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SECURITIES ALERT

SEC AMENDS SECTION 16 RULES TO CLARIFY SCOPE OF TWO EXEMPTIONS FROM SHORT-SWING PROFIT LIABILITY

On August 3, 2005, the Securities and Exchange Commission (the SEC) adopted amendments to Rules 16b-3 and 16b-7 under the Securities Exchange Act of 1934, as amended (the Exchange Act). These rules exempt certain transactions from the private right of action to recover short-swing profit provided by Section 16(b) of the Exchange Act. The amendments are intended to eliminate uncertainty caused by the opinion of the U.S. Court of Appeals for the 3rd Circuit in *Levy v. Sterling Holding Company, LLC,* 314 F.3d 106 (3d Cir. 2002). The amendments clarify that Rule 16b-3 is not limited to transactions with a compensatory nexus, and Rule 16b-7 applies to reclassifications in the same manner that it applies to mergers and consolidations.

The amendments to Rules 16b-3 and 16b-7 are effective August 9, 2005, but because they clarify regulatory conditions that applied to these rules since they became effective on August 15, 1996, and May 1, 1991, respectively, they are available to any transaction on or after such dates that satisfies the regulatory conditions so clarified.

BACKGROUND

Section 16(a) requires officers, directors and holders of 10 percent or more of a class of equity security registered under Section 12 (insiders) to file reports with the SEC disclosing the insiders' beneficial ownership of all equity securities of the issuer and changes in such ownership. Section 16(b) provides the issuer (or shareholders suing on behalf of the issuer) a private right of action to recover from an insider any profit realized by the insider from any purchase and sale (or sale and purchase) of any equity security of the issuer within any period of less than six months. Section 16(b) is a strict liability statute, which imposes liability without consideration of whether an insider actually was aware of material non-public information.

Since the enactment of the Exchange Act, the SEC has adopted a number of exemptive rules. Rule 16b-3 provides a broad exemption from Section 16(b) for transactions between issuers of

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securities and their officers and directors. The SEC believes that such transactions do not present an opportunity for one party to take advantage of the other party on the basis of inside information. Rule 16b-7 exempts securities acquisitions or dispositions by insiders pursuant to a merger, consolidation or similar transaction when the acquisition or disposition pursuant to such transaction results from the relinquishment of a security issued by a company that, before the transaction, owned 85 percent or more of either the equity securities or the combined assets of all the companies party to the transaction. While reclassifications are not mentioned in the text of Rule 16b-7, the title to the rule refers to reclassifications, and the SEC confirmed in a 1981 interpretive release that the rule applies to transactions involving reclassifications.

The 3rd Circuit's opinion in *Levy v. Sterling* casts 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 3rd Circuit held that neither rule exempted the directors' acquisitions of issuer securities in a reclassification undertaken by the issuer preparatory to its initial public offering, which would permit the matching of those acquisitions for Section 16(b) profit recovery with the directors' sales within six months after the initial public offering.

RULE 16b-3

In its *Levy v. Sterling* opinion, the 3rd Circuit construed Rule 16b-3(d), which applies to "grants, awards, or other acquisitions," to limit this exemption to transactions that have some compensation-related aspect. This construction of Rule 16b-3(d) is not in accord with the SEC's intent, as expressed in prior SEC releases and interpretive guidance. By requiring a compensatory element, the 3rd Circuit made it difficult to plan legitimate securities transactions between a company and its officers and directors.

To eliminate uncertainty caused by the *Levy v. Sterling* opinion, the SEC amended Rules 16b-3(d) and (e) to clarify that Rule 16b-3 is not limited to transactions with a compensatory purpose by expressly stating so in the body of the rule. As amended, Rule 16b-3(d) exempts any transaction, other than certain discretionary employee benefit plan transactions excluded from the exemption under the existing rule, involving an acquisition by an officer or director from the issuer (including without limitation a grant or award), whether or not intended for a compensatory or other particular purpose, if any one of the following three alternative conditions is satisfied:

(1) approval of the transaction by the issuer's board of directors, or board committee composed solely of two or more non-employee directors

(2) approval or ratification of the transaction, in compliance with Section 14 of the Exchange Act, by the issuer's shareholders

(3) the officer or director holds the acquired securities for a period of six months following the date of acquisition.

Rule 16b-3(e), as amended, exempts any transaction, other than the discretionary employee benefit plan transactions referred to above, involving the disposition by an officer or director to the issuer of issuer equity securities, whether or not intended for a compensatory or other particular purpose, provided that the terms of such disposition are approved in advance in the manner prescribed by clauses (1) or (2) above.

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RULE 16b-7

Rule 16b-7, entitled "Mergers, reclassifications, and consolidations," exempts from Section 16(b) 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. While the *Levy v. Sterling* opinion acknowledged that Rule 16b-7 could exempt a reclassification, it narrowly construed Rule 16b-7 not to exempt an acquisition pursuant to a reclassification that (i) resulted in the insiders owning equity securities (common stock) with different risk characteristics from the extinguished securities (preferred stock) and (ii) involved an increase in the percentage of insiders' common stock ownership. The SEC noted that the conditions imposed by the *Levy v. Sterling* opinion are inconsistent with the terms of Rule 16b-7, the rule's interpretive history and the SEC's intent, and would not apply to a merger or consolidation relying upon the rule.

In response to the opinion in *Levy v. Sterling*, the SEC amended Rule 16b-7 by (i) adding the term "reclassification" each place in the rule where the text "merger or consolidation" currently appears to clarify that the same standard applies to reclassifications as applies to mergers and consolidations and (ii) adding a new paragraph specifying that the Rule 16b-7 exemption applies to any securities transaction that satisfies the conditions of the rule and is not conditioned on the transaction satisfying any other conditions. The existing requirement that the security relinquished in the transaction be issued by a company that, before the transaction, owned 85 percent or more of the equity or the assets of all the companies party to the transaction remains unchanged.

The SEC did not include a definition of "reclassification" in the rule, but noted in the August 3, 2005, adopting release that transactions that are exempt as reclassifications generally include transactions in which the terms of the entire class or series are changed, or securities of the entire class or series are replaced with securities of a different class or series of securities of the company, and all holders of the reclassified class or series are entitled to receive the same form and amount of consideration per share.

ITEM 405 OF REGULATION S-K

The SEC also amended Item 405 of Regulation S-K to harmonize this item with the two-business-day Form 4 due date and mandated electronic filing and Web site posting of Section 16 reports. Item 405 of Regulation S-K requires issuer disclosure of Section 16 reporting delinquencies. This disclosure is required in the issuer's proxy or information statement for the annual meeting at which directors are elected, and in its Form 10-K. Item 405(b)(1) permits an issuer to presume that a Section 16 form it receives within three calendar days of the required filing date was filed with the SEC by the required filing date. In light of the two-business-day due date generally applicable to Form 4 and the requirements of mandatory EDGAR filing and Web site posting of Section 16 reports, this presumption no longer is appropriate or necessary, and the SEC is amending Item 405 to rescind it.

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