

## MEMORANDUM

**Date:** February 9, 2024

**To:** Members of the ABA Subcommittee on Employee Benefits, Executive Compensation, and Section 16

**From:** Mark A. Borges, C. Alex Bahn, and Ron O. Mueller

**Re:** Discussion with SEC Staff on Interpretation of Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3) – Scope of “eligible sell-to-cover” transactions

Alex, Ron, and I have had the opportunity to speak informally with members of the Staff of the SEC’s Division of Corporation Finance about an interpretive question that has been raised concerning the scope of the exception to Exchange Act Rule 10b5-1(c)(1)(ii)(D)’s limitation on overlapping open-market trading plans and Exchange Act Rule 10b5-1(c)(1)(ii)(E)’s limitation on single-transaction trading plans contained in Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3).

### **Background:**

In June 2023, the ABA’s Joint Committee on Employee Benefits submitted a request for interpretive guidance to the SEC Staff to obtain clarification as to what qualifies as an “eligible sell-to-cover” transaction under amended Exchange Act Rule 10b5-1.

Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3) defines an “eligible sell-to-cover” transaction as one where an agent is authorized to sell “only such securities as are necessary to satisfy tax withholding obligations arising exclusively from the vesting of a compensatory award” where the employee does not otherwise exercise control over the timing of such sale. Practitioners questioned whether the language used in this definition limits the amount of securities to only the amount required to satisfy statutory *minimum* tax withholding rates. As we noted to the SEC Staff last year, some companies allow employees to designate a higher expected effective tax rate as the rate at which their employer will withhold taxes upon the vesting of a compensatory award. The issue is whether the definition of “eligible sell-to-cover” transactions was meant to mean the same as “statutory minimum.”

Question: Can a contract, instruction, or plan qualify as one providing for the sale of “only such securities as are necessary to satisfy tax withholding obligations arising exclusively from the vesting of a compensatory award,” and thus be an “eligible sell-to-cover transaction” under Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3), if it provides for the sale of shares at the rate identified by the employee as the employee’s expected effective tax rate, provided such rate does not exceed the aggregate of the maximum applicable federal, state, and local tax rates applicable to the employee, as permitted under tax and accounting rules?

Suggested Answer: An “eligible sell-to-cover” transaction under Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3) means the sale of shares up to the tax rate designated by the

employee for withholding, provided such rate does not exceed the aggregate of the maximum applicable federal, state, and local tax rates applicable to the employee, as permitted under tax and accounting rules.

**Discussion:**

1. Application of Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3) to “eligible sell-to-cover” transactions by employees (including executive officers)

As a result of our informal discussion with the SEC Staff, we understand that the reference in Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3) to “only such securities as are necessary to satisfy tax withholding obligations” is not intended to mean only the number of shares required to satisfy *minimum* tax withholding requirements and that the rule is not intended to use technical tax language or to disrupt practice with respect to legitimate tax arrangements. Put another way, the focus of the SEC Staff appears to be on whether the arrangement is designed to pay the tax obligation arising in connection with the vesting event, which can take into account the expected effective tax rate and is not focused on only the required tax withholding rate. It appears the SEC Staff agrees with our proposed response and will interpret the provision to allow sales of shares to satisfy an employee’s expected effective tax rate. This interpretation, however, does not apply if any of the proceeds from the sale are intended to satisfy taxes relating to income from sources other than the vesting of a compensatory award. The SEC Staff thus cautioned that persons could not characterize a sale as an “eligible sell-to-cover” transaction where shares are sold with the intent of covering taxes for events unrelated to the vesting event. For example, selling shares in an “eligible sell-to-cover” transaction where the proceeds are intended in part to cover taxes for the sale of property other than the shares received in the vesting event would not be considered an “eligible sell-to-cover” transaction.

2. Application of Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3) to “eligible sell-to-cover” transactions by non-employee directors

Similarly, we understand that the SEC Staff will not object to a non-employee director establishing a similar contract, instruction, or plan as an “eligible sell-to-cover” transaction despite the fact that non-employee directors are not subject to tax withholding obligations. Again, if the non-employee director’s sale in this scenario is designed to cover the person’s withholding tax obligation arising exclusively from the vesting of a compensatory award, the same rationale would apply. Similar to employees, we believe the SEC Staff will not consider a non-employee director’s sale to qualify as an “eligible sell-to-cover” transaction if the sale is intended to also cover taxes that may be owed from sources of income other than the vesting event.

Question: May a non-employee director, for whom there is no tax withholding obligation, be permitted to sell shares on the same basis as an “eligible sell-to-cover” transaction applicable to employees?

Suggested Answer: A non-employee director’s contract, instruction, or plan providing only for the sale of shares in connection with the vesting of a compensatory award for the purpose of satisfying such individual’s expected effective tax rate arising from the

vesting event will qualify as an “eligible sell-to-cover” transaction for purposes of Exchange Act Rule 10b5-1(c)(1)(ii)(D)(3).