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Business Law Section
Committee on Securities Regulation

August 9, 2004

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

E-mail address: rule-comments@sec.gov

Attention: Jonathan G. Katz, Secretary

Re: File No. S7-27-04
Proposed Rules: Ownership Reports and Trading by Officers, Directors and Principal Security Holders
Release No. 34-49895

Ladies and Gentlemen:

The Committee on Securities Regulation (the "Committee") of the Business Law Section of the New York State Bar Association appreciates the Commission's invitation in Release No. 34-49895 (the "Release") to comment on proposed amendments to Rules 16b-3 and 16b-7 under the Securities Exchange Act of 1934.

The Committee is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was reviewed by certain members of the Committee, and the views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on this letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association or its Business Law Section.

Summary

Rules 16b-3 and 16b-7 exempt certain transactions from Section 16(b) of the Securities Exchange Act of 1934. In its 2002 opinion in *Levy v. Sterling Holding Company, LLC*.[1] ("*Levy v. Sterling*"), the U.S. Court of Appeals for the Third Circuit (the "Third Circuit") cast doubt as to the nature and scope of transactions exempted from Section 16(b) short-swing profit recovery by Rules 16b-3 and 16b-7. The Commission has proposed amendments to Rules 16b-3 and 16b-7 in order to clarify the exemptive scope of those Rules, consistent with statements in previous Commission releases.

We urge the Commission to adopt promptly the proposed amendments to Rules 16b-3 and 16b-7. Adoption of the amendments is necessary because of the confusion created by the *Levy v. Sterling* opinion, and would accord with the purposes of Section 16(b) and the clear intent of the Commission in adopting such Rules. We also have suggested some minor additional changes that we believe would further clarify the intended meaning of the Rules.

Rule 16b-3

Rule 16b-3 relates to transactions between an issuer and its officers and directors. Rule 16b-3(d) exempts from Section 16(b) "any transaction involving a grant, award or other acquisition from the issuer", subject to certain conditions. In *Levy v. Sterling*, the Third Circuit construed the Rule to require that transactions involving "other acquisitions" must be compensation related in order to be exempted by Rule 16b-3(d). As the Commission noted in the Release, this construction of Rule 16b-3(d) is inconsistent with the clearly expressed intent of the Commission in adopting the Rule, staff interpretations of the Rule consistent with the adopting release, and the 2002 decision of the Second Circuit Court of Appeals in *Gryl v. Shire Pharmaceuticals Group PLC.*[2]

The effects of the *Levy v. Sterling* opinion have been unsettling and profound. An overwhelming percentage of United States public companies are incorporated under the laws of the State of Delaware. The opinion of the Third Circuit, which includes Delaware, potentially subjects Delaware corporations to the reach of that opinion. The implications of the opinion are neither subtle nor academic, removing from the exemptive scope of Rule 16b-3 entire categories of transactions that, prior to the opinion, were uniformly construed, both by the staff of the Commission and by securities law practitioners, as being squarely within the ambit of the Rule. The Release notes that the staff has provided interpretive letters in two situations involving the acquisition of acquiror equity securities by acquiror officers and directors through the conversion of target equity securities in connection with a corporate merger, and also in the context of an officer's or director's indirect pecuniary interest in transactions between the issuer and certain other persons or entities. In addition to those

[1] 314 F.3d 106 (3d. Cir. 2002), cert. denied, Sterling Holding Co. v. Levy, 124 S. Ct. 389 (U.S., Oct. 14, 2003).

[2] 298 F.3d 136 (2d Cir. 2002).

transactions, the Rule has been applied to a wide range of acquisitions of issuer equity securities from the issuer by officers and directors in non-compensatory transactions. By removing non-compensatory acquisitions otherwise meeting the requirements of Rule 16b-3(d) from the scope of the Rule, *Levy v. Sterling* has subjected officers and directors to the risk of significant personal liability, as well as reputational harm, with respect to transactions involving the sale of such equity securities occurring within six months of the transaction with the issuer. As the Release notes, a similar change should be made to Rule 16b-3(e) to clarify that dispositions to the issuer should be treated in the same manner as the Commission intends for acquisitions under Rule 16b-3(d).

Furthermore, we believe the proposals are consistent with the purposes of Section 16(b). Congress enacted Section 16(b) to deter insiders from using confidential corporate information for personal trading gain. Testimony at Congressional hearings indicated that unscrupulous insiders had misused such information on a regular basis in market transactions in which they had taken advantage of traders not having access to the same information. Rule 16b-3 is entirely consistent with the intent of Congress in enacting Section 16(b), since it exempts only transactions involving parties on an equal footing from the standpoint of knowledge of inside information. Market transactions are not exempted by the Rule, and gate-keeping conditions exist to prevent overreaching. Given these circumstances, it is irrelevant to the purposes of Section 16(b) whether the transactions covered by the Rule are compensation-related or not. What is critical is that the Rule does not present the opportunities for the misuse of inside information, which the statute is intended to prevent. Accordingly, it is entirely appropriate for the Commission not only to adopt the proposals as drafted, but also to extend them to Rule 16b-3(e) as well.

In view of the foregoing, we strongly recommend that the Commission adopt the proposed amendment. We would urge that the adoption occur as promptly as possible, because of the cloud of doubt that now hangs over Rule 16b-3. In addition, we would suggest that the Commission consider the following modifications:

1. The exception should be set forth in the text of Rule 16b-3(d). This can be accomplished either by amending the initial part of the first sentence of the Rule to provide "Any transaction involving a grant, award or other acquisition (whether or not such acquisition is intended for a compensatory or other purpose) from the issuer …", or by adding a subclause (f) to Rule 16b-3 to set forth the language included in the proposed Note (4). Although we are of the view that the Notes to the Rule should be considered by a court reviewing the Rule as integral to the Rule itself, the inclusion of the clarifying language in the Rule itself will eliminate possible claims that the notes are not to be accorded the same consideration as the text of the Rule.

2. We believe that a note to the Rule should be added that states that reference in Rule 16b-3(d) to the clause "whether or not such acquisition is intended for a compensatory or other purpose" is intended to clarify the meaning of the Rule as in effect prior to the time that such clause was added.

Rule 16b-7

As the Commission notes in the release, Rule 16b-7, entitled "Mergers, reclassifications and consolidations" exempts from Section 16(b) certain transactions involving affiliated entities having at least 85% cross-ownership that do not involve a significant change in the issuer's business or assets. The Rule is typically relied upon where a company reincorporates in a different state or reorganizes its corporate structure. In *Levy v. Sterling*, the Third Circuit held that a reclassification was not exempt under Rule 16b-7 if it resulted in the insiders owning equity securities (common stock) with different risk characteristics from the securities (preferred stock) extinguished in the transaction, where the preferred stock had not been convertible into common stock; and thus involved an increase in the percentage of the insiders' common ownership.

As the Release notes, the conditions applied by the Third Circuit do not appear in the language of Rule 16b-7 and would significantly restrict the exemption's availability for reclassifications by narrowing it to the situation where the original security and the security for which it is exchanged have the same characteristics. This is inconsistent with staff interpretations of the Rule that applied the Rule to reclassifications, and imposed no requirement that securities have the same characteristics or that the proportionate ownership of common stock not be changed.

If it were to remain in effect, the *Levy v. Sterling* opinion would have disastrous effects on shareholders acquiring or disposing of securities in reclassification and similar transactions, subjecting such persons to significant potential liabilities. The exceptions to Section 16(b) set forth in the Commission's Rules reflect the Commission's understanding that certain transactions involving the purchase or sale of securities carry no potential for speculative abuse. In its interpretations of Section 16(b) and the rules thereunder, the staff of the Commission has been consistently cognizant of the need to distinguish between transactions having no potential for speculative abuse, and those transactions within the intended scope of Section 16(b). The amendments to be effected by the Release would confirm that prior staff positions under Rule 16b-7 were appropriate, in accord with the Rule, and in accord with the purposes of Section 16(b).

The Release proposes to add the term "reclassification" to the text of Rule 16b-7, and adds as well a new paragraph (c) that provides that the exemption is not conditioned on the transaction satisfying any other conditions. We strongly suggest prompt adoption of the proposal, subject to two suggested revisions to the Rule. As the Commission has noted, the inclusion of reclassifications within the scope of the Rule has been a matter of staff interpretation. As such, the staff was able to determine the specific nature of transactions within the scope of the term "reclassification", whether or not the transaction was formally styled as a reclassification, recapitalization, share exchange transaction or other type of transaction. We would suggest, especially in view of the decision by the Third Circuit in *Levy v. Sterling*, that the Commission add to the phrase "merger, reclassification or consolidation" the words "or other substantially similar transaction" for the avoidance of

doubt. Alternatively, the Commission should consider adding a note to Rule 16b-7 stating that the term reclassification is intended to include reclassifications and substantially similar transactions, regardless of the characterization of such transactions for corporate law purposes, such as recapitalizations and share exchange transactions. In addition, we would suggest that the note state that the addition of the term "reclassification" is intended to clarify the meaning of the Rule as in effect prior to the time that such term was added.

We hope the Commission finds these comments helpful. We would be pleased to discuss them with the staff.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION

By: /s/ Michael J. Holliday
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Chair of the Committee

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