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DEVELOPMENTS UNDER SECTION 16
(Part I of Two Parts)

The SEC's Overhaul in 1991 of the Rules and Forms Relating to Reporting and Short-Swing Trading by Public Company Insiders Under Section 16 Produced an Improved but Excessively Complex Regulatory Scheme. Rule Revisions in 1996 Reduced the Complexity of the Revamped Approach, and Numerous Judicial Decisions and SEC Interpretations Have Clarified its Application.

Peter J. Romeo and Alan L. Dye

INTRODUCTION

In 1991, the Securities and Exchange Commission ("SEC" or "Commission") overhauled the regulatory scheme under Section 16 of the Securities Exchange Act of 1934 ("1934 Act") in an effort to modernize the rules and forms relating to insider reporting and short-swing trading.[1] These revisions, together with earlier legislation that enhanced the Commission's enforcement powers,[2] required public company insiders and their advisers to adapt to a completely revamped system.

The complexity of the new regulatory scheme soon became apparent, as evidenced by the more than 250 interpretive letters issued by the SEC staff during the first three years following the adoption of the 1991 changes. In recognition of this complexity, the Commission issued two sets of proposals in the mid-1990's designed to simplify the regulatory scheme.[3] In May 1996, the Commission took final action on these proposals by adopting revisions to the rules and forms under Section 16 that substantially relaxed and simplified many existing requirements.[4]

Subsequent to the adoption of the 1996 changes, both the courts and the SEC have provided extensive guidance regarding the application of the revamped regulatory scheme. The courts have issued over 30 decisions relating to Section 16, and the SEC has published several interpretive letters and numerous telephone interpretations.[5]

Due to the breadth of the 1991 and 1996 changes and the large volume of judicial decisions and SEC interpretations relating to them, a complete analysis of the revamped regulatory scheme is not possible within the limited scope of this article.[6] Instead, a general overview is provided, with citations to rule changes and interpretive letters where appropriate.[7] The discussion begins with a brief summary of Section 16 and then addresses five major areas of interest under Section 16: (1) statutory insiders, (2) beneficial ownership, (3) the reporting system, (4) derivative securities, and (5) transactions with the issuer. Because of the length of this article, the first

1. See Rel. No. 34-28869 (1991). Technical corrections to certain rules and forms subsequently were made in Rel. Nos. 34-28869B (1991) and 34-29131 (1991). The revised rules and forms became effective on May 1, 1991, subject to certain transition provisions described in Rel. Nos. 34-28869 (1991), 34-30850 (1992), 34-32574 (1993), 34-34513 (1994) and 34-36063 (1995). For complete information about the Section 16 regulatory scheme, see P. Romeo and A. Dye, Section 16 Treatise and Reporting Guide (1994), P. Romeo and A. Dye, Section 16 Forms and Filings Handbook (1996), and P. Romeo, Comprehensive Section 16 Outline (1999), all of which are published by Executive Press, Inc. (Concord, CA).

2. See the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429 (1990).

3. See Rel. No. 34-34514 (1994), which was supplemented by Rel. No. 34-34681 (1994), and Rel. Nos. 34-36356 (1995) and 34-36356A (1995).

PETER J. ROMEO and ALAN L. DYE are partners of Hogan & Hartson L.L.P. in Washington D.C.

4. See Rel. Nos. 34-37260 (1996), 34-37261 (1996) and 34-37262 (1996). The rule revisions became effective on August 15, 1996, but issuers were permitted at their election to defer becoming subject to revised Rule 16b-3 until as late as November 1, 1996.

5. See the Division of Corporation Finance's Manual of Publicly Available Telephone Interpretations (known commonly as the "Telephone Interpretations Manual") at Tab "R" (July 1997), and the March 1999 Supplement to the Manual at the section captioned "Section 16 Rules and Forms 3, 4 and 5."

6. For more complete information about Section 16, see the other publications of the authors listed in Note 1.

7. Relevant SEC letters are cited herein by providing the name of the person or entity who is the subject of the letter and the date the letter became publicly available.

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four topics are addressed in Part I appearing in this issue, and the fifth in Part II, which will appear in the next issue.

THE STATUTORY PROVISION

Section 16 is a charter provision of the 1934 Act which imposes reporting obligations and trading limitations on officers and directors of issuers that have a class of equity securities registered under Section 12 of the 1934 Act, and on beneficial owners of more than ten percent of such a class. These statutory insiders must file with the SEC public reports disclosing their holdings of and transactions in the issuer's equity securities under Section 16(a), disgorge to the issuer any profits resulting from "short-swing" transactions in the issuer's equity securities under Section 16(b),[8] and refrain from short sales of the issuer's equity securities under Section 16(c).

STATUTORY INSIDERS

Determining who is an officer, director or ten percent owner for purposes of Section 16 often presented difficulties prior to the 1991 changes. Under the former rules, for example, there was uncertainty whether a person holding the title of vice president who did not have high-level executive responsibilities nevertheless should be deemed an officer. In addition, there were doubts as to the calculation of ten percent beneficial ownership in certain situations. The Commission addressed most of these difficulties head-on and produced guidelines that are clear-cut, although not entirely free of controversy.

Officers

The 1991 changes introduced a new definition of the term "officer" which applies solely for purposes of Section 16.[9] Unlike its predecessor,[10] the definition focuses on a person's duties rather than the person's title. Specifically, the definition identifies as Section 16 officers the issuer's president, principal financial officer, principal accounting officer (or, if the issuer has no principal accounting officer, its controller), any vice-president in charge of a principal business unit, division, or function (such as sales, administration, or finance), and any other person, including officers of the issuer's parent or subsidiaries, who performs significant policy-making functions for the issuer. The definition allows persons (typically vice presidents) who are officers in name only and do not perform in a high-level executive capacity to avoid the responsibilities and burdens of Section 16.

Because the current definition is modeled after the definition of "executive officer"[11] (with the addition of the principal financial officer and the principal accounting officer), an issuer's Section 16 officers will in most cases be the same persons who are considered executive officers for purposes of the issuer's Form 10-K and annual proxy statement.[12] Where they are not the same, the issuer should be ready with a good explanation, since the SEC may inquire about the variance.

A note to the definition of "officer" states that persons identified as executive officers (together with the issuer's principal financial officer and principal accounting officer) will be presumed to have been designated by the issuer's board of directors as the issuer's officers for purposes of Section 16.[13] As a consequence of this note, many companies find it advisable to have the board of directors pass a resolution annually (usually in connection with the approval of the Form 10-K) designating those persons within the company who are deemed Section 16 insiders. Such a resolution not only enhances continued compliance with Section 16, but also should protect from liability those persons excluded from the list.

As under the pre-1991 rules, issuers and their counsel are responsible for determining whether, in light of the particular facts and circumstances, an individual employee is an officer for purposes of Section 16. Because of the fact-intensive nature of the analysis, the staff will not express a view whether a particular person is a Section 16 officer.[14]

Directors

The Commission did not disturb the pre-1991 criteria for determining who is a director,[15] choosing

8. A short-swing transaction is any purchase and sale, or sale and purchase, of the issuer's equity securities occurring within a period of less than six months. After soliciting comment in October 1995 on whether Section 16(b) should be repealed, the Commission determined not to recommend repeal to Congress on the basis of its belief that the changes adopted by it in 1996 "retain the market protections provided by Section 16(b) while curtailing compliance costs, thereby striking an appropriate balance between benefits and costs." See Rel. Nos. 34-36356, § V. (1995) and 34-37260, § VI. (1996).

9. See Rule 16a-1(f).

10. See the definition of "officer" in Rule 3b-2 under 1934 Act, which applied under Section 16 prior to the adoption of Rule 16a-1(f).

11. See Rule 3b-7 under the 1934 Act for the definition of "executive officer."

12. Item 401(b) of Regulation S-K, which is invoked by Item 7 of Schedule 14A and Item 10 of Form 10-K, requires issuers to identify their executive officers.

13. Rule 16a-1(f) also should be used to determine which officers of a registered closed-end investment company and its investment advisor are subject to Section 30(f) of the Investment Company Act of 1940, a counterpart of Section 16. Investment Company Institute (June 12, 1991).

14. American Bar Association (July 3, 1991) (Q.1).

15. See generally Rel. No. 34-26333, § III.A.2. (1988).

to continue reliance on the definition of the term "director" in Section 3(a)(7) of the 1934 Act and related judicial and other interpretations.[16] Under those criteria, honorary, advisory, and emeritus directors may be deemed directors in certain circumstances.[17]

Ten Percent Owners

One of the most significant changes made in 1991 was the adoption of a requirement that the determination of ten percent owner status be based on the standards of beneficial ownership applicable under Section 13(d) of the 1934 Act,[18] subject to certain modifications.[19] Under these standards,[20] a person generally will be deemed the beneficial owner of securities over which the person has or shares voting or investment power,[21] or can exercise such power within 60 days.[22] A stockholder may rely on the issuer's most recent SEC filing to determine the number of shares outstanding for the purpose of calculating ten percent ownership.[23]

Generally, the courts have been reluctant to accept creative arguments for avoiding ten percent owner status.[24] For example, two courts have held that a holder of more than ten percent of a class of convertible preferred stock registered under Section 12 of the 1934 Act could not treat the preferred stock and underlying common stock as a single class of stock (thereby enlarging the computation base) for purposes of the ten percent calculation.[25] Another has held that a person is the beneficial owner, for purposes of the ten percent calculation, of common stock that can be acquired upon the conversion of preferred stock that has a floating conversion price, even though floating price instruments are not considered derivative securities until their price is fixed.[26] And still another made the surprising determination that the presence in debentures convertible into more than ten percent of the issuer's common stock of a provision precluding the holder from owning more than 9.9% of the common stock following a conversion did not prevent the holder from being deemed the beneficial owner of all of the underlying common stock and therefore a ten percent owner.[27]

Importing the Section 13(d) standards into Section 16 remains a controversial action because it effectively overturned several court decisions prior to the 1991 changes which indicated that the Section 13(d) standards were inappropriate under Section 16 insofar as they caused members of groups owning more than ten percent to be subject to Section 16.[28] As a result of the Commission's action, many investors who are not ten percent owners in their own right but are members of a group owning more

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16. A person who has a representative on a board of directors may be deemed a director by virtue of having "deputized" the individual to represent the person's interests. See, e.g., Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969), cert. denied, 396 U.S. 1036 (1970).

17. See generally P. Romeo and A. Dye, Section 16 Treatise and Reporting Guide § 2.02 (1994). See also Rel. No. 34-28869, § VIII.C. (1991), which affirmed prior staff interpretations in Rel. No. 34-18114, Q. 2 & 3 (1981), relating to directors.

18. Among other things, Section 13(d) excludes certain securities from beneficial ownership, including nonvoting securities and securities underlying options which become exercisable more than sixty days in the future. Also, at least three courts have held that statements in Section 13(d) reports are not dispositive on the question of ten percent beneficial ownership under Section 16. See Morales v. Quintel Entertainment, Inc., CCH Fed. Sec. L. Rep. ¶ 90,698, at 93,322 (S.D.N.Y. 1999); Schaffer v. Soros, 1994 WL 381442 (S.D.N.Y. 1994); Levner v. Prince Alwaleed, 903 F. Supp. 452, 461 n.14 (S.D.N.Y. 1994).

19. See Rule 16a-1(a)(1). The Commission has adopted several exclusions from the Section 13(d) standards for securities held in customer or fiduciary accounts by certain institutions specified in Rule 16a-1(a)(1)(i) through (x), all of which would be eligible to report under Section 13(d) on short-form Schedule 13G. These exclusions generally are strictly construed. See, e.g., Strauss v. Kopp Investment Advisers, Inc., CCH Fed. Sec. L. Rep. ¶ 90,666 (S.D.N.Y. 1999) (exclusion in Rule 16a-1(a)(i)(x) for securities held by a group available only if all members of the group would individually qualify for an exclusion).

20. See Rule 16a-1(a)(1) and Section 13(d). Despite some early indications to the contrary (see Mario J. Gabelli, April 29, 1991), the staff generally has carried over its interpretive positions under Section 13(d) to the Section 16 area with little change (see Edward C. Johnson 3d, August 20, 1991).

21. The mere possession of voting or investment power over securities, even if the power is unexercised, is sufficient to make a person the beneficial owner of the securities under the Section 13(d) standards. Schaffer v. Soros, 1994 WL 381442 (S.D.N.Y. 1994).

22. See, e.g., Lerner v. Millenco, L.P., 23 F. Supp. 2d 337 (S.D.N.Y. 1998) (securities underlying an option, warrant or right are includable in the calculation of ten percent beneficial ownership under Rule 13d-3(d)(1)(i) only where the option, warrant or right can be exercised within 60 days). Where a person holds a right to acquire stock that is subject to a material future contingency (e.g., approval by a regulatory authority of the exercise of the right), the person is deemed not to be the beneficial owner of such stock until the contingency is removed and the right can be exercised within 60 days. Levner v. Prince Alwaleed, 61 F.3d 8 (2d Cir. 1995). But if such a right is subject to a condition that is based on past rather than future events (e.g., the conversion price is to be based on the average closing prices of the underlying common stock during the five trading days immediately preceding the date of conversion), the person will be deemed the beneficial owner of the common stock that can be acquired on any given day within 60 days. Medtox Scientific, Inc. v. Morgan Capital L.L.C., 50 F. Supp. 2d 896 (D. Minn. 1999).

23. See C.R.A. Realty v. Enron Corp., 842 F. Supp. 88, 91 (S.D.N.Y. 1994). Where a conflict exists in the issuer's SEC filing as to the number of shares outstanding, a court will adopt, for purposes of a motion to dismiss, the figure most favorable to the plaintiff. See Strauss v. American Holdings, Inc., 902 F. Supp. 475, 476 (S.D.N.Y. 1995).

24. See, e.g., Morales v. Freund, 163 F.3d 763 (2d Cir., 1999); Editek v. Morgan Capital, L.L.C., 150 F.3d 830 (8th Cir. 1998); Medtox Scientific, Inc. v. Morgan Capital LLC, 50 F. Supp. 2d 896 (D. Minn. 1999); Strauss v. Kopp Investment Advisers, Inc., CCH F. Sec. L. Rep. ¶ 90,666 (S.D.N.Y. 1999); Schaffer v. Capital Ventures International, 98 Civ. 3900 (S.D.N.Y. September 13, 1999); Lerner v. Millenco, L.P., 23 F. Supp. 2d 337 (S.D.N.Y. 1998); Schaffer v. Soros, 1994 WL 381442 (S.D.N.Y. 1994); Strauss v. American Holdings, Inc., 902 F. Supp. 475 (S.D.N.Y. 1995); Schaffer v. Dickstein & Co., L.P., 1996 WL 148335 (S.D.N.Y. April 2, 1996).

25. See Morales v. Freund, 163 F.3d 763, 766 (2d Cir. 1999); Schaffer v. Dickstein & Co., L.P., 1996 WL 148335 (S.D.N.Y. April 2, 1996).

26. Editek v. Morgan Capital, L.L.C., 150 F.3d 830 (8th Cir. 1998); Medtox Scientific Inc. v. Morgan Capital L.L.C., 50 F. Supp. 2d 896 (D. Minn. 1999).

27. Schaffer v. Capital Ventures International, 98 Civ. 3900 (S.D.N.Y. September 13, 1999). The decision is inconsistent with a prior SEC no-action letter (BancBoston Capital, Inc., August 10, 1987) and at least one previous judicial decision (Global Intellicom, Inc. v. Thomas Kernaghan & Co., CCH Fed. Sec. L. Rep. ¶ 90,534 (S.D.N.Y. 1999)).

28. See Mayer v. Chesapeake Insurance Co., Ltd., 877 F.2d 1154 (2d Cir. 1989), cert. denied, 110 S. Ct. 722 (1990); C.R.A. Realty Corp. v. Goodyear Tire & Rubber Co., 705 F. Supp. 972 (S.D.N.Y. 1989); Rothenberg v. Jacobs, CCH Fed. Sec. L. Rep. ¶ 94,199 (S.D.N.Y. 1989) See also Mendell v. Gollust, 793 F. Supp. 474 (S.D.N.Y. 1992). Since 1991, a number of courts impliedly have accepted the validity of the SEC's incorporation into the Section 16 regulatory scheme of the Section 13(d) standards of beneficial ownership (including the standards relating to the "group" issue). See, e.g., Morales v. Freund, 163 F. 3d 763 (2d Cir. 1999); Schaffer v. Soros, 1994 WL 381442 (S.D.N.Y. 1994); Strauss v. American Holdings, Inc., 902 F. Supp. 475 (S.D.N.Y. 1995).

than ten percent have found (sometimes belatedly and to their sorrow under Section 16(b)) that they are subject to Section 16.[29] In a few instances, however, investors have escaped group treatment because of determinations by the courts or the SEC that certain types of agreements or arrangements do not meet the requirements for finding a group.[30]

Under certain circumstances, the current ten percent ownership standard brings within the ambit of Section 16 persons who have voting and/or dispositive power over more than ten percent of a registered class of equity securities but little or no economic interest in them (e.g., trustees under trusts for the benefit of others). The Commission staff has been willing in some of these situations to provide relief where a flexible application of the ownership standard is possible. It has indicated, for example, that the trustee of a defined contribution plan will be deemed not to beneficially own securities allocated to plan participants with pass-through voting rights,[31] and that individual participants in a defined benefit plan which does not maintain separate accounts for participants may disregard holdings by the plan when filing their reports.[32]

On the other hand, the staff takes the position that a plan trust which holds unallocated shares constituting more than ten percent of a registered class is a ten percent owner, notwithstanding that the trustee is not considered a ten percent owner because it is a Schedule 13G-eligible institution.[33] Securities are considered to be unallocated (and therefore attributable to the trust for purposes of the ten percent calculation) where the plan allocates cash balances to participants in lieu of the issuer's securities.[34] Where a plan trust holds unallocated stock constituting more than ten percent of a class and the plan trustee is an individual who is not eligible to file on Schedule 13G, the trustee will be subject to Section 16 as a ten percent owner, to the extent that he or she has or shares voting power or investment control over the plan securities.[35]

Trusts

One of the anomalies of the revamped regulatory scheme adopted in 1991 (and one which proved to be a trap for the unwary) was a provision which subjected certain family trusts to Section 16 even though the trust was not an officer, director, or ten percent owner, as required by the statute. This was possible under former Rule 16a-8(a)(1)(ii), which stated that a trust is subject to Section 16 if (i) the trustee is a statutory insider (ii) the trustee exercises or shares investment control over the issuer's securities held by the trust, and (iii) either the trustee or a member of the trustee's immediate family has a pecuniary interest in the securities. This rule was rescinded as of August 15, 1996,[36] with the result that a trust now is subject to Section 16 only if it is a ten percent owner. This change did not affect the previously applicable requirement that insider-trustees of such trusts must report the trust's holdings and transactions in their individual reports.[37]

29. Pursuant to Rule 13d-5(b)(1), the existence of an agreement to acquire, hold, vote or dispose of securities is sufficient to cause all parties to the agreement to be deemed a group for purposes of both Section 13(d) and the ten percent ownership standard of Section 16. See, e.g., Morales v. New Valley Corp., 999 F. Supp. 470 (S.D.N.Y. 1998) (agreement containing right of first refusal and profit-sharing arrangement sufficient to create a group); Lerner v. Milleneo, L.P., 23 F. Supp. 2d 337, 344 (S.D.N.Y. 1998) (acting in a coordinated fashion when engaging in investment activities sufficient to create a group). A group can be deemed to exist for purposes of the ten percent ownership calculation even where there is no formal agreement to act together. See, e.g., Strauss v. American Holdings, Inc., 902 F. Supp. 475 (S.D.N.Y. 1995) (partnership and corporation purportedly controlled by same individual deemed, for purposes of a motion to dismiss, to be a group with the individual notwithstanding the absence of an agreement to act together.) A sale by a group member that reduces the group's aggregate holdings below the ten percent threshold shields all subsequent sales by group members from Section 16. Schaffer v. Soros, 1994 WL 381442 (S.D.N.Y. (1994). In 1996 the Commission adopted Rules 16a-3(j) and 16a-1(a)(3) permitting members of a Section 13(d) group to report their holdings and transactions jointly under Section 16 rather than on multiple individual filings. See Rel. No. 34-37260, § IV.E., § III.C. (1996).

30. See Morales v. Quintel Entertainment, Inc. CCH Fed. Sec. L. Rep. ¶ 90,698 (S.D.N.Y. 1999) (lock-up agreement restricting resale of securities on terms requested by issuer does not create a group); Morales v. New Valley Corp., 999 F. Supp. 470, 475 (S.D.N.Y. 1998) (close consulting relationship does not create a group). The SEC staff has provided some relief from the Section 13(d) group standard in the employment context where collective voting may be required by the employer. See Morgan Stanley Group, Inc. (April 30, 1991) (employees who are parties to voting agreement imposed by employer may disregard securities attributable to other employee participants when calculating ten percent ownership); Alex Brown, Inc. (July 22, 1991) (same); Goldman Sachs Group (April 30, 1999) (same).

31. Hewitt Associates, (April 30, 1991) (Q.1); Thompson, Hine & Flory (March 29, 1991) (Q.3). The staff takes this position without regard to whether the trustee is an institution or an individual. See American Bar Association (July 3, 1991) (Q.2a). Insider participants in such a plan, however, would be required to report such securities following allocation. Hewitt Associates (April 30, 1991) (Q.1). Transactions by an employee benefit plan trust which is a ten percent owner are reportable by the trust unless they are made at the direction of the participant, in which case they are reportable by the participant. Ventura County National Bancorp (August 30, 1991).

32. Hewitt Associates (April 30, 1991) (Q.1). The staff also has indicated that a trust for a defined contribution plan may disregard securities allocated to participant accounts for reporting purposes, although insiders receiving such allocations become obligated to report the securities as of the date of allocation. Id.

33. American Bar Association (July 3, 1991) (Q.2b). See also Rule 16a-8(a)(1)(i). The staff's position, however, applies only with respect to unallocated employer securities held by defined contribution plans. Master Pension Trust of AT&T (June 30, 1993). Thus, a defined benefit plan trust (which, by definition, does not allocate securities to individual accounts) may exclude such securities from the ten percent ownership calculation on the ground the securities are held for the benefit of third parties or in customer or fiduciary accounts within the meaning of Rule 16a-1(a)(1), since the proviso in that rule requiring that plan participants have pass-through voting rights is deemed to apply only to defined contribution plans holding employer securities. Id.

34. CIGNA Companies (August 6, 1991).

35. American Bar Association (July 3, 1991) (Q.2c). The plan trust also will be a ten percent owner in such circumstances because it holds more than ten percent of the class. Id.

36. See Rel. No. 34-37260, § IV.F. (1996).

37. See Rel. No. 34-18114, Q.57 (1981).

BENEFICIAL OWNERSHIP

The concept of beneficial ownership is critical to Section 16 because the provision applies only to equity securities of the issuer beneficially owned by an insider.[38] Until the 1991 changes were adopted, however, the SEC had never defined the term "beneficial owner." This deficiency was remedied by the adoption of two definitions of the term, one for the purpose of calculating ten percent beneficial ownership (which already has been discussed) and the other for reporting, short-swing liability and all other purposes under Section 16.

The second definition bases beneficial ownership on whether the insider has or shares a direct or indirect pecuniary interest in the issuer's equity securities.[39] The term "pecuniary interest" is broadly defined to mean "the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities."[40] According to the Commission, such an interest may arise through any "contract, arrangement, understanding, relationship or otherwise."[41]

The definition for reporting and other purposes adopted in 1991 is extremely helpful, particularly since the Commission has provided precise guidance on its application to several common indirect ownership situations, as described below.

Family Holdings

Generally, an insider will be presumed to be the beneficial owner of securities held by members of his or her immediate family who share the insider's household.[42] The presumption of ownership is subject to rebuttal by the insider,[43] and the insider may disclaim beneficial ownership of reported securities.[44] An insider, however, cannot avoid reporting transactions by immediate family members merely because the transactions were designed to avoid losses rather than produce profits.[45]

Corporate Holdings

Although the Commission has not stated the circumstances under which attribution of corporate holdings of portfolio securities will occur, it has provided a safe harbor for insiders who are not controlling shareholders of the corporation and do not have or share investment control over the corporation's portfolio securities.[46] Because the rule regarding corporations is only a safe harbor, a failure to satisfy both of its conditions does not necessarily mean that the insider will be deemed the beneficial owner of the corporation's portfolio securities.[47]

Partnership Holdings

A general partner of a general or limited partnership is deemed the beneficial owner of portfolio securities held by the partnership to the extent of the greater of the partner's capital account or interest in the profits of the partnership.[48] The 1991 rule changes did not directly address the question whether a limited partner can be deemed the beneficial owner of the partnership's portfolio securities, although the Commission indicated that "absent other circumstances" limited partners will not be deemed beneficial owners of securities held by the partnership.[49] Further, the SEC staff stated that a limited partner may rely on the safe harbor afforded by Rule 16a-1(a)(2)(iii) for interests in the portfolio securities of a corporation "or similar entity" if the person does not hold a controlling interest in the limited partnership and does not have or share investment control over the partnership's portfolio securities.[50]

Trust Holdings

The holdings of a trust can be attributed to an insider trustee, settlor, or beneficiary under certain circumstances.[51] Generally, no attribution can occur unless the insider has or shares investment control

38. See Section 16(a), Rule 16a-2(a), and General Instructions 4(a)(i) of Form 3 and 3(a)(i) of Forms 4 and 5.

39. Rule 16a-1(a)(2).

40. Rule 16a-1(a)(2)(i). A number of examples of situations in which an indirect pecuniary interest exists are detailed in Rule 16a-1(a)(2)(ii). It has been held that the examples set forth in the rule are nonexclusive and therefore do not constitute all of the situations in which such an interest may arise. Strauss v. Kopp Investment Advisors, Inc., CCH Fed. Sec. L. Rep. ¶ 90,666 (S.D.N.Y. 1999); Bull & Bear U.S. Government Securities Fund, Inc. v. Karpus Management, Inc., 1998 WL 388546 (S.D.N.Y. July 13, 1998).

41. Rule 16a-1(a)(2).

42. Rule 16a-1(a)(2)(ii)(A); SEC v. Lipson, 1997 WL 452701 (N.D. Ill. 1997); SEC v. Chandler, Lit. Rel. 15854 (1998).

43. Rel. No. 34-29131, § IV. (1991).

44. See Rule 16a-1(a)(4).

45. SEC v. Lipson, 1997 WL 452701 (N.D. Ill. 1997).

46. Rule 16a-1(a)(2)(iii).

47. See, e.g., Feder v. Frost, 1999 WL 163174 (S.D.N.Y. March 24, 1999), which held that sales of stock of an insider's company by a corporation in which the insider was a director, 17% stockholder, and a party to an agreement controlling 50% of the corporation's stock, were not attributable to the insider for purposes of Section 16(b) liability. See also L.B. Smith and Arthur O. Smith (April 19, 1991).

48. Rule 16a-1(a)(2)(ii)(B).

49. Rel. No. 34-26333, § III.A.4.d. (1988). The "other circumstances" that might cause a limited partner to be a beneficial owner of the securities held by the partnership could include the ability to control, or share the control of, transactions involving the issuer's securities.

50. Widett, Slater & Goldman, P.C. (March 25, 1992).

51. See Rule 16a-8. See also Fulbright & Jaworski (March 13, 1992); Munger, Tolles & Olson (December 10, 1991).

over the issuer's securities held by the trust.[52] Unfortunately, the staff has cast some doubt on the application of this standard by stating that clauses (i) and (ii) of Rule 16a-8(b)(3) do not set forth all situations in which a trust beneficiary is considered the beneficial owner of the trust's securities for reporting purposes, but simply specify when trust beneficiaries who are beneficial owners have reporting obligations.[53] It is uncertain what other situations might give rise to beneficial ownership.

Notwithstanding the above, the SEC staff has provided some helpful guidance. Specifically, it has said that an insider is deemed not to have investment control with respect to his or her interest in securities held in a trust for a defined benefit plan which neither maintains separate accounts for individual participants nor allocates the plan's investment fund to such persons.[54] Similarly, an insider is deemed not to have investment control of unallocated securities held by a trustee under a defined contribution plan, although such control ordinarily is deemed to shift to an insider-participant once shares have been allocated to his or her account, absent unusual circumstances.[55] On the other hand, an insider-participant in a profit-sharing plan is deemed to have a pecuniary interest in unallocated shares held by the trust if the insider can profit from an appreciation in value of those shares, and therefore must report the shares if he or she also has investment control over plan holdings.[56] In addition, an insider who elects to defer receipt of a cash performance award pursuant to an arrangement under which deferred awards are invested in issuer stock and held in trust for distribution upon the insider's retirement will be deemed to have investment control over the securities by virtue of the election.[57]

52. Sullivan & Cromwell (April 30, 1991) (Q.1); Taylor Voting Trust (January 3, 1992). A trust beneficiary having or sharing investment control need report only his or her pro rata interest in issuer securities held by the trust. Sullivan & Cromwell, supra (Q.3). Generally, the general partner of a publicly traded limited partnership will not be deemed to have a pecuniary interest in partnership units placed in a rabbi trust for later issuance under employee benefit plans of the general partner, so long as the general partner does not retain the power to revoke the trust. See Plum Creek Management Co., L.P. (March 30, 1994).

53. Sullivan & Cromwell (April 30, 1991) (Q.1).

54. Hewitt Associates (April 30, 1991) (Q.1).

55. Id. See also Thompson, Hine & Flory (March 29, 1991) (Q.3); Fulbright & Jaworski (March 13, 1992) (Q.6).

56. See Fulbright & Jaworski (March 13, 1992) (Q. 2). The general partner of a publicly traded limited partnership, as settlor of a rabbi trust formed to hold limited partnership interests issued by the partnership, is deemed not to have a pecuniary interest in such limited partnership interests so long as the general partner does not retain the power to revoke the trust. See Plum Creek Management Company, L.P. (March 30, 1994).

57. See Eaton Corp. (January 19, 1993). This result is troublesome to the extent that it suggests that an insider remains subject to Section 16 with respect to subsequent transactions by the trust over which he or she has no control.

THE REPORTING SYSTEM

The 1991 revisions made major changes to the reporting system for the purpose of eliciting more information about transactions by insiders, reducing the frequency of reporting, and improving the rate of compliance with Section 16(a). The changes made the reporting system more complex, and initially resulted in a large number of inadvertent reporting violations and other reporting errors.[58] The Commission staff, however, subsequently issued a number of interpretations that assisted insiders in complying with the revised requirements.[59]

Notwithstanding the relief provided by the staff interpretations, the Commission adopted further revisions to the rules and forms in 1996 that simplified the reporting requirements in several important respects.[60] Among the changes adopted by the Commission were broad exemptions under Section 16(a) that exclude a number of transactions from reporting.[61] In addition, the 1996 revisions simplified the reporting system by requiring current reporting of most transactions, including option exercises, and permitting deferred reporting of other transactions exempt from Section 16(b), as well as small acquisitions subject to new Rule 16a-6.[62] The

58. See The Corporate Executive (September-October 1991) at 5.

59. See, e.g., Emergent Group, Inc., (April 6, 1992) (insiders who receive a stock dividend should explain in a footnote to their next Form 4 or Form 5 the reason for the appearance on the form of shares not previously reported); Clorox Co. (March 27, 1992) (tax withholding right may be reported as a feature of the option or restricted stock to which it relates, or as a separate derivative security); William M. Mercer (March 6, 1992) (SARs and LSARs may be reported as a feature of the related option or as a separate derivative security); American Society of Corporate Secretaries, Inc. (January 24, 1992) (reports on Form 5 of exempt accumulations of stock under employee benefit plans need not include holdings of derivative or other non-stock securities); Varity Corp. (October 15, 1991) (Q.3) (insiders of company which changed domicile need not file a special report relating to the change of domicile transaction, but can simply indicate in the next Form 4 or 5 otherwise required that the new company is the successor to the old); Joseph A. Grundfest (August 19, 1991) (Q.7) (transaction for which Rule 16b-3 exemption is lost retroactively is timely reported if reported within 10 days after end of month in which exemption is lost); Frederic W. Cook & Co., Inc. (July 3, 1991) (grant of security subject to stockholder approval need not be reported until stockholder approval is obtained); Bell, Boyd & Lloyd (June 3, 1991) (Forms 4 and 5 need not list all derivative securities relating to underlying class each time a transaction in the underlying security is reported); Bryan, Cave, McPheeters & McRoberts (April 25, 1991) (Q.4) (equity securities underlying a derivative security need not be disclosed in Table I of the reporting forms, so long as the derivative security is properly reported in Table II); Bryan, Cave, McPheeters & McRoberts (April 25, 1991) (Q.5) (employee benefit plan holdings may be based on most recent plan statement distributed on a timely basis); Joseph A. Grundfest (April 25, 1991) (Q. 4) (multiple reporting delinquencies may be disclosed in a single reporting form); Thompson, Hine & Flory (March 29, 1991) (Q.2) (insiders need include in their end-of-period holdings on Forms 4 and 5 only those derivative securities which have characteristics identical to those of the securities being reported); Shea & Gould (April 23, 1991) (Q.1) (insiders need report only their proportionate interest in securities indirectly owned through a corporation); Thompson, Hine & Flory (March 29, 1991) (Q.1) (previously undisclosed derivative securities granted prior to November 1, 1990 may be aggregated in the first Form 4 or Form 5 filed after May 1, 1991). See also Rel. Nos. 34-34514, § III.G. (1994) and 34-37260, § IV.H. (1996) for guidance in reporting equity swaps.

60. See Rel. No. 34-37260, § IV. (1996).

61. See the discussion in this section captioned "Reportable Transactions."

62. Rule 16a-3(f)(1).

Commission also eliminated "second-tier" reporting under which option exercises and small acquisitions were reportable on the earlier of the next current report on Form 4 otherwise due, or on the annual report at year-end on Form 5.[63]

Reporting Forms

In 1991, the SEC added a new annual reporting form and redesigned the existing reporting forms to provide additional information about derivative securities and certain transactions,[64] In 1996, it made additional changes to the reporting forms, which now require that 20 separate codes be considered when reporting the nature of a transaction.[65]

Under the current reporting scheme, Form 3 serves as the entry to the system, showing the insider's holdings of equity securities as of the date of becoming an insider.[66] Form 4 shows changes in beneficial ownership of such securities within ten days after the close of the month in which such changes occur, although it is not required for most changes that are exempt by Commission rule from short-swing liability.[67] Form 5 is a "clean-up" report filed within 45 days after the close of the issuer's fiscal year to disclose transactions exempt from prior reporting, as well as transactions that should have been reported previously but were not. No Form 5 is necessary if there are no such transactions to report.

Reporting of end-of-period holdings on Forms 4 and 5 is relatively simple, since insiders are required to show only their holdings of the class of securities involved in transactions described in the report rather than their entire holdings.[68] Accordingly, when reporting a transaction in the issuer's common stock, an insider need not include in the end-of-period holdings shown on the form any preferred stock or convertible debentures owned. In such circumstances, however, the insider must report all holdings of common stock, whether owned directly or indirectly, even though such shares may have been reported previously on a Form 4 or Form 5. In addition, if a reportable transaction involves a class of equity security of the type involved in a "tax-conditioned plan" (as in the case of the cash-out of a phantom stock unit from an excess benefits plan), the holdings of that entire class must be reported at that time,[69] even though previous transactions under the plan may have been exempted from reporting.[70]

When reporting options and other derivative securities, an insider need not include previously reported derivative securities in his or her end-of-period holdings, unless the previously reported securities have terms identical to those involved in the reported transaction. Accordingly, when reporting an option transaction, the insider does not have to include in his or her end-of-period holdings previously reported options having a different exercise price or expiration date.[71]

Among other things, Forms 4 and 5 contain an exit box for a reporting person to check if the person no longer is subject to Section 16, and Form 5 contains boxes to check in the event the insider is reporting holdings or transactions that should have been reported previously on Form 3 or Form 4. Also, an insider can satisfy the manual signature requirement with a photocopied or facsimile signature, so long as the original manually signed report is kept on file by the reporting person for five years and is furnished to the Commission or its staff upon request.[72]

Reportable Transactions

Prior to the 1996 changes, practically all transactions by insiders resulting in a change in beneficial ownership were subject to reporting. In 1996, however, the Commission exempted a number of transactions from reporting,[73] with the result that an insider's reports no longer need reflect all changes in the insider's holdings. Among the transactions exempted from reporting were the following: (1) the acquisition and disposition of withholding and surrender rights relating to cashless exercises and tax

63. Rel. No. 34-37260, § IV.D. (1996).

64. See Rel. No. 34-28869, § II.C. (1991). For illustrated information on how to report in 153 discrete situations, see P. Romeo & A. Dye, Section 16 Forms and Filings Handbook (1996).

65. See Rel. No. 34-37260, § IV.I. (1996). By interpretation, the Commission also eased the footnote requirements for the reporting forms by permitting footnotes to be included on a separate 8-1/2 x 11 inch sheet of white paper attached to the reporting form containing certain minimal identifying information. Formerly, all footnotes had to be squeezed into the "explanation" section on side two of the reporting forms. See Rel. No. 34-37260,§ IV.I. at n.152 (1996).

66. Insiders need not file a new Form 3, or Forms 4 or 5, when the issuer is merged out of existence in a change of domicile merger, provided that insiders indicate in their next Form 4 or Form 5 that the new company is the successor to the prior entity. Horn and Hardart Co. (June 18, 1993) (Q.1.B.).

67. See generally the discussion in this section captioned "Reportable Transactions."

68. See General Instructions 4(a)(i) of Forms 4 and 5.

69. Rel. No. 34-37260, § IV.A. at n.104 (1996).

70. Pursuant to Rule 16a-3(f)(1)(i)(B), transactions qualifying for the exemption provided by Rule 16b-3(c) for transactions under tax-conditioned plans need not be reported.

71. Thompson, Hine & Flory (March 29, 1991) (Q.1).

72. See Rule 16a-3(i). Note that while fax signatures are permitted, fax filings of Section 16(a) reports are not. Insiders can now, however, voluntarily file their Section 16(a) reports electronically on EDGAR. See Rel. Nos. 34-36479 (1995) and 34-37260, § IV.I. (1996).

73. Rel. No. 34-37260, § IV.B. (1996).

withholding,[74] (2) changes in the form of ownership,[75] (3) transactions under tax-conditioned plans,[76] (4) dividend or interest reinvestments under broad-based plans,[77] (5) post-termination transactions that are not matchable under Section 16(b) with pre-termination transactions,[78] (6) transactions pursuant to domestic relations orders,[79] (7) spin-off transactions,[80] (8) cancellations or expirations of long derivative security positions exempt from Section 16(b),[81] and (9) amendments to derivative securities to remove transferability restrictions.[82] At the same time, the Commission required the reporting of transactions involving certain stock-based cash-only rights that previously were excluded from the reporting and other provisions of Section 16 under former Rule 16a-1(c)(3).[83]

Generally, transactions exempted from Section 16(b) are reportable on year-end Form 5, although they can be voluntarily reported earlier on Form 4 if desired.[84] Exercises and conversions of derivative securities (which ordinarily are exempt from Section 16(b)) formerly were reportable on the earlier of the first Form 4 otherwise required after the transaction or Form 5, but as of August 15, 1996 became reportable on Form 4.[85] Small acquisitions that qualify for deferred reporting under Rule 16a-6 also were formerly reportable on the earlier of the next Form 4 or Form 5, but as of August 15, 1996 they became reportable on Form 5.[86] Pursuant to a staff interpretation, the exempt grant of a stock option is reportable on an accelerated basis if the exercise of the option occurs before the grant is reportable on Form 5.[87] In addition, the cancellation of a portion of a fixed-price option under a Section 423 stock purchase plan must be reported on any Form 4 that reports the exercise of the remaining portion of the option.[88]

Filing Mechanics

Insiders are required to file their reports under Section 16(a) with the Commission and to furnish a copy to the issuer's secretary or other designated person at the time they transmit their reports to the Commission.[89] Generally, such reports are not considered filed until they are received by the Commission. A report received after the due date, however, will be deemed to have been filed on a timely basis if (i) it is delivered to an express mail service or other third party courier who guarantees delivery of the filing to the Commission no later than the due date, and (ii) the insider retains a receipt or other written evidence of timely delivery of the package to the delivery service.[90]

Issuer Disclosure

In 1991, the Commission adopted Item 405 of Regulation S-K, which seeks to enhance compliance by requiring issuers to make embarrassing public disclosures of reporting violations by their insiders.[91] Item 405 requires an issuer to disclose in its annual proxy statement and Form 10-K the names of all delinquent insiders and the number of delinquent reports and transactions for each violator.[92] To prevent issuers from burying their Item 405 disclosures in obscure parts of the proxy statement or Form 10-K, the Commission adopted in 1996 a requirement that reporting delinquencies be disclosed under the caption, "Section 16(a) Beneficial Ownership Reporting Compliance."[93]

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74. These rights are considered features of the securities to which they are attached, rather than separate derivative securities, due to the adoption of an exclusion for them in Rule 16a-1(c)(3) from the definition of derivative securities. See Rel. No. 34-37260, § III.C. (1996).

75. Rule 16a-13. The SEC and the courts are in conflict as to whether transactions involving a "GRAT" (i.e., a grantor retained annuity trust) involve a change in the form of ownership. The SEC staff has said that a transfer to a GRAT by an insider-grantor constitutes a nonreportable change in the form of ownership where the insider serves as a trustee of the GRAT. See Peter J. Kight (October 16, 1997). But a district court has held that a withdrawal of stock from a GRAT by an insider-grantor who also was a trustee of the GRAT was a nonexempt purchase under Section 16(b). Morales v. Quintiles Transnational Corp., 25 F. Supp. 2d 369 (S.D.N.Y. 1998). Note, however, that the view of the district court was undermined to some extent by a later settlement of the case, in which the defendant's estate agreed not to pursue an appeal of the court's decision in exchange for a reduction in short-swing liability from $1.4 million to $650,000. Morales v. Quintiles Transnational Corp., 96 Civ. 4021 (S.D.N.Y. August 31, 1999).

76. Rule 16a-3(f)(1)(i)(B).

77. Rule 16a-11.

78. Rule 16a-2(b).

79. Rule 16a-12.

80. Rule 16a-9(a).

81. Rule 16a-4(d).

82. Rel. No. 34-37260 n.169 (1996).

83. See generally Rel. No. 34-37260, § III.A. (1996).

84. Rule 16a-3(g)(2). A voluntary report need not be filed within ten days after the close of the month in which the transaction occurs, as in the case of a required Form 4 report, but instead may be filed any time before the due date of the form in which the transaction would otherwise have to be reported. Id.

85. See Rules 16a-4(b) and (c) and Rel. No. 34-37260, §§ IV.C.&D. (1996).

86. See Rule 16a-6. The 1996 changes also broadened the small acquisitions exemption of Rule 16a-6 in certain minor respects. See Rel. No. 34-37260, § IV.C. (1996)

87. Simpson Thacher & Bartlett (April 29, 1991) (Q.1); Rel. No. 34-37260, n. 126 (1996).

88. See Vorys, Sater, Seymour & Pease (October 22, 1991) (Q.2).

89. Rule 16a-3(e).

90. Rule 16a-3(h).

91. Item 405 has been successful in increasing the rate of compliance with Section 16(a). At a meeting of the Commission on August 10, 1994, a staff member stated that the level of noncompliance, which formerly was as high as 40%, had declined to approximately 5%.

92. The issuer must disclose reporting delinquencies even if the late or non-filed reports relate solely to exempt transactions (Simpson Thacher & Bartlett, April 29, 1991, Q.2). Also, a legend is required on the cover page of the Form 10-K to indicate whether the issuer is including in the 10-K or a subsequently filed proxy statement disclosures pertaining to Section 16 reporting violations.

93. See Rel. No. 34-37260, § IV.G. (1996).

The issuer's disclosures under Item 405, or the lack thereof, may be based solely on a review of Forms 3, 4, and 5 submitted to the issuer.[94] An issuer is not be deemed to have constructive knowledge of reporting violations that it could have discovered by reviewing records in its possession (other than insiders' reporting forms) or by interviewing personnel.[95] It is inappropriate, however, for an issuer to ignore information of which it is aware regarding delinquencies not discernible from the submitted forms because Item 405 requires disclosure of any "known failure to file" a required report.[96]

The issuer may presume that a report was timely filed if the issuer receives its copy of the report from the insider within three calendar days after the date it was due at the SEC.[97] Further, the issuer may assume that an insider was not required to file a Form 5 if the insider furnishes a written representation that a Form 5 was not required, the issuer retains the written representation for at least two years, and the issuer makes the written representation available to the Commission and its staff upon request.

Expanded Remedies

The Commission did not intend to rely solely on the shame factor of Item 405 to enhance compliance with the reporting requirements. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990,[98] enacted in late 1990, authorizes the Commission to issue cease-and-desist orders in administrative proceedings and to seek monetary penalties in federal court based on violations of the 1934 Act. Because the cease-and-desist remedy is an ideal enforcement tool for violations of Section 16(a), given the relative ease with which violations can be established, it generally has supplanted the time-consuming and cumbersome injunctive action as the principal remedy for such violations. Indeed, the Commission has utilized its cease-and-desist authority in the Section 16(a) context on over four dozen occasions against violators of Section 16(a).[99] The Commission also continues to use the injunctive powers available under the 1934 Act to pursue Section 16(a) violations.[100]

Civil monetary penalties for violations of the securities laws may range up to $5,000 per violation or, in the case of reckless disregard of a regulatory requirement, up to $50,000 per violation.[101] To date, the Commission has obtained monetary sanctions in over a dozen egregious situations. Three involved concealment of insider trading violations through either a false Section 16(a) report,[102] or a failure to file required Section 16(a) reports.[103] Three involved concealment of numerous transactions effected through accounts in the name of a relative,[104] or various relatives, friends, and co-workers,[105] or a foreign trust.[106] Five involved a pattern of noncompliance with the Section 16(a) and Section 13(d) reporting requirements,[107] including one that also involved other violations.[108] Two involved repeated Section 16(a) reporting delinquencies by persons who previously were the subject of injunctions for violations of the federal securities laws.[109] And one involved a fine for violating a previous cease-and-desist order relating to reporting violations by again failing to file required reports on a timely basis.[110]

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94. See Item 405(a) of Reg. S-K. The issuer is not required by Item 405 to research or make inquiry about delinquent Section 16(a) filings. Rel. No. 34-28869, § VI.B. (1991). Thus, an issuer need not make inquiries of administrators of its employee benefit plans as to insiders' holdings and transactions under such plans. Hewitt Associates (April 30, 1991) (Q.5b). Item 405, however, states that the absence of a Form 3, as well as the absence of a Form 5 without a written representation from the insider or knowledge by the issuer that no such filing is required, are indications to the issuer that disclosure is required. See Rel. No. 34-37260, § IV.G. (1996).

95. Bryan, Cave, McPheeters & McRoberts (April 25, 1991) (Q.3).

96. Item 405(a)(2) of Reg. S-K.

97. Item 405(b)(1) of Reg. S-K.

98. Id. See also Simpson Thacher & Bartlett (June 19, 1991) (Q.4).

99. Pub. L. No. 101-429 (1990).

100. See Rel. Nos. 34-41428, 41312, 41042 (all in 1999); 34-40362, 40346, 40128, 40127 and 39710 (all in 1998); 34-39464, 39463, 39155, 39125, 38803, 38802, 38666, 38508, 38477, 38476, 38228 and 38192 (all in 1997); 34-37641, 37408, 37354, 37353, 37352, and 36678 (all in 1996); 34-35856, 35794, 35665 (all in 1995); 34-35075, 34964, 34904, 34870, 34689, 34108, 33917, 33861 (all in 1994); 34-33044, 33029, 32757, 32727, 32657, 32033 (all in 1993); 34-31263, 31250, 31198, 31186, 30715, 30666, 30633 (all in 1992); and 34-29609 (1991). The Commission will accept an insider's defense that the person relied on a third party to prepare and file the person's ownership reports only where (i) there is a clear written delegation of the reporting function to the third party, (ii) the third party acknowledges the delegation in writing, (iii) the insider timely informs the third party of each transaction conducted, and (iv) the insider monitors the third party's reporting effectiveness. See Rel. Nos. 34-40362 (1998) and 34-32033 (1993).

101. See, e.g., SEC v. Lipson, 1997 WL 452701 (N.D. Ill. 1997); SEC v. Parris Holmes, Jr., Lit. Rel. 15190 (1996).

102. There is a third tier of penalties under the Enforcement Remedies Act ranging up to $100,000 per violation by a natural person, but a predicate for its application is substantial losses or the significant risk of such losses as a result of a violation involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement.

103. Lit. Rel. 13579 (1993) [$5,000 fine].

104. Lit. Rel. 13638 (1993) [$5,000 fine]; Lit Rel. 15189 (1996) [fines of $186,877 and $79,825 against two individuals who also committed other violations].

105. Lit. Rel. 14774 (1996) [$10,000 fine].

106. Lit. Rel. 14629 (1995) [$25,000 fine].

107. Lit. Rel. 15190 (1996) [$50,000 fine].

108. Lit. Rel. 14959 (1996) [fines against four related parties of $15,000 each]; Lit. Rel. 15462 (1998) [$25,000 fine]; Lit. Rel. 15658 (1998) [fines against three parties, one of $20,000, and two of $10,000 each]; Lit. Rel. 16157 (1999) [$10,000 fine].

109. Lit. Rel. 16114 (1999) [fine of $58,000 against individual who was delinquent in filing 53 reports and also was involved in violations of the periodic reporting and proxy provision of the Act by companies with which he was affiliated].

110. Lit. Rel. 13714 (1993) [$15,000 fine]; Lit. Rel. 13827 (1993) [$75,000 fine].

It is apparent from the foregoing not only that the Commission can readily identify delinquencies due to Item 405 and the delinquency box on Form 5, but also that it is willing to use its enforcement powers to redress significant violations of the reporting requirements. All of this suggests that insiders should take their reporting obligations seriously, and that issuers should develop strong compliance programs to assist their insiders in complying with the reporting requirements.[111]

Compliance Methods

Although the responsibility for complying with the reporting requirements of Section 16(a) rests solely with a company's insiders, the complexity of the reporting system is so great that it is unreasonable, in the authors' view, to expect such persons to prepare and file their reports without some missteps along the way. Accordingly, it is advisable for every issuer to implement an in-depth program for assisting its officers and directors in the preparation and filing of their reports.

A top-grade assistance program might involve, among other things

- The appointment of a company employee to oversee the reporting process for officers and directors;
- A requirement that such persons preclear all proposed transactions involving company equity securities with a designated person;
- The mailing of monthly reminders regarding the need to report transactions on a timely basis, along with a transaction diary for the preceding month that is to be returned to the issuer;
- The preparation and filing of reports by the company for such persons, pursuant to a broad power of attorney;
- The review of all such reports by the insiders;
- A year-end review to determine whether there were obvious reporting violations (such as the failure to file a Form 3) disclosable under Item 405;
- The obtaining of a "no filings due" statement after the close of the fiscal year from any person who was an officer or director during the year and did not file a Form 5 for the year; and
- The obtaining of EDGAR access codes for all officers and directors to permit the company to file Section 16(a) reports electronically when no other method is available for assuring a report will be timely filed.

DERIVATIVE SECURITIES

In 1991, the SEC reversed its long-standing approach to transactions involving stock options and other derivative securities.[112] Formerly, the exercise or conversion of such securities was the key transaction, with the grant or acquisition often being viewed as a nonevent. Under the revised regulatory scheme adopted in 1991, however, the acquisition of the derivative security is a purchase or sale (depending on the nature of the derivative security),[113] while the exercise or conversion generally is exempt.[114] In the 1996 changes to the Section 16 rules, the SEC did not disturb the general approach adopted in 1991, which has been widely acclaimed. It did, however, make changes to the definition of derivative securities by deleting an exclusion provided for cash-only rights, and adding exclusions for surrender and withholding rights and overallotment options.[115]

Securities Covered

The term "derivative securities" is broadly defined by the Commission in Rule 16a-1(c) to mean "any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived

111. Lit. Rel. 15854 (1998) [$60,000 fine].

112. For a discussion of the components of a compliance program, see Romeo and Dye, Section 16 Treatise and Reporting Guide, § 7.02 (1994).

113. See generally Rel. No. 34-28869, § III. (1991), and P. Romeo and A. Dye, Section 16 Treatise and Reporting Guide, § 9.04[2] (1994). As indicated in Frankel v. Slotkin, 984 F.2d 1328 (2d Cir. 1993), the 1991 changes cannot be applied retroactively to transactions that occurred before the changes became effective on May 1, 1991.

114. See Rule 16b-6(a). An acquisition of a derivative security can be deemed to occur if the terms of an existing derivative security are materially changed. See, e.g., Lerner v. Millenco, L.P., 23 F. Supp. 2d 337 (S.D.N.Y. 1998) (agreement to lower maximum price for converting debentures to common stock deemed a purchase under Section 16(b)). Where a derivative security is acquired from, or disposed to the issuer (as in the case of transactions involving employee stock options), the acquisition or disposition would be eligible for the exemption provided by Rule 16b-3. That rule is discussed in § VII of the outline.

115. See Rule 16b-6(b). In addition, a precise method of calculating the maximum profits recoverable on transactions involve derivative securities is set forth in Rule 16b-6(c), and certain cancellations or expirations of options are subject to potential short-swing liability under Rule 16b-6(d). Note also that Rule 16b-6(a) is available to exempt a sale or purchase of shares of stock underlying a derivative security where the exercise of the derivative security is outside the control of the insider and the exercise price is not known until the date of exercise. Magma Power Co. v. Dow Chemical Co., 136 F. 3d 316 (2d Cir. 1998).

from the value of an equity security." This definition is far-reaching, since the reference to any "similar right" bearing a price "related to" an equity security of the issuer can encompass a multitude of instruments not specifically enumerated in the definition.[116]

A number of interests issued in connection with employee and director benefit plans have been deemed by the courts or the SEC staff to be derivative securities. These include:

- Phantom stock, the value of which is based on the value of a specified number of hypothetical shares of the issuer's stock;[117]
- A right to purchase stock under a Section 423 stock purchase plan at a price fixed at the beginning of the offering period;[118]
- A right to obtain equity securities of the issuer in the future upon the deferral of director fees;[119]
- A bonus unit having a value not less than 95 percent of the market value of the issuer's stock on the award date;[120]
- "Cheap stock" representing a right to buy issuer securities at a specified deep discount price;[121]
- A dividend equivalent right entitling the holder of the related option to acquire additional shares with dividends deemed to have accrued on the underlying stock during the term of the option;[122]
- A note providing the holder with a right to exchange the note for either a fixed number of shares of stock or its cash equivalent on the date of exercise, as determined by the issuer of the notes;[123]
- A debenture convertible into common stock at the lower of a fixed price per share or a fixed percentage of the average closing price of the stock during a prescribed period.[124]

Note, however, that performance rights (a term broad enough to encompass performance shares and performance units) can be derivative securities only if their value is based solely on the market price of the underlying equity security.[125]

Excluded Securities

There are several important exclusions from the definition of derivative securities that serve to lighten its impact.[126] Three of these are particularly relevant to employee and director benefit plans.

The first important exclusion was inserted in Rule 16a-1(c)(3) as part of the 1996 changes and applies to cashless exercise, tax withholding and similar rights involving the surrender or withholding of stock or other securities.[127] This exclusion eliminates the need to report the acquisition or disposition of these rights, although transactions involving the surrender or withholding of securities upon the exercise of such rights remain reportable.[128] The second important exclusion is contained in Rule 16a-1(c)(5) and excludes from the definition of derivative securities "interests or rights to participate in employee benefit plans of the issuer." For purposes of this exclusion, the staff deems direct and indirect majority-owned subsidiaries of the issuer to be included within the term "issuer," so that rights to participate in the employee benefit plans of subsidiaries are covered by the exclusion.[129] The third exclusion relevant to executive compensation arrangements is set forth in Rule 16a-1(c)(6) and

116. The Commission also decided not to adopt a proposal to add an exclusion from the definition of derivative securities for derivative instruments which are subject to a material non-market price based condition to exercise or settlement. Although the Commission endorsed the concept of such an exclusion, it felt it would be best to continue applying the concept through the issuance of interpretations by its staff. In taking this position, the Commission affirmed the staff's previous position outlined in Certilman Balin Adler & Hyman (April 20, 1992) that a non-market price based condition will be considered material "only if it possesses substance independent of the passage of time or continued employment." See Rel. No. 34-37260, § III.D. (1996).

117. Note, however, that where either the quantity or price of the securities covered by a derivative instrument are uncertain, the instrument will not be a derivative security until both of these elements are established. Gwozdzinsky v. Zell/Chilmark Fund, L.P., 979 F. Supp. 263 (S.D.N.Y. 1998), aff'd on other grounds, 156 F.3d 305 (2d Cir. 1998).

118. Thacher Proffitt & Wood (December 20, 1991); Emerson Electric Co. (May 9, 1991).

119. Vorys, Sater, Seymour and Pease (October 22, 1991) (Q.2); CSX Corp. (August 30, 1991) (Q.2). If the price is not fixed at the beginning of the offering period, or may be adjusted downward at the end of the offering period, the right is not a derivative security. See Rel. No. 34-28869 n.147 (1991).

120. Emerson Electric Co. (May 9, 1991).

121. AMP, Inc. (June 12, 1992) (Q.1).

122. Rel. No. 34-18114 (Q.88e) (1981), as modified by Rel. No. 34-28869, § VIII.C. (1991).

123. O'Connor, Cavanagh, Anderson, Westover, Killingsworth & Beshears (December 11, 1991); Davis Polk & Wardwell (August 23, 1991).

124. Magma Power Co. v. Dow Chemical Co., 136 F.3d 316 (2d Cir. 1998).

125. Lerner v. Millenco, L.P., 23 F. Supp. 2d 337 (S.D.N.Y. 1998).

126. See, e.g., Equifax, Inc. (January 5, 1993) (Q.1).

127. See Rules 16a-1(c)(1)-(7).

128. Rel. No. 34-37260, § III.C. (1996).

129. In adopting the exclusion, the Commission effectively rescinded staff interpretations stating that the amount of securities withheld or surrendered for tax withholding purposes had to be limited to the insider's maximum marginal tax rate. Instead, all that is necessary is that the amount withheld be applied to the tax obligation generated by the underlying transaction. Rel. No. 34-37260, § III.C. at n.100 (1996).

applies to rights without a fixed exercise or conversion price. This exclusion, however, ceases to apply when the exercise or conversion price becomes fixed, with the result that the rights become derivative securities at that time.[130]

Among the instruments deemed by the SEC staff or the courts not to constitute derivative securities because of the availability of an exclusion or otherwise are the following:

- A right to purchase stock under a Section 423 stock purchase plan at a price that will not become fixed until the end of the measurement period;[131]
- A right to receive director fees in company stock based on the value of the stock at the end of the compensation year;[132]
- A right arising under the issuer's policy of generally repurchasing shares of its stock from optionees immediately following an option exercise;[133]
- A full recourse loan from the issuer to pay the purchase price of stock that can be acquired under a plan;[134]
- A right to defer the receipt of cash or securities under a plan;[135]
- A right to sell "book value shares" back to the issuer, where the value of the shares is based on the book value (rather than the market value) of the issuer's stock on a prescribed date;[136]
- An award of restricted stock;[137]
- A right to receive stock to satisfy amounts due under a cash incentive plan;[138]
- A right to a performance-based advisory fee deemed to be in the nature of an employment contract rather than a security;[139]
- Unattached rights to receive cash payments equal to dividends paid on company stock;[140]
- A standby purchase agreement to purchase a quantity of shares that will not be known until the completion of a rights offering.[141]

In the course of making the 1996 changes, the Commission deleted the controversial exclusion formerly provided in Rule 16a-1(c)(3) for derivative rights that are payable only in cash and satisfy certain conditions.[142] The elimination of the exclusion, however, was softened by the grandfathering of cash instruments issued prior to the August 15, 1996 effective date of the 1996 changes,[143] and by the Commission's comment that an exemption from Section 16(b) should be available under new Rule 16b-3 for most transactions involving such instruments.[144]

130. Chadbourne & Parke (January 10, 1992).

131. Where a derivative instrument contains both a fixed price option and a floating price option, the instrument should be analyzed as two separate derivative securities rather than as a single floating price derivative security. Magma Power Co. v. Dow Chemical Co., 136 F.3d 316 (2d Cir. 1998). Further, where an option or right is, by its terms, exercised at the same time that the exercise price becomes fixed, it is not necessary to report the acquisition and exercise of a derivative security. Instead, the insider need report only the acquisition of the underlying security. Lincoln National Corp. (March 30, 1992) (Q.3); American Stores Co. (May 5, 1992). Because a purchase is deemed to occur upon the exercise of a floating price derivative instrument, the exercise is not eligible for the exemption provided by Rule 16b-6(b) for exercises and conversions of derivative securities. Medtox Scientific, Inc. v. Morgan Capital L.L.C., 50 F. Supp. 2d 896 (D. Minn. 1999).

132. Rel. No. 34-28869 n.147 (1991); Rel. No. 34-18114 (Q.88c) (1981), as modified by Rel. No. 34-28869, § VIII.C. (1991).

133. Ecolab, Inc. (January 9, 1992).

134. Safeco Corp. (August 23, 1991).

135. American Stores Co. (May 5, 1992). See also CSX Corp. (August 30, 1991) (Q.4).

136. Rel. No. 34-18114 (Q.89) (1981), as modified by Rel. No. 34-28869, § VIII.C. (1991).

137. Merrill Lynch & Co. (September 1, 1992) (Q.5).

138. Rel. No. 34-18114 (Q.88d) (1981), as modified by Rel. No. 34-28869, § VIII.C. (1991); Becton Dickinson and Co. (November 6, 1991) (Q.2); Lincoln National Corp. (March 20, 1992) (Q.3).

139. CIGNA Corp. (March 20, 1992).

140. Morales v. New Valley Corp., 968 F. Supp. 139 (S.D.N.Y. 1997).

141. Id. Where the rights in question are attached to a specific option or company stock, they would be deemed derivative securities. O'Connor, Cavanagh, Anderson, Westover, Killingsworth & Beshears (December 11, 1991).

142. Gwozdzinsky v. Zell/Chilmark Fund, L.P., 979 F. Supp. 263 (S.D.N.Y. 1997), aff'd on other grounds, 156 F.3d 305 (2d Cir. 1998).

143. The Commission at one time had proposed to broaden the exclusion by eliminating all conditions to its availability. See Rel. Nos. 34-34514, § II.C. (1994) and 34-34681 (1994). Ultimately, however, it decided that an exclusion for such instruments was inappropriate. Rel. No. 34-37260, § III.A. (1996).

144. Rel. No. 34-37260, § VII.A. (1996). As a result, settlements and other transactions on or after the effective date involving cash rights issued prior to May 1, 1991 continue to be excluded entirely from the reach of Section 16, as are transactions involving rights issued between May 1, 1991 and August 14, 1996 in reliance on the former Rule 16a-1(c)(3) exclusion.

145. Rel. No. 34-37260, § III.A. at n. 92 (1996).