP)
- Defined Benefit Plan

Equity-Based Plans
- Employee Stock Purchase Plan (ESPP)
- Stock Option, Restricted Stock, Phantom Stock and Stock Appreciation Rights (SARs) Plans

Nonqualified Deferred Compensation Plans
Employee Plan Regulatory Environment

*Internal Revenue Code*
*Employee Retirement Income Security Act (ERISA)*
*Federal and State Securities Laws*
*Federal and State Employment Laws*

---

General Principles under Federal Securities Law

*Section 5 of the Securities Act of 1933 requires that every offer and sale of a security must be registered with the SEC unless an exemption under the Securities Act is available.*
What is a Security under Federal Securities Laws?

Section 2(1) of the Securities Act provides a detailed and lengthy listing of what constitutes a “security,” including:

– Stock
– Treasury stock
– Certificate of interests or participation in any profit-sharing agreement
– Investment contract
– Warrant
– Option or privilege on any security

Section 2(1) also includes a catch-all definition:

Any interest or instrument commonly known as a “security” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the other types of securities included in the definition.
What is a Security? (cont’d)

Some Examples of Securities and Plans
– Restricted Stock
– Stock Options
– Stock Appreciation Rights
– Phantom Stock
– Employee Stock Purchase Plan (ESPP)
– Employee Stock Ownership Plan (ESOP)

Investment contract under the Howey test
– A transaction in which individuals:
  • Invest money
  • In a common enterprise
  • With the expectation that they would earn a profit
  • Solely through the efforts of others
– A participation interest in a benefit plan is analyzed under the investment contract test
  • *e.g.* Daniel and subsequent cases
What is a Security? (cont'd)

SEC’s view of when participation interests in employee plans are securities:

<table>
<thead>
<tr>
<th>Participation by Employee</th>
<th>Contribution from Employee</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Involuntary</td>
<td>No</td>
</tr>
<tr>
<td>2. Involuntary</td>
<td>Yes</td>
</tr>
<tr>
<td>3. Voluntary</td>
<td>No</td>
</tr>
<tr>
<td>4. Voluntary</td>
<td>Yes</td>
</tr>
</tbody>
</table>

When Do You Have An Offer or a Sale of a Security?

- Section 2(3) of the Securities Act provides that:
  - a “sale” includes every contract of sale or disposition of a security or an interest in a security for value
  - an “offer to sell” includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security or an interest in a security for value
What is “Value” in Connection with Employee Plans?

- Out-of-pocket payment?
- Services?
- Investment elections?
- Choice of benefits?

Exemptions from Registration under Federal Securities Law

Most common exemptions:
- Section 3(a)(2)
- Rule 701
- Regulation D
Section 3(a)(2) exemption:
  – applies to an interest or participation in a trust fund
  – issued in connection with a stock bonus, pension or profit-sharing plan meeting the requirements under Section 401 of the IRC
  – no amount in excess of the employer’s contribution is allocated to the purchase of securities issued by the employer or a company controlling, controlled by or under common control with the employer

Exempts a class of securities; not transaction-based

Rule 701 Exemption:
  – Pertains to offers and sales of an issuer’s securities pursuant to certain compensatory benefit plans
  – Covers purchase, savings, option, bonus, stock appreciation, profit-sharing, thrift, incentive and pension plans
  – Participants may be employees and specified insiders of the issuer, its parent, or majority-owned subsidiaries
Rule 701 Exemption (cont’d):

– The exemption is available to specified issuers
  • e.g., those not subject to the reporting requirements of
    Exchange Act Section 13 or 15(d)
– The aggregate sales price or amount of the issuer’s
  securities sold under Rule 701 during any 12-month
  period cannot exceed the greatest of:
  • $1,000,000
  • 15% of the issuer’s total assets
  • 15% of the outstanding securities of the class
– Disclosure requirements

Regulation D Exemption:

– A series of rules under which certain issuers may
  effect offerings of securities without registering the
  offers and sales under the Securities Act, provided
  that specified conditions have been met
– Regulation D provides exemptions only for the
  transaction in which the securities are offered and
  sold by the issuer
– Offers and sales meeting the requirements of
  Regulation D are deemed to be transactions that do
  not involve a public offering within the meaning of
  Section 4(2) of the Securities Act
Regulation D Exemption (cont’d):
- Accredited Investor – meets one of several enumerated categories of purchasers at the time of the sale, including:
  - Directors, executive officers or general partners of issuer (does not include parent, subsidiaries or affiliates)
  - Natural person with individual net worth (or joint net worth with spouse) greater than $1 million
  - Natural person with individual income greater than $200,000 (or joint income with spouse greater than $300,000) in each of past two years and reasonably expected in current year
- Securities are restricted
- Must file Form D within 15 days after first sale

Rule 504 Exemption:
- Aggregate offering price of all securities sold must not exceed $1 million
- Issuer must not be subject to Exchange Act reporting

Rule 505 Exemption:
- Aggregate offering price of all securities sold must not exceed $5 million
- No more than 35 non-accredited investors
- Unlimited number of accredited investors
- Requires disclosure of information
**Rule 506 Exemption:**
- No limit on aggregate offering price of securities sold
- No more than 35 non-accredited investors
- Unlimited number of accredited investors
- Issuer must reasonably believe all non-accredited purchasers to be financially sophisticated (personally or through advisor)
- Requires disclosure of information

**Exemptions (cont'd)**

**Other considerations**
- Resales of Securities
  - Restricted securities – legend
- Seller
  - Non-affiliates
  - Affiliates – Rule 144 or registration
- Rule 144 “safe harbor”
  - Current public information
  - One year holding period
  - Limitation on amount sold
  - Manner of sale
  - File notice with SEC
  - Non-affiliate sales after 2 years
Registration under Federal Securities Law

Form S-8
– Who may use?
– General requirements
  • Facing page & fee
  • Prospectus – plain English
  • Additional information
  • Opinions
  • Consents
  • Signature pages
– Effective automatically upon filing

Registration under Federal Securities Law (cont'd)

Prospectus Delivery:
– Updating
– Summary Plan Descriptions for ERISA
– Legends
– New Participants
– Posting on Company Website
Comparison with ERISA Disclosures

ERISA plans typically use the same document to satisfy ERISA and federal securities law disclosure requirements, but

– Differences in content
– Differences in delivery

Registration under Federal Securities Law (cont’d)

Form S-8 Considerations:
– Accountant’s Consent
– Form 11-K – only when plan interests are registered
Nonqualified Deferred Compensation Plans (NQDC)

- Generally not required to be funded – benefit is a general obligation of the employer
- “Rabbi” trust should not make plan funded
- S-8 for NQDC registers general obligations of the employer
- 11-K should not be required

Share-Counting Considerations

*Employers must keep track of securities used under a plan for multiple purposes:*
  - Shares reserved for plan
  - Shares registered on Form S-8
  - Accounting for stock issuances

*Share-counting issues:*
  - Stock grants
  - Stock options
  - Qualified plans
    - Unitized accounting vs. share allocation
    - Net vs. gross method of counting
    - No formal guidance from the SEC
What happens if you fail to register and no exemption applies?

- Rescission right for shares purchased – return of consideration paid
- SEC liability
- Limitations period
- ERISA fiduciary concerns
- Lack of records
- Disclosure to participants
- See In Re Electronic Data Systems Corporation – “ERISA” Litigation

Other Federal Securities Law Issues (cont’d)

- Transactions based on material non-public information
- Section 16 issues
- Section 13 reporting
- Proxy disclosure regarding plans
- Sarbanes-Oxley black-out periods
- Accounting for stock options
- Mutual funds trading issues
SOX Blackout – ERISA Plans

- Applies to individual account plans
- 30-day advance written notice of blackout period to participants and issuer of securities
  - No more than 60 days advance notice
  - Exception for blackouts due to merger, acquisition, divestiture and circumstances beyond reasonable control of plan administrator

Blackout period
- Any period of at least 3 business days during which ability to direct or diversify assets, obtain plan loans or obtain distributions is suspended, limited or restricted

Blackout period does not include:
- Restrictions due to federal securities laws
- Restrictions regularly scheduled under the plan and disclosed to participants

DOL Model Notice
Penalty - $100 per day per participant

Accounting Issues

Currently stock options are not expensed until exercised
- No impact to earnings at grant or while outstanding
- FASB expected to require mandatory expensing of options
- Likely will be effective 2005

Possible Results:
- Curtailment of broad-based stock options
- Options likely to be limited to top executives
- More restricted stock and stock appreciation rights payable in stock only
Mutual Fund Trading Issues

Trading Practices That May Adversely Affect Long Term Investors
– Late Trading – Trading after the market closes
– Timing – Buying and selling shares to take advantage of short term changes in value

ERISA Fiduciary Concerns

Questions
Show #: 90073