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Trading  
Reporting***

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# BUSINESS & THE LAW

## SARBANES-OXLEY ACT- INSIDER TRADING REPORTING

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### INTRODUCTION

On July 25, 2002, Congress passed, and on July 30, 2002 President Bush signed, the Sarbanes-Oxley Act which enacted sweeping reforms of the federal securities laws. Among the reforms enacted by Sarbanes-Oxley is an amendment to Section 16(a) of the Securities Exchange Act which, among other changes, shortens the deadline by which insiders — executive officers, directors and 10% stockholders — of reporting companies must report changes in ownership<sup>1</sup> of equity securities of the applicable reporting company. The amendment to Section 16(a) of the Exchange Act is contained in Section 403 of Sarbanes-Oxley. Portions of the amendments to Section 16 are effective August 29, 2002, and other portions are effective July 30, 2003. This memorandum analyzes the amendments to Section 16(a) of the Exchange Act implemented by Section 403 of Sarbanes-Oxley. The Securities and Exchange Commission, on August 6, 2002, issued Release No. 34-46313 (the “Section 16 Release”) to give guidance with respect to its plans to implement Sarbanes-Oxley’s amendments to Section 16(a). This memorandum also summarizes the comments and proposed rule changes set forth in the Section 16 Release.

### AMENDMENTS TO SECTION 16(a)

The chart below sets out the changes in Section 16(a) of the Exchange Act effected by the passage of Sarbanes-Oxley and the time frame in which the changes are to be effective.

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	<b>Current Section 16 (a):</b>	<b>As Amended by Sarbanes-Oxley:</b>
<b>By August 29, 2002</b>	Insiders must report changes in ownership or security based swap agreement <sup>2</sup> transactions:	within 10 days after the close of the calendar month in which there was a change in ownership. <sup>3</sup>
<b>By July 30, 2003</b>	Section 16 reports may be filed with the SEC. <sup>5</sup>	by the end of the second business day following the day on which the transaction was executed (unless otherwise established by the SEC). <sup>4</sup>
	The SEC must post Forms 4 on a publicly available internet site:	either by EDGAR or on paper (whether Form 3, 4 or 5).  Forms 4 must be filed <sup>6</sup> by EDGAR; Forms 3 and 5 may still be filed either on paper or by EDGAR (but see the discussion below).
	The reporting company must post Forms 4 to its website, if it has one:	by the end of the day <sup>7</sup> following the filing on EDGAR.  by the end of the business day following the filing of the report with the SEC.

**THE SECTION 16 RELEASE**

In its Section 16 Release, the SEC announced that it anticipated adopting final rules, to become effective no later than August 29, 2002, that will:

- Amend Form 4 to conform all references to the amended statutory filing deadline;
- Amend Rule 16a-3(f) so that transactions between officers or directors and the issuer exempted from Section 16(b) of the Exchange Act by Rule 16b-3 (so that they are currently reportable on Form 5 within 45 days of the end of the reporting company's fiscal year) must instead be filed within the two business day deadline established by Sarbanes-Oxley; and

- Designate specific and narrow exemptions from the two business day statutory filing deadline for Forms 4, as permitted by Sarbanes-Oxley.

The most interesting thing to note with respect to Sarbanes-Oxley and the Section 16 Release is that, although exposure to Section 16(b) liability has not changed under Sarbanes-Oxley, there will be additional transactions which will now be currently reportable on Form 4. Under the pre-Sarbanes-Oxley regime, transactions (other than the exercises or conversions of derivatives) which were exempt from Section 16(b) liability were eligible for deferred reporting on Form 5. This allowed insiders to delay for up to one year the reporting of transactions such as sales by the CEO of Enron of large amounts of stock to Enron. Because the SEC has not yet issued its final rules, what the post-Sarbanes-Oxley regime will be like exactly is a matter of some speculation. However, it is clear that the SEC intends for all transactions between directors or officers and the reporting company, even if the transaction qualifies for exemption from Section 16(b) liability, to be currently reportable. The biggest category of transaction affected by this change in law will be grants of securities (e.g. options and restricted stock) by reporting companies to insiders under compensation plans. As a practical matter, the only transactions which may continue to be reportable on Form 5 (due within 45 days of the end of the reporting company's fiscal year) are:

- Transactions under \$10,000 in value which together with all other transactions in securities of the same class executed within six months (excluding acquisitions exempt from Section 16(b) liability or previously reported on Form 4 or 5) do not exceed \$10,000 in value and for which there is no "opposite way transaction" (which is not exempt from Section 16(b) liability) within a six month period;
- Holdings and transactions which should have been reported previously on Form 3 or 4, but were not; and
- Transactions exempt from Section 16 liability pursuant to other Section 16(b) rules, such as gifts and inheritances under Rule 16b-5 and acquisitions and distributions associated with reclassifications and consolidations under Rule 16b-7.

Another interesting thing to note with respect to the Section 16 Release is that the SEC is not interpreting Sarbanes-Oxley's complete revision of Section 16(a) of the Exchange Act as nullifying all current SEC regulations promulgated with respect to Section 16(a). The SEC plans only to amend those of its current regulations that are inconsistent with Sarbanes-Oxley in accordance with its required rule-making procedures. Consequently, much of the law applicable to Section 16 reporting will remain the same.

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# R E V I E W

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**Real Estate & The Law** provides up-to-date information on legal developments affecting real estate including opportunities for readers to protect their properties, and provides general insights into related areas of interest.

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Other interesting clues to the future contained in the Section 16 Release include the fact that the SEC intends to:

- Proceed with its rules, proposed in Release No. 34-42461, to make filing Section 16 reports on EDGAR mandatory;<sup>1</sup>
- No longer consider requiring reporting companies to report director and executive officer transactions in the reporting company's equity securities on Form 8-K as it proposed in Release No. 34-45742;
- Continue to consider requiring reporting companies to disclose on Form 8-K information regarding:
  - arrangements with officers and directors intended to satisfy the conditions, set forth in Rule 10b5-1(c), necessary to establish an affirmative defense against insider trading;
  - and company loans and loan guarantees which are not now prohibited under Section 402 of Sarbanes-Oxley. These proposals were also contained in Release No 34 45742;
- Not provide exemptions from the two business day filing deadline based upon type of issuer, type of insider or size of transaction; and
- Provide exemptions from the two business day filing deadline, if at all, only for narrowly specified types of transactions where the insider does not control (or sometimes even know) the date of the transaction.

A significant area of confusion which remains is what will be the reporting requirements on August 29, 2002, with respect to acquisitions of securities under 401(k) plans or similar qualified plans which result from contributions of "new" money (as opposed to acquisitions of securities resulting from fund switching). Pre-Sarbanes-Oxley, acquisitions exempt from liability under Rule 16b-3(c) (such as routine acquisitions of securities under qualified plans) were exempt for Section 16(a) reporting requirements under Rule 16a-3(f)(1)(i)(B). While it is clear that the SEC intends to accelerate the reporting deadlines for insider transactions generally and without regard to whether the transaction is exempt from Section 16(b) liability, it is also clear that the SEC intends to create exemptions from the two-day filing deadline for situations in which an insider has no control over the date of the transaction and filing reports within two business days is not feasible. Certainly routine acquisitions of securities under a qualified plan are not within the control of an insider in any meaningful way and requiring reporting of these acquisitions within two business days would be a logistical nightmare for reporting companies and their insiders. We must hope that this is one of the specific and narrow exemptions from the

statutory filing deadline that the SEC will make pursuant to the clause in Sarbanes-Oxley which permits the SEC to create such exemptions by rule.

## SECTION 16 COMPLIANCE PROCEDURES

As a practical matter, the very short deadline for filing Forms 4 will require a much greater level of attention from insiders and reporting companies and will probably require one or more of the following compliance procedures.

- *Mandatory Pre-clearance Procedures* - Insiders together with their family members would not be permitted to execute trades in the reporting company's securities (including those associated with benefit or compensation plans) without first obtaining sufficient prior clearance from the reporting company's general counsel or other designated person.
- *Broker Interface Procedures* - Insiders would have to execute trades in the reporting company's securities through a specified broker who would sign an agreement not to enter an order without checking that the trade had been cleared with the reporting company and that the trade otherwise complied with the brokerage firm's compliance procedures (with respect to Rule 144, etc.). If insiders were not all required to use the same specified broker to execute trades in securities of the reporting company, then each broker who executed trades in the reporting company's securities for insiders would sign an agreement to the same effect.
- *Powers of Attorney* - To meet the filing deadline for Forms 4, reporting companies which assist their insiders with Section 16 filing compliance should have each insider execute a power of attorney which would permit several other people to execute Section 16 reports on behalf of the insider. This will make working around vacations and business trips easier. We note, however, that we do not favor using powers of attorney to file Section 16 reports that have not been reviewed by insiders. These reports are already error-prone, and we do not believe that public companies should invite liability for errors that are not their responsibility.
- *Prepare to File by EDGAR* - In situations where a Form 4 is to be filed with the SEC on paper, a Form 4 must usually be filled out, signed and sent by overnight courier to the SEC and the appropriate securities exchange by the business day following the trade date. Powers of attorney will be especially important under these circumstances. Filing by EDGAR gives an insider almost a full extra day to file with the SEC and has the added advantage that both the New York Stock Exchange and the

American Stock Exchange treat an EDGAR filing of a Section 16(a) report as fulfilling the requirement to file with the exchange. Even though Sarbanes-Oxley gives insiders a year to comply with the requirement to file by EDGAR, there are significant advantages to filing by EDGAR earlier.

Please note that compliance procedures will have to be adjusted if and when the SEC implements rules requiring disclosure of Rule 10b5-1(c) transactions as proposed in Release No. 34-45742.

## CONCLUSION

The definition of insider covered under Section 16 of the Exchange Act, and the types of transactions which are reportable, have not changed. What has changed is that:

- The filing deadline for Forms 4 has been dramatically shortened from within 10 days after the close of the calendar month in which a reportable transaction occurred to within two business days after the day the reportable transaction occurred;
- The types of transactions for which delayed reporting on Form 5 is allowed will be severely curtailed, and most executive compensation transactions will have to be reported on Form 4 within two business days of the date of grant even though these transactions may be exempt from Section 16(b) liability; and
- Transactions which used to be eligible for delayed reporting on Form 5 because they were exempt from Section 16(b) liability must now be reported currently on Form 4.

In addition, insiders and reporting companies must enable themselves, by July 30, 2003, to file Section 16 reports on EDGAR and to post Section 16 reports on websites. Finally, given the dramatically truncated period of time in which Forms 4 must be filed, which goes into effect on August 29, 2002, reporting companies should quickly implement or amend Section 16 reporting compliance procedures to facilitate complying with this new deadline.

One sanction for failing to comply with the reporting requirements of Section 16(a) of the Exchange Act remains disclosure of the delinquencies in the reporting company's proxy statement. Also, Section 32 of the Exchange Act has always provided that any willful violation of the Exchange Act may result in a fine of up to \$5,000,000 and up to 20 years in prison. However, Sarbanes-Oxley had given the SEC new broad powers to seek "any equitable relief that may be appropriate or necessary for the benefit of investors" for violations of securities laws.

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### Footnotes

<sup>1</sup> An insider must report changes in ownership of securities in which he or she has a pecuniary interest.<sup>1</sup> The ownership of securities reported pursuant to Section 16(a) differs from the concept of beneficial ownership<sup>2</sup> defined in Rule 13d-3 which is the usual concept of ownership that applies within the context of federal securities laws. However, Rule 13d-3 applies for determining whether a person is a 10% stockholder and therefore an insider.

<sup>2</sup> Security based swap agreement<sup>3</sup> is defined in Section 206(b) of Gramm-Leach-Bliley Act. The requirement that swap transactions be reported on Form 4 is not new with Sarbanes-Oxley. This requirement was enacted by the Commodities Futures Modernization Act of 2000.

<sup>3</sup> In the past, the date on which a change in beneficial ownership<sup>4</sup> occurred for reporting purposes was deemed to be the date upon which the insider was irrevocably committed to the transfer of ownership. This was the trade date (rather than the settlement date) for open market transactions. Sarbanes-Oxley states that the reporting requirement is triggered on the day the transaction is executed. Although there has not been much discussion of the matter, it appears that Sarbanes-Oxley does not intend to change how a transaction date is determined for Section 16(a) purposes even though it uses new language.

<sup>4</sup> Sarbanes-Oxley permits the SEC, by rule, to allow longer filing deadlines in those cases where filing within two business days is not feasible.

<sup>5</sup> Unless Section 16 reports are filed with the SEC by EDGAR, they must also be submitted by paper to the securities exchange on which the reporting company's securities are traded. Sarbanes-Oxley does not change this requirement.

<sup>6</sup> For a report submitted by paper, a report is filed<sup>5</sup> with the SEC on the day that it is received by the SEC at its Washington, D.C. offices. For a report submitted by EDGAR, a report is filed with the SEC when it is accepted by EDGAR. Thus, filing by EDGAR gives insiders almost an extra day to comply with reporting requirements.

<sup>7</sup> Presumably this means business day;<sup>6</sup> however, Sarbanes-Oxley says day,<sup>7</sup> and not business day<sup>8</sup> in the context of time limits for internet posting. In contrast, Sarbanes-Oxley specifies business day<sup>9</sup> for the insider reporting deadline and for the deadline by which reporting companies must post changes in ownership by insiders on its website. The way Sarbanes-Oxley is drafted, the requirement that Section 16 reports be posted to a reporting company's website applies only to Forms 4.

<sup>8</sup> This would require that all Section 16 reports, not just Forms 4, be filed on EDGAR. Query whether the SEC would also expand the requirement to post Forms 4 on a reporting company's website to include a requirement to post Forms 3 and 5 as well.