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SEC PROPOSES AMENDMENTS TO CLARIFY RULES 16B-3 AND 16B-7

On June 22, 2004, the Securities and Exchange Commission (SEC) announced proposals to amend Rules 16b-3 and 16b-7 under the Securities Exchange Act of 1934 (the Exchange Act). The proposals aim to clarify the exemptive scope of these rules in light of the *Levy v. Sterling* case. According to the SEC, the opinion of the U.S. Court of Appeals for the 3rd Circuit in *Levy v. Sterling Holding Co.,* 314 F.3d 106 (3d Cir. 2002), cert. denied, 124 U.S. 389 (2003), casts doubt as to the nature and scope of the transactions exempted from Section 16(b) short-swing profit recovery by Rules 16b-3 and 16b-7. In particular, the SEC noted that the opinion interpreted Rules 16b-3 and 16b-7 to require satisfaction of conditions that are neither contained in the text of the rules nor intended by the SEC. The SEC observed that the resulting uncertainty has made it difficult for corporate issuers and insiders (as defined) to plan legitimate transactions. The proposed amendments are intended to clarify the regulatory conditions that apply to these exemptions.

In addition, the SEC proposed to amend Item 405 of Regulations S-K and S-B to harmonize this item with certain recent developments under Section 16(a) of the Exchange Act, including mandated electronic filing and expedited due dates of certain reports filed pursuant to Section 16(a).

The staff of the SEC has recommended a 45-day comment period after the date of its release (Release No. 34-49895) relating to the proposed rules has been published in the Federal Register.

LEVY V. STERLING

Levy v. Sterling involved a reclassification of securities prior to an issuer's initial public offering. Shareholders of the issuer, Fairchild Semiconductor International, Inc. (Fairchild), had approved a plan of recapitalization involving an automatic conversion upon completion of Fairchild's IPO of all shares of the issuer's preferred stock into shares of class A common stock. Upon completion of the IPO, the two corporate defendants that had officers who sat on Fairchild's board of directors acquired shares of common stock upon conversion of their preferred stock. Within six months, the two corporate defendants sold shares and realized profits of $58.5 million and $14.1 million, respectively. The plaintiff sued the defendants under Section 16(b), alleging that the conversion of the preferred stock was a non-exempt purchase that could be matched with the sales within six months. The district court upheld the defendants' motion to dismiss the complaint on the grounds that the conversion was exempt under Rule 16b-7. Upon appeal, however, the 3rd Circuit reversed the lower court's decision and held that neither Rule 16b-7 nor Rule 16b-3 appeared to be available to exempt the conversion.

Specifically, the 3rd Circuit's opinion in *Levy v. Sterling* held that:

(1) Rule 16b-7 does not provide a blanket exemption for all reclassifications from Section 16(b) liability.

(2) The SEC could have intended to exempt only those reclassifications that did not pose the risk of speculative, insider "short-swing trading" profits that Section 16(b) sought to prevent. The court held that Fairchild's reclassification of preferred stock to common stock in connection with its IPO presented insiders with opportunities for such speculative abuse, noting that the proportionate interests of the issuer's security holders were changed as a result of the reclassification (i.e., the two defendants' beneficial ownership increased as a result of the reclassification by 4.15 percent and 0.28 percent, respectively).

(3) Finally, the court held that the exemption provided by Rule 16b-3(d) for grants, awards and other acquisitions from the issuer was limited only to acquisitions from the issuer that have a compensatory element of the type that exists under an employee benefit plan.

This decision was unexpected and created uncertainty as to whether Rules 16b-3 and 16b-7 exempted transactions that were commonly understood to be exempt, making it difficult for corporate issuers and insiders to plan legitimate transactions in reliance on these rules. The defendants in the case had pointed to numerous and various pronouncements of the SEC that exempted reclassifications from Section 16(b), to no avail. When the defendants applied for a rehearing of the case to the 3rd Circuit, the SEC took the unusual step of submitting an *amicus curiae* memorandum to express its traditional interpretation of its rules. Ultimately, the 3rd Circuit ignored the SEC's memorandum and declined to grant the rehearing petition.

In light of the uncertainty created by the *Levy v. Sterling* decision, the SEC has proposed for comment certain rules designed to resolve any doubt as to the meaning and interpretation of Rules 16b-3 and 16b-7 by reaffirming the SEC's views previously expressed regarding their appropriate construction.

RULE 16B-3

Rule 16b-3 exempts from Section 16(b) certain transactions between issuers of securities and their officers and directors. In *Levy v. Sterling* the 3rd Circuit interpreted Rule 16b-3(d), which applies to "grants, awards or other acquisitions," to limit this exemption to transactions that have some compensation-related aspect. The court reasoned that because "grants" and "awards" are compensation-related, "other acquisitions" also must be compensation-related in order to be exempted under the rule. The SEC noted that this construction is not in accord with what it believes is its clearly expressed intent in adopting this rule. In adopting the current version of Rule 16b-3 in 1996, the SEC noted at the time that "a transaction need not be pursuant to an employee benefit plan or any compensatory program to be exempt, nor need it specifically have a compensatory element."

Under Rule 16b-3(d) any transaction involving a grant, award or other acquisition from the issuer is exempted from Section 16(b) liability if any one of three alternative conditions of the rule is satisfied. These conditions require:

- 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 Exchange Act Section 14, by the issuer's shareholders, or
- the officer or director to hold the acquired securities for a period of six months following the date of acquisition.

To eliminate any uncertainty generated by the *Levy v. Sterling* opinion, the SEC proposes to amend Rule 16b-3(d) — and Rule 16b-3(e) as well — to eliminate the references in the title of the rule to "grants, awards and other acquisitions" and to refer simply to "acquisitions from the issuer." This change is made to remove any implication that "other acquisitions" include only those similar in substance to grants and awards. In addition, the proposal would add a new Note 4 to the rule, stating that "[t]hese exemptions are not conditioned on the transaction being intended for a compensatory or other particular purpose."

RULE 16B-7

Rule 16b-7, which is titled "Mergers, reclassifications, and consolidations," exempts certain transactions from Section 16(b) that do not involve a significant change in the issuer's business or assets. This rule is intended to address such insignificant changes as a reorganization of an issuer's corporate structure or the reincorporation of the issuer to another state. Under the rule, an insider's 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 percent or more of the equity securities of all other companies party to the merger or consolidation, or
- 85 percent or more of the combined assets of all companies undergoing the merger or consolidation.

The rule also will exempt from Section 16(b) the insider's corresponding disposition of securities, pursuant to a merger or consolidation, as long as the securities satisfied either of the 85 percent tests set forth above.

In *Levy v. Sterling* the court held that Rule 16b-7 does not exempt reclassifications generally from liability under Section 16(b), noting that despite the reference to reclassifications in the title of the rule, the word is not mentioned thereafter within the text of the rule. As a result, the court held, the SEC must have intended that only those reclassifications that do not provide any possibility of speculative abuse are exempt from Section 16(b) liability. Further, *Levy v. Sterling* interpreted 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 the 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 the insiders owned some common stock before the reclassification extinguished their preferred stock in exchange for common stock.

The SEC found that the exemptive conditions imposed upon reclassifications by the *Levy v. Sterling* opinion are not found in the language of Rule 16b-7, nor do they reflect the SEC's interpretive history of this rule. Moreover, the SEC determined that these conditions significantly restrict the rule's availability for reclassifications by narrowing it to the less-frequent situation where the original security and the security for which it is exchanged have the same characteristics.

To eliminate any uncertainty with regard to the interpretation of Rule 16b-7, the SEC now proposes to amend the text of Rule 16b-7 to add the word "reclassifications" everywhere the rule currently refers only to "a merger or consolidation" and to add a new Section (c) to 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 transaction satisfying any other condition.

ITEM 405 OF REGULATIONS S-K AND S-B

Issuers are required to disclose Section 16 reporting delinquencies by their insiders by Item 405 of Regulations S-K and S-B in certain forms and reports filed with the SEC. The SEC proposes to eliminate from Item 405 a provision that a Section 16 report may be deemed to be timely filed if it has been received by the issuer within three days of its due date. This provision, adopted when Section 16 filings were allowed to be made in paper form, is now considered obsolete in light of the changes occasioned by the Sarbanes-Oxley Act of 2002, such as mandated electronic filing of Section 16 reports and certain expedited filing requirements. Because electronically filed Section 16 reports are now required to be posted on the issuer's Web site, this provision of Item 405 would allow issuers to ignore information that is readily available on the issuer's own Web site.

CONTACT INFORMATION

If you have any questions or would like to learn more about this topic, please contact the partner who normally represents you, or:

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