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SEC Proposes Amendments to Section 16 Rules

The SEC has proposed amendments to Rules 16b-3 and 16b-7 (Release 34-49895), which would exempt certain transactions from a private right of action to recover short-swing profits under Section 16(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). The SEC has also proposed amendments to Item 405 of Regulation S-K and S-B to harmonize this item with the recent Section 16(a) amendments requiring a two-business day Form 4 filing, mandated electronic filing and website posting of Section 16 reports.

Background

In response to the recent court decision by the U.S. Court of Appeals for the Third Circuit in *Levy v. Sterling Holding Company, LLC* ("*Sterling v. Levy*"), which the SEC believes is inconsistent with the intent of Rules 16b-3 and 16b-7, it is proposing amendments to such rules. Specifically, the SEC proposes to amend

- Rule 16b-3 – "Transactions between an issuer and its officers or directors" to make clear that acquisitions from the issuer need not be compensation- related in order to fall within the exemption provided by Rule 16b-3(d) and
- Rule 16b-7 – "Mergers, reclassifications and consolidations" to make clear that "reclassifications" are subject to the same requirements as "mergers and consolidations" and are not conditioned on the transactions satisfying any other conditions.

Proposed Rule 16(b) Amendments

Rule 16b-3

Rule 16b-3 exempts from Section 16(b) of the Exchange Act certain transactions between issuers of securities and their officers and directors. Rule 16b-3(a) provides that a transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from Section 16(b) of the Exchange Act if the transaction satisfies certain conditions. Rule 16b-3(d), which applies to "Grants, awards and other acquisitions of the issuer," exempts from Section 16(b) liability "[a]ny

transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction[1])" as long as one of the following conditions is satisfied:

- approval of the transaction by the issuer's board of directors, or board committee composed solely of two or more non-employee directors;
- approval or ratification of the transaction, in compliance with the proxy rules, by the issuer's shareholders; or
- the officer or director holds the acquired securities for a period of six months following the date of acquisition.

Rule 16b-3(e) exempts an officer's or director's disposition to the issuer of issuer equity securities pursuant to the first two conditions above.

The Third Circuit in *Levy v. Sterling* held that "other acquisitions" must be compensation-related in order to fall within the exemption provided by Rule 16b-3(d). The Third Circuit reasoned that since "grants" and "awards" are compensation-related, "other acquisitions" also must be compensation-related in order to be exempted by Rule 16b-3(d). In the proposing release, the SEC disagrees with the Third Circuit's interpretation and notes that "[t]his construction of Rule 16b-3(d) is not in accord with our clearly expressed intent in adopting the rule."

In order to eliminate uncertainty generated by the *Levy v. Sterling* opinion, the SEC proposes to amend Rule 16b-3(d)[2]. As amended, this paragraph would be entitled "Acquisitions from the issuer", rather than "Grants, awards and other acquisitions from the issuer", and would provide that any transaction involving an acquisition from the issuer, other than a Discretionary Transaction, including, without limitation, a grant or award, will be exempt if any one of the rule's three existing alternative conditions is satisfied.

In addition, the SEC proposes to amend Rule 16b-3 by adding Note 4, to state:

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1 A "Discretionary Transaction" means a transaction pursuant to an employee benefit plan that (i) is at the volition of a plan participant, (ii) is not made in connection with the participant's death, disability, retirement or termination of employment, (iii) is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code, and (iv) results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security.

2 The SEC has previously interpreted Rule 16b-3(d) to exempt a number of transactions outside the compensatory context. In addition, the U.S. Court of Appeals for the Second Circuit construed Rule 16b-3(d) to exempt acquiror directors' acquisition of acquiror options upon conversion of their target options in a corporate merger.

> The exemptions provided by paragraphs (d) and (e) of this section apply to any securities transaction by the issuer with an officer or director of the issuer that satisfies the specified conditions of paragraph (d) or (e) of this section, as applicable. These exemptions are not conditioned on the transaction being intended for a compensatory or other particular purpose.

Rule 16b-7

Rule 16b-7 exempts certain transactions that do not involve a significant change in the issuer's business or assets. The rule is typically relied upon in situations where a company reincorporates in a different state or reorganizes its corporate structure. Rule 16b-7(a)(1) provides that the acquisition of a security pursuant to a merger or consolidation is not subject to Section 16(b) if the security relinquished in exchange is of a company that, before the merger or consolidation, owned:

- 85% or more of the equity securities of all other companies party to the merger or consolidation; or
- 85% or more of the combined assets of all companies undergoing merger or consolidation.

Rule 16b-7(a)(2) exempts the corresponding disposition, pursuant to a merger or consolidation, of a security of an issuer that before the merger or consolidation satisfied either of the 85% ownership tests.

The *Levy v. Sterling* opinion construed Rule 16b-7 not to exempt an acquisition pursuant to a reclassification that:

- resulted in the insiders owning equity securities (common stock) with different risk characteristics from the securities (preferred stock) extinguished in a transaction, where the preferred stock previously had not been convertible into common stock; and
- thus involved an increase in the percentage of insiders' common stock ownership, based on the fact that insiders owned some common stock before the reclassification extinguished their preferred stock in exchange for common stock.

The SEC notes that these conditions are not found in the language of Rule 16b-7 and would not apply to a merger or consolidation relying upon the rule. The SEC further stated that "[i]mposing these conditions is inconsistent with the text of Rule 16b-7, the rule's interpretive history and the SEC's intent."

The SEC proposes to amend Rule 16b-7 so that, consistent with the Rule's title, the text would state "merger, reclassification or consolidation" each place it currently states "merger or consolidation." In addition, a proposed new paragraph would specify that the exemption

specified by Rule 16b-7 applies to any securities transaction that satisfies the conditions of the rule and is not conditioned on the transactions satisfying any other conditions.

Proposed Amendment to Item 405 of Regulations S-K and S-B

Issuers must disclose their insiders' Section 16 reporting delinquencies as required by Item 405 of Regulation S-K and S-B. Item 405(b)(1) currently provides that a form received by an issuer within three calendar days of the required filing date may be presumed to have been filed with the SEC by the required filing date. The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") amended Section 16(a) to require two-business day reporting of changes in beneficial ownership. In addition, the Sarbanes-Oxley Act amended Section 16(a) to require insiders to file these reports electronically, and the SEC and issuers to post these reports on their websites not later than the end of the business day following filing.

In light of the Section 16(a) amendments enacted by the Sarbanes-Oxley Act, the Item 405(b)(1) presumption of timeliness for a Section 16(a) report received by the issuer within three calendar days of the required filing date is no longer appropriate. By reviewing Section 16 reports posted on EDGAR, an issuer is readily able to evaluate their timeliness. Moreover, a report that is not received by the issuer in time for the issuer to post that report on its website by the end of the business day following filing should not be presumed to have been timely filed. Accordingly, the SEC proposes to amend Item 405 of Regulations S-K and S-B to delete the Item 405(b)(1) presumption, without substituting a different presumption or otherwise modifying the substance of Item 405.

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Mark S. Bergman	(44 20) 7367 1601	John C. Kennedy	(1) 212-373-3025
Richard S. Borisoff	(1) 212-373-3153	Edwin S. Maynard	(1) 212-373-3024
Andrew J. Foley	(1) 212-373-3078	Raphael M. Russo	(1) 212-373-3309
Paul D. Ginsberg	(1) 212-373-3131		

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP