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Ownership Reports and Trading By Officers, Directors and Principal Security Holders

AGENCY: Securities and Exchange Commission.

ACTION: Final rules and solicitation of comments.

SUMMARY: The Commission today is adopting amendments to its rules and forms, as well as related disclosure requirements for issuers, regarding the filing of ownership reports by officers, directors, and principal security holders, and the exemption of certain transactions by those persons from the short-swing profit recovery provisions of section 16 of the Securities Exchange Act of 1934 and related provisions of the Investment Company Act of 1940 and the Public Utility Holding Company Act of 1935. The amendments are intended to achieve greater clarity, enhance consistency with the statutory purpose, and improve compliance with the reporting provisions of the rules. The Commission also is soliciting further public comments on the addition of an exit box to Forms 4 and 5.

EFFECTIVE DATE: These amendments are effective May 1, 1991; however, special phase-in provisions are contained in Section VII of this release.

Comment date: Comment letters on the exit box on Forms 4 and 5 should be received on or before March 31, 1991.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth St., NW., Washington, DC 20549. Comments should refer to File No. S7-3-91. All comments received will be available for public inspection and copying in the Commission's Public Reference Room at the same address.

FOR FURTHER INFORMATION CONTACT: Brian J. Lane, Richard P. Konrath, Mark W. Green, or Emanuel D. Strauss, (202) 272-2573, Division of Corporation Finance; Dorothy Donohue (202) 272-2030, Division of Investment Management; or Joanne Rutkowski (202) 504-2267 with respect to the Public Utility Holding Company Act.

SUPPLEMENTARY INFORMATION: The Commission today announced the adoption of revisions to its rules promulgated under section 16¹ of the Securities Exchange Act of 1934 ("Exchange Act").² Every rule under section 16 has been amended, deleted, or reorganized except for Rule 16e-1,³ and several new Section 16 rules have been added. Further, Exchange Act Rule 12h-2⁴ has been deleted as obsolete and Rule 30f-1⁵ under the Investment Company Act of 1940 ("Investment Company Act")⁶ has been amended.

In addition, new Item 405 of Regulation S-K⁷ and new Form 5 have been adopted, as have changes to Schedule 14A⁸ and Forms 10-K,⁹ 3,¹⁰ 4¹¹ and N-SAR.¹²

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¹ 15 U.S.C. 78p (1988).

² 15 U.S.C. 78a *et seq.* (1988).

³ 17 CFR 240.16e-1.

⁴ 17 CFR 240.12h-2.

⁵ 17 CFR 270.30f-1.

⁶ 15 U.S.C. 80a-1 *et seq.* (1988).

⁷ 17 CFR 229.10-229.802.

⁸ 17 CFR 240.14a-101.

⁹ 17 CFR 249.310.

¹⁰ 17 CFR 249.103.

¹¹ 17 CFR 249.104.

¹² 17 CFR 274.101.

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I. Executive Summary

The beneficial ownership reporting and short-swing profit recovery provisions of section 16 of the Exchange Act apply to every person who is directly or indirectly the beneficial owner of more than ten percent of any class of equity securities that is registered pursuant to section 12 of the Exchange Act ("ten percent holders").¹³

¹³ 15 U.S.C. 78l (1988). When referring to an issuer with securities registered under section 12, this release includes securities of closed-end investment companies subject to section 30(f) of the Investment Company Act (15 U.S.C. 80a-29(f) (1988)) and public utility holding companies subject to Section 17 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79q (1988)). The insiders of a closed-end investment company also include the adviser and any affiliated person of the adviser. Section 2(a)(3) of the Investment Company Act (15 U.S.C. 80a-2(a)(3) (1988)).

and to every director and officer of an issuer with a class of equity securities so registered.¹⁴ Section 16 of the Exchange Act was designed to provide the public with information on securities transactions and holdings of corporate insiders and to deter insiders from speculative short-swing trading in their corporations' securities and from engaging in transactions in their corporations' securities while in possession of material, non-public information. Section 16 is but one weapon against insider trading. Unlike other provisions applicable to insider trading, such as sections 10(b),¹⁵ 14(e)¹⁶ and 21A¹⁷ of the Exchange Act, section 16 is a strict liability provision under which an insider's short-swing profits can be recovered regardless of whether the insider actually was in possession of material, non-public information.

In response to developments in the trading of derivative securities, the growth of complex and diverse employee benefit plans, and substantial filing delinquencies, the Commission undertook a comprehensive review of the rules and forms under section 16. Noting that the regulatory framework had resulted in interpretive uncertainty, substantial litigation, and, in some instances, unnecessary regulatory burdens, the Commission proposed to revise the rules to achieve greater clarity, rescind unnecessary requirements, streamline mandated procedures, increase compliance with the reporting provisions of the rules, and enhance consistency with the statutory purposes of section 16.

The Commission initially proposed comprehensive revisions to the rules promulgated pursuant to section 16 in December 1988; 271 comment letters were received.¹⁸ In response to comments, the Commission revised the proposed amendments and republished the rules for comment in August 1989; 211 comment letters were submitted in response to the reproposal.¹⁹ For the

reasons provided in the Proposing and Reproposing Releases, and as further explained in this release, the Commission today is adopting the proposed regulatory scheme, with a number of modifications in response to comments made on the reproposal.

Rule 16b-3, the employee benefit plan rule, has been modified in several respects from that repropoed. The shareholder approval condition to the exemption, applicable to issuer grant plans and other plans unable to satisfy the conditions of former Rule 16a-8,²⁰ has been retained. The repropoed extension of the required period of disinterested status for plan administrators to one year following the administration of a plan has not been adopted. In response to comments, Rule 16b-3 has been reorganized to clarify the application of the regulatory framework to transactions under broad-based, non-discriminatory plans and the availability of the intra-plan transaction exemption for elections and transactions within a participant-directed plan. The revisions are intended to facilitate compliance with Rule 16b-3 by section 401(k) plans²¹ and other similar broad-based participant-directed plans.

In addition to the revisions addressing employee benefit plans, revisions have been made to modify the repropoed conditions under which a trust becomes subject to section 16 where it has an insider trustee; specify the extent of insiders' obligations to disclose on the first Form 5 unreported transactions and holdings that should have been reported prior to the effective date of the rules; delete the former exemption for surrenders of options in a merger as unnecessary; provide a reporting as well as a short-swing profit exemption for non-events such as pro rata stock splits, stock dividends, and similar grants; add an exit box to Forms 4 and 5; add a provision deeming a Form 3, 4 or 5 timely filed if delivered to a third party business that guarantees delivery to the Commission no later than the due date; and clarify the application of the rules to specific situations.²² Comment is

letters and a staff summary of the letters may be inspected and copied at the Commission's Public Reference Room (File No. S7-23-89).

¹⁴ 17 CFR 240.16a-8.

¹⁵ I.R.C. 401(k) (26 U.S.C. 401(k) (1988)).

¹⁶ Section VIII, *infra*, contains charts summarizing the changes from the former rules, as well as a chart summarizing changes in staff interpretations enumerated in the section 16 question-and-answer interpretive release, Exchange Act Release No. 18114 (September 24, 1981) (48 FR 48147) ("Release No. 34-18114").

solicited on the exit box, as discussed in section II.C.2 below.

II. Section 16(a) Reporting

A. Who Must Report

1. Officers and Directors

The definition of "officer" has been adopted without substantive change from the reproposal. It is modeled after the definition of "executive officer" used elsewhere in the Exchange Act rules,²³ but also specifically includes principal financial officers and principal accounting officers (or controllers where there is no principal accounting officer), as well as officers of a parent having policy-making functions with respect to the issuer.²⁴ Thus, persons having policy-making duties, as specified under Rule 3b-7, will be deemed officers for purposes of section 16.²⁵ A person's title alone should not determine whether that person is subject to section 16; the proper focus should be on whether a person is "a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions."²⁶ If title were determinative, persons with executive functions could avoid responsibility by forgoing title; moreover, persons with officer titles but no significant managerial or policy-making duties would be subject to the draconian

²³ Rule 3b-7 (17 CFR 240.3b-7). The term includes presidents, vice-presidents in charge of a principal business unit, division or function, other persons who perform similar policy-making functions, and executive officers of subsidiaries who perform policy-making functions for the registrant. A technical change is being made to this rule to correct a typographical error.

²⁴ Rule 16a-1(f). A note has been added to the rule that makes it clear that those persons identified by an issuer as meeting the policy-making definition pursuant to Item 401(b) of Regulation S-K (17 CFR 229.401) (based on the Rule 3b-7 definition) will be presumed to be those persons who, together with the other persons specified in Rule 16a-1(f), are subject to section 16, and the note makes it clear that the term "policy-making function" does not include functions that are not significant. The rule as adopted also clarifies that when an issuer with equity securities registered under section 12 is structured as a trust, employees of the trustee performing policy-making functions with respect to the trust are deemed officers of the trust.

²⁵ See *C.R.A. Realty Corp. v. Crotty*, 878 F.2d 562 (2d Cir. 1989); *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949); see also *Merrill Lynch, Pierce Fenner & Smith, Inc. v. Livingston*, 586 F.2d 1119 (9th Cir. 1978); *Pier 1 Imports of Georgia, Inc. v. Wilson*, 529 F. Supp. 239 (N.D. Tex. 1981); see also *National Medical Enterprises, Inc. v. Samal*, 680 F.2d 63 (9th Cir. 1982).

²⁶ *Colby v. Klune*, *supra* 178 F.2d at 873, as quoted in *C.R.A. Realty Corp. v. Crotty*, *supra*, 878 F.2d at 566.

¹⁴ Officers, directors, and ten percent holders are referred to throughout this release as "insiders." The term also includes an officer or director who has terminated officer or director status but continues to be subject to reporting under section 16 for six months following his or her last transaction as an officer or director, including the Form 5 filing requirement.

¹⁵ 15 U.S.C. 78j(b) (1988).

¹⁶ 15 U.S.C. 78n(e) (1988).

¹⁷ 15 U.S.C. 78u(a)(1) (1988).

¹⁸ Release No. 34-26333 (December 2, 1988) (53 FR 49997) ("Proposing Release"). The comment letters and a staff summary of the letters may be inspected and copied at the Commission's Public Reference Room (File No. S7-23-88).

¹⁹ Release No. 34-27149 (August 18, 1989) (54 FR 35667) ("Reproposing Release"). The comment

liability of section 16(b). Similarly, in determining whether an advisory, emeritus or honorary director is a director for section 16 purposes, the person's title is not determinative and no change in current staff interpretation is being made.²⁷

2. Transactions While not an Officer or Director

Rule 16a-2(a) is adopted substantially as repropoed. Thus, a person will not be required to disclose transactions or be subject to section 16(b) short-swing profit liability for transactions that occurred within six months prior to the date the individual first became an officer or director, except that an officer or director who becomes subject to section 16 as a result of the issuer's registration of a class of equity securities pursuant to section 12 of the Exchange Act will be subject to section 16 with respect to transactions conducted during the six months prior to the first transaction requiring a Form 4 filing.²⁸

In contrast, consistent with the prior rules,²⁹ transactions by officers and directors after termination of employment with an issuer are not necessarily exempt from section 16. In response to commenters' concerns, the rule makes it clear that, as is currently the case, an insider continues to be subject to section 16 for up to six months following termination. However, a transaction occurring after a person has terminated insider status must be reported only if it occurs within six months of a transaction that took place while the person was an officer or director.³⁰ As a result, a person is

required to file on Form 4 to report non-exempt transactions within six months of the last transaction while the person was an officer or director subject to Section 16. In addition, the person is required to file on Form 5 to report transactions on a deferred basis for that portion of the issuer's fiscal year during which the person was an officer or director subject to section 16, and also is required to report exempt transactions occurring within six months of the last transaction while the person was an officer or director subject to section 16.

For example, if an insider executes a transaction on April 28 and terminates officer or director status on April 30, any transaction executed on or before October 28 must be reported, since it occurred within six months following the last transaction prior to termination of officer or director status. If, in this example, the insider filed a Form 5 in June to report exempt acquisitions and dispositions in an employee benefit plan, and in September exercised an option previously granted and reported on a Form 5, the insider must file another Form 5 (or an optional Form 4) to report the exercise, since it occurred within six months following the last transaction prior to termination of officer or director status. In addition, the insider should indicate on the Form 4 or 5 reporting the exercise that insider status has terminated.³¹ Where all prior transactions, including transactions otherwise reportable on Form 5, have been reported, and the insider has not had any transactions, including transactions exempt from Section 16(b), in the six months prior to termination, there is no Form 5 filing obligation or other post-termination reporting obligation. In this case, the insider may wish to furnish the issuer with a written representation that no further report on Form 5 is required.

3. Ten Percent Holder

Section 16, as applied to ten percent holders, is intended to reach those persons who can be presumed to have access to inside information because they can influence or control the issuer as a result of their equity ownership. Section 13(d) of the Exchange Act³²

that short-swing transactions can occur only if there is both a sale and purchase within six months while the person beneficially owned more than ten percent of the issuer. *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232 (1978); see also Rule 16a-2(c).

³¹ Both Form 4 and Form 5 have an exit box on the face of the Form that should be checked. See I.L.C.2, *infra*. If the exit box is checked to reflect termination of insider status and a subsequent transaction necessitates another filing, the exit box should also be checked on the subsequent filing.

³² 15 U.S.C. 78m(d) (1988).

specifically addresses such relationships. As proposed, the rules adopted today³³ define ten percent holders under section 16 as persons deemed ten percent holders under section 13(d) of the Exchange Act and the rules thereunder. The section 13(d) analysis, such as the exclusion of non-voting securities³⁴ and counting only those derivative securities exercisable or convertible within 60 days,³⁵ are imported into the ten percent holder determination for section 16 purposes.³⁶ The section 13(d) definition of beneficial ownership is used only to determine status as a ten percent holder; once status is determined, the reporting and short-swing profit provisions of section 16 apply only to those securities in which the insider has a pecuniary interest.³⁷

Under the rule, adopted as repropoed, shares held by institutions eligible to file beneficial ownership reports on Schedule 13G³⁸ that are held for clients in a fiduciary capacity in the ordinary course of business are not counted for purposes of determining ten percent holder status ("13G exemption").³⁹ This is a limited

³³ Rule 16a-1(a)(1). For a discussion of the application of Section 16 to section 13(d) groups, see Section II.B.3, *infra*.

³⁴ Rule 13d-1(d) (17 CFR 240.13d-1(d)).

³⁵ Rule 13d-3(d)(1) (17 CFR 240.13d-3(d)(1)).

³⁶ With respect to derivative securities, Rule 16a-4(a) states that derivative securities are deemed to be the same class of equity securities as the underlying securities. This essentially codifies the holding in *Chemical Fund v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967). Accordingly, a holder of section 12 debt convertible into Section 12 common stock would not consider the debt itself in the ten percent owner calculation, but rather would consider only the common stock into which the debt was convertible within 60 days.

In contrast to convertible debt, a security that is an equity security in its own right, as well as on account of a conversion feature, would require a double calculation. For example, if a class of voting preferred stock registered under section 12 is convertible into section 12 common stock, the beneficial owner of the preferred stock is deemed the owner of both the preferred stock and the underlying common stock. Accordingly, the ten percent holder calculation must be performed with respect to the preferred stock and the common stock separately. If the convertible preferred stock is non-voting, the preferred stock is not considered a separate class of equity for purposes of the ten percent holder calculation, because Rule 13d-3(d)(1) excludes non-voting securities; therefore, the beneficial owner of the non-voting preferred stock, like a holder of convertible debt, performs the ten percent holder calculation only with respect to the underlying common stock.

³⁷ Rule 16a-1(a)(2).

³⁸ 17 CFR 240.13d-102. In order to qualify to use Schedule 13G, the institution must acquire or hold securities of the issuer in the ordinary course of business without the purpose or effect of influencing or changing control. Rule 13d-1(b)(1)(i) (17 CFR 240.13d-1(b)(1)(i)).

³⁹ Rule 16a-1(a)(1). The rule is modeled after Rule 13d-1(b)(1)(ii) (17 CFR 240.13d-1(b)(1)(ii)).

Continued

