SEC Clarifies Issues Regarding Reporting Issuer Repurchases of Equity Securities Pursuant to Employee Compensation Plans

Item 703 of Regulation S-K ("Item 703") requires companies that are publicly listed in the United States to provide in their quarterly reports on Form 10-Q and their annual reports on Form 10-K (or Form 20-F with respect to foreign private issuers) information about their repurchases of equity securities registered under section 12 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").1 This disclosure requirement is imposed for periods ending on or after March 15, 2004. For domestic issuers whose fiscal year is the calendar year, Item 703 disclosure was required for the first time in the Form 10-Q filed for the first quarter of 2004.

As the filing deadline for first quarter Form 10-Q reports approached, many issuers had to consider whether, and if so how, the disclosure requirements of new Item 703 should be applied to a variety of issuer repurchases of equity securities pursuant to employee compensation plans. At a meeting with representatives of the American Society of Corporate Secretaries on May 14, 2004, Alan L. Beller, director of the SEC’s Division of Corporation Finance, and other senior members of the Division’s staff (the "Staff") dispelled some of the confusion that has surrounded the application of Item 703 to employee compensation plans. The principal points that emerged from their comments are summarized in this memorandum.

As a preliminary matter, Mr. Beller and other Staff members noted that Item 703 generally requires public disclosure of all issuer repurchases of equity securities that are registered under section 12 of the Exchange Act. There is no general exception for issuer repurchases made in the context of employee compensation plans. Within this framework, however, the Staff has provided guidance about the application of the disclosure requirements, as explained below.

1. "Net option exercises" to pay tax withholding and/or the exercise price of a stock option or stock appreciation right. No Item 703 disclosure is required when shares are withheld to pay taxes incurred upon exercise of a stock option or to pay the exercise price of the stock option. Thus, "net share settlement" arrangements do not trigger Item 703 disclosure. The Staff’s rationale is that withholding in these circumstances is not a repurchase, presumably because the shares are never issued to the employee and the employee never becomes the record owner of the shares withheld.

By the same rationale, share withholding to pay taxes incurred upon the exercise of a stock appreciation right would not trigger Item 703 disclosure.

2. Stock-for-stock exercises. When an employee tenders previously owned shares to pay the exercise price of a stock option or the withholding taxes due upon exercise, the issuer will be considered to have repurchased the tendered shares and must include them in its Item 703 disclosure for the relevant period. The Staff clarified the confusion in this situation that resulted in part from contrary advice given at the April meeting of the American Bar Association.

An intermediate case between net share settlement and share tendering is commonly referred to as “attestation,” where the employee satisfies his or her obligation to pay the exercise price or withholding taxes upon exercise of a stock option by attesting to ownership of shares without physically tendering the shares. Unfortunately, the Staff did not address this issue at the May 14th meeting. Because of the conceptual similarities between attestation and physical share tendering, we believe that, absent guidance to the contrary, issuers should treat shares as to which ownership is attested as repurchased shares.

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3. **Option exchanges: Cash-out of restricted stock units.** Where an issuer conducts an option exchange program (for example, in connection with an option repricing), its acquisition of previously outstanding stock options will not be treated as a repurchase for purposes of Item 703, as long as the stock options were not themselves registered under section 12 of the Exchange Act. Similarly, if an issuer purchases employee stock options for cash or settles restricted stock units in cash, the purchase or settlement will not be treated as repurchases for Item 703 purposes unless the stock options or units are separately registered securities under section 12 of the Exchange Act.

4. **Forfeiture of restricted stock upon failure to satisfy vesting conditions.** The Staff indicated that forfeiture of restricted stock when an employee fails to satisfy vesting conditions is not a “repurchase.” It is unclear whether the same result would apply where restricted stock is forfeited under other circumstances, such as an employee’s violation of a noncompetition condition or disclosure of confidential information.

   In those situations where an issuer’s stock options are registered under section 12 of the Exchange Act, a forfeiture of stock options would presumably be analyzed in the same manner.

5. **Delivery of stock to satisfy tax withholding upon lapse of vesting restrictions on restricted stock.** Item 703 disclosure is triggered when an employee delivers previously owned shares to satisfy tax withholding requirements that arise when a restricted stock or similar award vests. This situation is analytically similar to the share tendering discussed above.

6. **Transactions by tax-qualified benefit plans.** The reporting consequences for transactions in tax-qualified benefit plans, such as 401(k) savings plans, depend on whether the trustee is an affiliated purchaser, as Item 703 requires disclosure of equity repurchases made by any “affiliated purchaser” (as defined in Rule 10b-18) of the issuer, as well as by the issuer itself. This is likely to be an issue principally for smaller companies that administer their own tax-qualified plans. Issuers who use a third party administrator are less likely to have Item 703 disclosure obligations in connection with a tax-qualified plan.

7. **Non-qualified executive plans using rabbi trusts.** Repurchases made by a rabbi trust that holds assets related to obligations under non-qualified deferred compensation or other plans trigger Item 703 disclosure, even if the trustee is not an affiliate of the issuer. Although not articulated, the Staff’s rationale is most likely that, as the assets of a rabbi trust are considered assets of the issuer for tax purposes, repurchases should be attributed to the issuer.

8. **Application to Foreign Private Issuers.** Item 16E to Form 20-F requires the same disclosure by foreign private issuers of repurchases of equity securities set forth in Item 703. The disclosure required by Item 16E must appear in Form 20-F reports filed for fiscal years ending on or after December 15, 2004.

The views advanced by Mr. Beller and other members of the Staff at the May 14th meeting are not likely to be the last word on this subject. We believe that the Staff may be receptive to requests for more formal guidance under Item 703. At least for now, however, companies that are publicly listed in the United States should ensure that they have the administrative procedures in place to monitor those transactions that the Staff believes require Item 703 disclosure.

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2 Please note that this issue was discussed by the Staff at a meeting with the American Bar Association in April, not at the May 14th meeting.
This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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