SIMPSON THACHER

SARBANES-OXLEY ACT OF 2002
SUPPLEMENTAL MEMORANDUM NO. 2:
THE INSIDER LENDING PROVISIONS

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This memorandum addresses issues that arise under Section 402 of the Sarbanes-Oxley Act of 2002 (the "Act"), which was enacted on July 30, 2002. The memorandum supplements our other memoranda concerning the Act, including our July 31, 2002, memorandum (the "July 31st Memorandum") entitled *"Sarbanes-Oxley Act of 2002: CEO/CFO Certifications, Corporate Responsibility and Accounting Reform,"* additional copies of which are available upon request or at our website: www.simpsonthacher.com.

SUMMARY

- Section 402 of the Act provides, in part, that:

  "It shall be unlawful for any issuer . . . , directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. "

- The term "issuer" is defined under the Act to mean an issuer the securities of which are listed on a national securities exchange or otherwise registered under Section 12 of the Securities Exchange Act of 1934, as amended, that is required to file reports under Section 15(d) of the Exchange Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, as amended, and that has not been withdrawn.

- Significantly, the term "issuer" is not limited to U.S. companies and the Section 402 prohibition is not limited to loans that are made in the United States or to loans made to directors and executive officers that are located in the United States.

- The prohibition applies to directors and executive officers of the "issuer," but not to directors and executive officers of affiliates who are not also directors or executive officers of the "issuer."

- Loans made prior to July 30, 2002 are grandfathered, if they are not renewed or materially modified. Our view is that future loans under loan commitments that were legally binding on that date also should be grandfathered.

- Nontraditional extensions of credit, such as split-dollar life insurance and cashless exercises of options, also may be subject to Section 402.

- Certain consumer credit loans to directors and executive officers of an issuer are exempt from the prohibition, but only if offered in the ordinary course of the issuer's business and on market terms.

- An express exemption for margin loans by brokers or dealers is confined to loans by brokers and dealers that are registered under the Exchange Act to their own employees (not those of affiliates) to buy stock other than stock of the issuer.

- The Section 402 prohibition is part of the Exchange Act, and, accordingly, willful violations are subject to criminal penalties as discussed in our July 31st Memorandum.

- The language of Section 402 contains many ambiguities and, although the SEC may provide interpretive guidance or exemptive relief in the future, Section 402 is effective as of July 30, 2002.

SCOPE OF THE GENERAL INSIDER LENDING PROHIBITION

The Term "Executive Officer"

Section 402 does not define the term "executive officer" either directly or by cross-reference, but Rule 3b-7 under the Exchange Act provides the following definition:

"The term executive officer, when used with reference to a registrant, means its president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. Executive officers of subsidiaries may be deemed executive officers of the registrant if they perform such policy-making functions for the registrant."

Section 402 applies to loans made by subsidiaries of the issuer, but it only applies to loans made to directors and executive officers of the issuer. For example, it does not apply to loans made by the issuer or a subsidiary of the issuer to a person that is an executive officer of a subsidiary but not an executive officer of the issuer.

Section 402 applies to loans that are "to or for" a director or an executive officer of the issuer. Pending the issuance of guidance by the SEC it is unclear how broadly the term "for" will be interpreted. Issuers would be prudent to assume that loans to a family member of a director or an executive officer may be treated as loans "for" the director. Loans to companies in which a director is a principal shareholder might be construed as loans "for" the director, but, if such a company is a substantial operating company and the loan is made in the ordinary course of the issuer's business, the loan arguably would not be a "personal" loan covered by Section 402.

Grandfathering of Existing Extensions of Credit

Section 402 contains the following grandfather provision:

"An extension of credit maintained by the issuer on the date of enactment [July 30, 2002] of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after [July 30, 2002]."

The use of the term "extension of credit" in this provision raises the question whether or not the unfunded portion of a line of credit or a loan commitment that was in place on July 30, 2002 is subject to the Section 402 prohibition. There is no definition of the term "extension of credit" under the Exchange Act or the rules issued thereunder. In the banking laws, the term "extension of credit" often includes loans, but also includes loan commitments, lines of credit, letters of credit, guarantees, and repurchase agreements. For example, for purposes of national bank lending limits the phrase "loans or extensions of credit" is defined to include standby letters of credit and similar obligations, obligations under guarantees, and obligations to advance funds under a legally binding written commitment to lend. "Credit" under the margin regulations includes, in addition to loans, lines of credit and guarantees. A number of banking statutes refer to "loans or other extensions of credit." Perhaps the most apropos example is provided by Section 22(h) of the Federal Reserve Act, the bank insider lending statute, which defines an "extension of credit" as follows:

> "A member bank extends credit by making or renewing any loan, granting a line of credit, or entering into any similar transaction as a result of which a person becomes obligated (directly or indirectly, or by any means whatsoever) to pay money or its equivalent to the bank. "

The way in which the SEC will interpret this provision is difficult to predict. In our view, based on the way that the term "extension of credit" is used in similar statutes, the term should be interpreted in the grandfather provision of Section 402 to include legally binding loan commitments and guarantees, and drawings after July 30, 2002 on such extensions of credit (so long as not renewed or substantially modified) should be permissible under Section 402 if the credit were in place on or before July 30, 2002.

Treatment of Leveraged Co-Investment Programs

Several issues have arisen relating to the applicability of Section 402 to leveraged co-investment programs. One issue that has been raised is whether a loan to a private equity partnership that is sponsored by the issuer and in which officers and employees of the issuer have invested would be regarded as a loan to executive officers if the latter represented only a minority of the investors. In our view, such a loan likely would be subject to Section 402 even if only a few of those who benefit from that loan are "executive officers."

Another issue that has been raised is whether existing leveraged co-investment programs are grandfathered. As discussed above in the section relating to the Section 402 grandfather provision, loans made by issuers on or before July 30, 2002 are grandfathered. Although the matter is not free from doubt, our view is that advances after July 30, 2002 by an issuer under a leveraged co-investment program are grandfathered if they are made pursuant to a commitment that was legally binding on July 30, 2002. As the terms of these programs vary greatly, we recommend that issuers consult with counsel as to the applicability of Section 402 to their own leveraged co-investment programs. Issuers should also consider how they characterize such programs in their public filings. Issuers also should be careful not to make any material modification to any term of any such existing commitments or take any actions that could be construed as a renewal of such commitments, which would result in the loss of grandfathered status. Finally, issuers need to consider Section 402 in connection with the future establishment of such co-investment programs.

Treatment of Split-Dollar Life Insurance

An ambiguity exists as to whether Section 402's prohibition applies to split-dollar life insurance programs, under which employers may provide deferred compensation or life insurance coverage to executive officers. Under these arrangements, upon the death of the covered employee the employer receives back from the proceeds of the insurance policy at least the amount of the premiums paid by the employer and the employee's beneficiaries receive the balance of the proceeds of the policy, on a tax-free basis. Because these programs always involve an employer financing, directly or indirectly, of all or a substantial portion of the employee's life insurance policy premiums, an issue exists as to whether the programs will be viewed as extensions of credit for purposes of Section 402.

While we do not believe that split-dollar life insurance programs were necessarily intended to be prohibited by the Act, such arrangements are not expressly excluded from Section 402. In addition, the SEC might regard the Federal Reserve's treatment of split-dollar life insurance programs under the insider lending provisions of Section 22(h) of the Federal Reserve Act as an appropriate analogy. The Federal Reserve has taken the position that insurance premiums paid in part by a bank on behalf of its executive officers do not constitute an extension of credit for purposes of the insider lending restrictions of Section 22(h). However, in reaching this conclusion, the Federal Reserve expressly relied upon Internal Revenue Service rulings in which the IRS held that, generally, split-dollar life insurance does not involve a loan by the employer but rather taxable income to the employee. The IRS is in the process of issuing new regulations relating to the tax treatment of split-dollar life insurance, which, if finalized, would effectively revoke the revenue rulings relied upon by the Federal Reserve. Under the proposed regulations, if the employee is treated as the owner of the insurance policy, the IRS would treat the payment of premiums by the employer, either directly or indirectly, as a loan to the employee. This means that collateral assignment split-dollar life insurance arrangements generally would be treated as loans. Until the proposed regulations are finalized, the IRS has advised that taxpayers generally may continue to treat collateral assignment split-dollar life insurance arrangements as an economic benefit to the employee, or they may treat such arrangements as a loan.

Accordingly, affected issuers should carefully review any split-dollar life insurance program that they are anticipating establishing for their directors or executive officers. Affected companies should also carefully review any existing split-dollar life insurance programs maintained for their executives. With respect to the latter, an assessment must be made as to whether future premium payments under existing programs are grandfathered. Even if a program were otherwise grandfathered, modifications to the existing program to make it more tax efficient under the newly proposed tax regulations may constitute a material modification, which could result in the modified program losing its grandfathered status and being prohibited under the Act.

Treatment of Cashless Option Exercise Programs

Another issue relates to participation by an issuer's executive officers and directors in an issuer's cashless exercise program for its stock options. Typically, in such programs a broker accepts an executed exercise notice from the optionee instructing the issuer to deliver the securities to the broker. The short-term financing of the exercise by the broker is either paid off from the sale of the securities received pursuant to the exercise of the stock option or replaced with a margin loan against the securities.

An agreement by an issuer to defer payment of the exercise price of the options until the broker receives the proceeds of a sale of securities would be an extension of credit by the issuer for the benefit of the optionee and would be prohibited by Section 402 if the optionee is a director or executive officer of the issuer. If the broker were a subsidiary of the issuer, and the broker rather than the issuer temporarily financed the exercise of the option, the extension of credit would still be treated as an indirect extension of credit by the issuer and would violate Section 402.

If the broker in a cashless exercise program provides the temporary financing and the broker were unaffiliated with the issuer, the question would remain as to whether the issuer "arranged" the extension of credit by the broker, which also would be prohibited by Section 402 in the case of credit extended to a director or executive officer of the issuer. Section 402 does not define the term "arrange." In the context of the margin regulations issued pursuant to the Exchange Act, the term has been interpreted to apply to activity involving little more than introducing the borrower to the lender. The level of issuer involvement in cashless option exercise programs varies.

However, unless and until further guidance is issued by the SEC or the SEC exempts such extensions of credit from Section 402, issuers should exclude executive officers and directors from cashless exercise programs in which they have any involvement.

However, Section 402 would not preclude other means of exercising options, such as (1) an executive officer or director obtaining a loan from his or her broker, using the proceeds to exercise the options and instructing the broker to sell the shares immediately to repay the loan (although this would likely require a pledge of sufficient marginable securities to the broker to support the loan) or (2) a stock for stock exercise.

Treatment of Other Extensions of Credit

In addition, issues are being raised whether various types of advances constitute loans for purposes of Section 402 including:

- loans under Section 401(k) plans from the account of the executive officer to such officer (although finding such a transaction prohibited by the Act would appear to us to be an unwarranted and extreme extension of Section 402);
- use of a corporate credit card for personal use and travel advances;
- advances pursuant to an issuer's standard director and officer indemnity to cover legal fees and costs prior to a final determination as to whether the indemnity is applicable and based solely on the recipient's promise, which is generally required under applicable state corporation law, to repay if indemnification is not applicable;
- reimbursement of mortgage origination fees or interest payments to an executive officer who moves at the request of an issuer; and
- other means issuers may use (such as preferred capital) to provide leverage to co-investment programs.

The Act does not resolve these questions, although Congress or the SEC may provide guidance in the future.

EXEMPTION FOR CONSUMER LOANS MADE IN THE ORDINARY COURSE OF BUSINESS

Section 402 exempts from its prohibition the following types of consumer loans, if made on market terms in the ordinary course of the issuer's business:

- home improvement and manufactured housing loans;
- extensions of credit under a credit card;
- "consumer credit," as defined in the Truth in Lending Act; and
- margin loans made by a registered broker or dealer to one of its employees to purchase securities (other than stock of the issuer).

The term "consumer credit" is defined in the Truth in Lending Act to include any credit that is extended to a natural person for "personal, family, or household purposes" (as opposed to credit extended for a business purpose[1]). The term includes residential mortgage loans. In fact, the term "consumer credit" is broad enough to include all the other categories of loans specifically listed in Section 402.

The consumer loans listed above (including margin loans) are exempt from Section 402 only if they:

- are of a type that is generally made available "by such issuer" to the public;
- are made "in the ordinary course of the consumer credit business of such issuer"; and
- are made on market terms.

Because the general restriction in Section 402 applies to loans made by an issuer through a subsidiary, the consumer credit exemption to Section 402 should be available

[1] Additional guidance regarding the distinction between consumer and business credit may be found at 12 C.F.R. § 226.3.

for loans made by a subsidiary of the issuer in the ordinary course of its consumer credit business even if the issuer itself is not in the consumer credit business.

The Express Exemption for Margin Loans by Brokers to Their Employees

The express exception under Section 402 for margin loans is quite narrow:

- the exemption is only available to brokers and dealers that are registered under the Exchange Act and is not available, for example, to unregistered foreign brokers and dealers;
- the exemption only applies to loans made to employees of a registered broker or dealer and not to loans made to employees of affiliates who are not also employees of the registered broker or dealer;
- the exemption does not apply to loans to purchase stock of the issuer; and
- the exemption only applies to loans that are on market terms.

Exemption for Margin Loans as "Consumer Credit"

The term "consumer credit" is broad enough to include margin loans, but the specific exemption in Section 402 relating to margin loans by registered broker and dealers to their employees may indicate a Congressional intent not to exempt other margin loans by such brokers and dealers. Although the matter is not free from doubt, our view is that, notwithstanding the specific exemption, "consumer credit" in Section 402 should include a margin loan by an issuer that is not a registered broker or dealer to a director or executive officer who does not use the loan to purchase stock of the issuer. Any such loan would have to be in the ordinary course of the issuer's business and on market terms.

EXCLUSION FOR BANK LOANS SUBJECT TO THE BANK INSIDER LENDING LAW

Section 402 provides that the restriction on loans made to directors and executive officers of an issuer does not apply to any loan made or maintained by an insured depository institution (as defined in Federal Deposit Insurance Act) if the loan is subject to the insider lending restrictions of Section 22(h) of the Federal Reserve Act. Loans that are subject to Section 22(h) generally may have terms that are preferential relative to those offered to the public if the loans are made pursuant to a program that is widely available to employees and the loan terms are not preferential relative to the terms offered to other employees. Section 22(h) limits the aggregate amount of loans that may be made to individual executive officers and directors and to all such officers and directors as a group.

Section 22(h) only applies to loans made by an insured depository institution. Therefore, this exemption from Section 402 is not available for loans made by issuers or subsidiaries of issuers that are not insured depository institutions. In particular, this exemption is not available for loans made by U.S. branches and agencies of non-U.S. banks, except for insured U.S. branches of non-U.S. banks, which are relatively uncommon.

In order to be subject to the insider lending restrictions of Section 22(h) and fall within this exemption to Section 402, a loan must be made to an executive officer or director of the insured depository institution lender. Relatively few insured depository institutions are public companies. However, they are often controlled by a public company and a director or an executive officer of such a public company generally is deemed to be a director or an executive officer (as the case may be) of the subsidiary insured depository institution. For purposes of Section 22(h), the term "executive officer" is defined to mean "a person who participates or has authority to participate (other than in the capacity of a director) in major policymaking functions of the company". The term "includes every vice president unless the officer is excluded, by resolution of the board of directors or by the bylaws of the bank or company, from participation (other than in the capacity of a director) in major policymaking functions of the bank or company, and the officer does not actually participate therein". As a practical matter, the term "executive officer" is defined for a company that controls an insured depository institution by identifying in a board resolution those members of management that have authority to participate in major policymaking functions. In order to rely upon the Section 402 exemption for loans made by an insured bank subsidiary to an executive officer of the issuer, the bank would have to adopt a resolution indicating that such executive officers participate in major policymaking functions of the bank.

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Please contact your relationship partner or any of the individuals listed below if we can be of assistance regarding these important developments.

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