Insider Trading Rules—Section 16

The Basics

What is the rule?

Section 16 imposes restrictions on when and how a corporate “insider” may buy and sell shares of company stock.

Who does it apply to?

“Insiders”, defined as officers, directors, and more than 10% shareholders are covered by the rules.

What is the impact of Section 16?

An insider is prohibited from “short-swing” transactions (i.e., a sale and purchase of company stock within a 6-month period). The insider is required to surrender to the company all profits if such a “matching” transaction occurs. However, employee compensation and benefit plans can qualify for an exemption from the rules requiring forfeiture of profits.

What transactions are exempt from liability?

There are four basic types of transactions that can qualify for an exemption from liability under the short-swing trading rules of Section 16:

- Discretionary transactions;
- Grants, awards and other acquisitions from the company;
- Dispositions to the company; and
- Tax-conditioned plans.

In addition, the exercise of in-the-money stock options continues to be exempt from liability. (In-the-money stock options are options where the FMV of the stock on the date of exercise exceeds the option exercise price.)

Reporting Obligations

Insiders are required to publicly report their holdings and transactions in company stock.

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The Details

Discretionary Transactions

Discretionary transactions are exempt from liability if the transfer or distribution election is made at least six months after the time of the last election in the opposite direction.

A “discretionary transaction” is defined as one that is initiated by the participant and involves either: (i) an intra-plan transfer to or from a company stock fund; or (ii) a cash distribution to the participant that is funded by the disposition of an equity security.

However, certain intra-plan transfers and cash distributions, although voluntary, are **not** considered discretionary. These are:

- Transactions in connection with death, disability, retirement or termination of employment; and
- Transactions required under the Internal Revenue Code, such as the minimum distribution requirement (age 70½ rule) or the requirement to allow certain ESOP participants to diversify their investments or receive a distribution.

Thus, an election to transfer out of a company stock fund must be made at least six months after an election to transfer into the stock fund.

Grants, Awards and Other Acquisitions from the Company

Any transaction, other than a discretionary transaction, that involves a grant, award or other acquisition to an executive officer or director (even if the transaction is voluntary) is exempt if **any** of three conditions is satisfied.

The conditions are:

- The transaction is approved by the Board of Directors or a committee consisting solely of at least two nonemployee directors. The new rules contain a revised definition of a “nonemployee director”. A nonemployee director is generally one who is independent and does not have an employee or business relationship with the company.
- The transaction is either approved, or ratified no later than the next shareholder meeting, by a majority of the company’s shareholders.
- The securities acquired are held for at least six months following the date of acquisition. For stock options, the exemption is available as long as the ultimate sale of shares underlying the options occurs at least six months after the grant of the options.

Both the first and second conditions require the approval of each specific transaction. Thus, the condition is not satisfied if the board/committee or shareholders only approve the plan in its entirety. However, approval of a plan would meet the requirement if all of the terms and conditions of the transactions under the plan are fixed in advance. Also, if the terms of subsequent transactions are approved as part of the initial transaction, each subsequent transaction does not need additional approval.

Dispositions to the Company

Under the new rules, dispositions of securities by insiders to the company will be exempt from the Section 16 liability rules if approval is obtained from the Board of Directors, from a committee solely made up of at least two nonemployee directors, or from shareholders.

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The following types of transactions are exempt.

- Withholding of shares to satisfy the exercise price of options or to satisfy tax obligations.
- Exercises of SARs for cash. These need not be exercised during a quarterly ten-day window period (as was previously required).
- Cancellations, replacements and surrenders of outstanding awards.
- Buybacks by the company of outstanding awards. This is a particularly useful exemption when awards are redeemed in the context of a merger.

Tax-Conditioned Plans

The rules provide that all transactions under "tax-conditioned" plans that are not discretionary are exempt from liability with no conditions. Tax-conditioned plans are: (i) qualified retirement plans; (ii) nonqualified excess benefit plans set up for the sole purpose of making up for qualified plan limits; and (iii) certain stock purchase plans. Thus, routine acquisitions of company stock (including company matches) under a 401(k), thrift, or stock purchase plan are exempt. However, fund switches and cash withdrawals are discretionary transactions and subject to the conditions discussed above.

Reporting Requirements

The requirements for reporting changes in beneficial ownership have been dramatically streamlined, with reporting no longer required for the following transactions.

- Transactions under tax-conditioned plans (except discretionary transactions).
- Transactions pursuant to dividend reinvestment plans, interest reinvestment plans and domestic relations orders.
- Transactions, other than the exercise of stock options or other derivative securities, that change only the **form** of beneficial ownership.
- Expirations and cancellations of derivative securities where no value is received.
- Spin-off transactions in which equity securities of a different company are distributed to insiders of the company.

Stock option exercises and nonexempt transactions are reported on Form 4, "Statement of Changes in Beneficial Ownership". All other exempt transactions are reported on Form 5, "Annual Statement of Changes in Beneficial Ownership".

Form 4—Statement of Changes of Beneficial Ownership of Securities

An insider is required to file the Form 4 for all transactions in company stock (except small acquisitions that met specified conditions and most transactions exempted from Section 16 short-swing profit recovery) by the end of the **second business day** following the day the transaction is executed (the "two-day reporting rule"). Examples of transactions that are required to be reported on Form 4 are open-market purchases and sales of company stock. Also, stock option exercises, although exempt from Section 16 short-swing profit recovery, are required to be reported on Form 4.

There are two very limited exceptions to the two-day reporting rule. If one of the two exceptions is satisfied, the transaction must be reported within five days of the date of the transaction. Basically, the executing broker, dealer or plan administrator has a maximum of three days to notify the insider. Once the insider is notified, the two-day reporting rule applies. The two exceptions to the two-day reporting rule are:

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- Transactions pursuant to arrangements that satisfy the affirmative defense conditions of Rule 10b5-1(c) where the reporting person does not select the date of execution. These are commonly referred to as 10b5-1 Trading Plans.

  Comment: *For example, if a Section 16 executive officer has entered into a 10b5-1 Trading Plan that instructs the broker to sell 10,000 shares when the stock price reaches a specified price, the broker has a maximum of three days to notify the executive officer of the transaction and, upon notification, the executive officer has two days to file the Form 4. If, however, the 10b5-1 Trading Plan instructs the broker to sell 10,000 shares on the first day of every month, it is not a transaction that meets the exception because the executive officer has selected the date of execution. In this case, the transaction is subject to the two-day reporting rule.*

- Discretionary transactions pursuant to employee benefit plans where the insider does not select the date of execution. A discretionary transaction is a transaction that is volitional and either results in an intra-plan transfer involving an issuer equity securities fund, or is a cash distribution funded by a volitional disposition of an issuer equity security. However, discretionary transactions do not include any transactions that are made in connection with a participant's death, disability, retirement, or termination of employment or are required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code (e.g., ESOP diversification elections).

  Comment: *An example of a discretionary transaction is a participant electing to move funds from a fixed income fund in the 401(k) plan to the stock fund. Another example is a plan loan where company stock has to be sold to fund the loan disbursement. In most cases, the insider selects the date of execution of discretionary transactions and the exception to the two-day reporting rule is not met.*

Form 5—Annual Statement of Beneficial Ownership of Securities

Transactions between the company and an insider that are exempt from short-swing profit recovery under Rule 16b-3 and that were previously reported on Form 5, must now be reported on Form 4 according to the two-day reporting rule. Under Rule 16b-3, if certain requirements are satisfied, there are three exemptions where the required reporting was on the Form 5. These three exemptions are discretionary transactions, grants, awards, and other acquisitions from the company, and dispositions to the company.

Comment: *The Form 5 is the annual reporting form and is required to be filed within 45 days after the end of the fiscal year. Examples of grants, awards, and other acquisitions are stock options and restricted stock grants. Examples of dispositions to the issuer are sales of company stock back to the company, share withholding for taxes, or stock swaps to pay the option exercise price.*

Other transactions that are exempt from short-swing profit recovery are bona fide gifts or transfers pursuant to a will or the laws of descent and distribution, and certain transactions in a merger, reclassification or consolidation. These transactions remain reportable on the Form 5.

Also, small acquisitions that meet the conditions for reporting on Form 5 can continue to be reported on Form 5. Generally, small acquisitions are acquisitions that do not exceed $10,000 in market value.

Transactions Exempt from Reporting and Short-Swing Profit Recovery

Certain transactions are exempt from both the reporting and liability provisions of Section 16. These transactions are transactions under tax-conditioned plans (except discretionary transactions) and reinvestment of dividends or interest pursuant to broad-based dividend or interest reinvestment plans. A tax-conditioned plan is a tax-qualified plan, an excess benefit plan or a stock purchase plan. Examples of transactions that are exempt from both reporting and liability are employer or employee contributions to the stock fund in 401(k) plans, company matches to the stock fund in a 401(k) plan and acquisitions under an employee stock purchase plan that is qualified under Section 423 of the Internal Revenue Code.

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Proxy Disclosure Requirements

Under current rules, the company is required to disclose any delinquent Section 16 filings by insiders in its proxy statement and Form 10-K reports, including identifying each insider by name and disclosing the number of delinquent filings. Under the new rules, the company must not only disclose any known late filings, but also any filings that the company should know about. For example, when an individual becomes an insider for the first time, the individual must file a Form 3 “Initial Statement of Beneficial Ownership” with the SEC, and provide a copy to the company. If the company does not receive a Form 3 from the new insider, the company is obligated to consider its absence as an indication that disclosure is delinquent.

The rules require that the delinquent filings disclosure be provided under a discrete caption that reads, “Section 16(a) Beneficial Ownership Reporting Compliance”.

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