APPLIED KNOWLEDGE | ACCOUNTING GUIDELINES

Sarbanes-Oxley reporting requirements for equity securities in deferred comp plans

On July 30, 2002, Congress enacted the **Sarbanes-Oxley Act of 2002**. Among its far-reaching provisions on corporate governance and financial reporting standards are rules regarding the reporting of insider transactions involving company equity securities. These requirements directly impact nonqualified deferred compensation plans that offer company stock as an investment alternative.

The reporting requirements for transactions involving company equity securities are set forth in Release 34-46421, issued by the Securities and Exchange Commission (SEC) with an effective date of August 29, 2002. Company stock transactions that occur in a qualified plan, an excess benefit plan, or a stock purchase plan are exempt from reporting. This includes the reinvestment of dividends or interest pursuant to “broad-based” reinvestment plans. Company stock transactions in a deferred comp plan are specifically designated as reportable transactions under the Act. The only exception appears to be automatic dividend reinvestment in a deferred comp plan when there also is a broad-based dividend reinvestment program for other employees (SEC Division of Corporate Finance, Sarbanes Oxley—Frequently Asked Questions dated November 14, 2002).

Requirements as to who must file a disclosure and the timing of filings for any transactions are included in Section 403 of the Act, entitled “Disclosures of Transactions Involving Management and Principal Stockholders”. This section applies to any class of equity security registered under Section 12 of the Securities Exchange Act. A summary of the requirements:

Who must file (a reporting person)?

- Any person who is the beneficial owner of more than 10% of any class of equity security.
- Each Officer of the company.
- Each Director of the company.

When must the report be filed?

- For transactions where the reporting person selects the timing of the transaction, a report must be filed “before the end of the second business day following the day on which the subject transaction has been executed.”
- For transactions where the reporting person doesn’t select the timing of the transaction (e.g., a discretionary market order based on price), a report must be filed before the end of the second business day after the reporting person is notified that the transaction has occurred. The notification must occur within three business days of the trade date. This would apply to non-exempt dividend reinvestment.

Companies who offer company stock as an investment option in their deferred comp plan need to be aware of these reporting requirements and should set up internal systems to capture transaction information and control trading practices. It doesn't matter whether the company actually buys the company stock to informally finance the plan, the participants are deemed to hold the stock if it is credited to their account in the plan. Transactions that should be reported include:

- Periodic employee deferrals that credit an account with company stock.
- Company contributions that credit an account with company stock.
- Participant rebalancing activity that changes the amount of company stock in an account.
- Distributions from the plan that changes the amount of company stock in an account.
- Dividend reinvestments to the extent that they aren't exempt from reporting (see above).

Of particular concern is the effect of the flexibility inherent in deferred comp plans. For example, a participant may be credited with an employee deferral on a payroll date, but the information may not be recorded on the record-keeping system until a later date. Another example is the crediting of an employer contribution effective as of the end of an accounting period, but with an amount that is determined only after the results of that period are known. In either case, the two-day reporting clock starts as of the effective date of the transaction, which could cause the company to be in immediate violation of the reporting rules.

All plan participants are subject to the insider trading rules, as well. Trading "windows" that apply to control insider trading of actual holdings of company stock should also apply to holdings in deferred comp accounts. Any plan participant trading in a nonqualified account based on insider information could be subject to civil or criminal penalties.

In summary, companies offering company stock as an investment option in their deferred comp plan are subject to the reporting requirements of Sarbanes-Oxley. They should take immediate steps to:

- Understand the reporting requirements and the reporting methods as outlined in regulations issued by the SEC.
- Develop and implement internal controls and data collection systems to meet the requirements of the regulations.
- Modify deferred comp plan design and plan procedures to prevent inadvertent violation of the regulations.

Principal®

principal.com