

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR PARTS 228, 229 and 240**

**[RELEASE NOS. 33-8600; 34-52202; 35-28013; IC-27025; File No. S7-27-04]**

**RIN 3235-AJ27**

**OWNERSHIP REPORTS AND TRADING BY OFFICERS, DIRECTORS AND PRINCIPAL SECURITY HOLDERS**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

**SUMMARY:** We are adopting amendments to two rules that exempt certain transactions from the private right of action to recover short-swing profit provided by Section 16(b) of the Securities Exchange Act of 1934. The amendments are intended to clarify the exemptive scope of these rules, consistent with statements in previous Commission releases. We also are amending Item 405 of Regulations S-K and S-B 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.

**EFFECTIVE DATES:** August 9, 2005, except §§228.405(a), (a)(2) and (b) and 229.405(a), (a)(2) and (b) are effective September 8, 2005. §240.16b-3(d) and (e) are effective August 9, 2005, but because they clarify regulatory conditions that applied to these exemptions since they became effective on August 15, 1996, they are available to any transaction on or after August 15, 1996 that satisfies the regulatory conditions so clarified. §240.16b-7 is effective August 9, 2005, but because it clarifies regulatory conditions that applied to that exemption since it was amended effective

May 1, 1991, it is available to any transaction on or after May 1, 1991 that satisfies the regulatory conditions so clarified.

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**SUPPLEMENTARY INFORMATION:** We are adopting<sup>1</sup> amendments to Rules 16b-3<sup>2</sup> and 16b-7<sup>3</sup> under the Securities Exchange Act of 1934 (“Exchange Act”),<sup>4</sup> and Item 405 of Regulations S-K and S-B.<sup>5</sup>

## **I. EXECUTIVE SUMMARY AND BACKGROUND**

Section 16 of the Exchange Act<sup>6</sup> applies to every person who is the beneficial owner of more than 10% of any class of equity security registered under Section 12 of the Exchange Act,<sup>7</sup> and each officer and director (collectively, “insiders”) of the issuer of such security. Upon becoming an insider, or upon the Section 12 registration of that

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<sup>1</sup> The amendments were proposed in Exchange Act Release No. 49895 (June 21, 2004) [69 FR 35982] (“Proposing Release”). Comment letters are available for public inspection and copying in the Commission’s Public Reference Room, 100 F Street, NE, Washington, DC 20549. We have posted electronically submitted comment letters on our Web site at <http://www.sec.gov/rules/proposed/s72704.shtml>. [Add when posted: A comment summary also is available at <http://www.sec.gov/rules/extra/s72704summary.htm>.]

<sup>2</sup> 17 CFR 240.16b-3.

<sup>3</sup> 17 CFR 240.16b-7.

<sup>4</sup> 15 U.S.C. 78a *et seq.*

<sup>5</sup> 17 CFR 229.405 and 17 CFR 228.405.

<sup>6</sup> 15 U.S.C. 78p.

<sup>7</sup> 15 U.S.C. 78l.

security, Section 16(a)<sup>8</sup> requires an insider to file an initial report with the Commission disclosing his or her beneficial ownership of all equity securities of the issuer.<sup>9</sup> To keep this information current, Section 16(a) also requires insiders to report changes in such ownership, or the purchase or sale of a security-based swap agreement<sup>10</sup> involving such equity security.<sup>11</sup>

Section 16(b)<sup>12</sup> 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. This statute is designed to curb abuses of inside information by insiders.<sup>13</sup> Unlike insider trading prohibitions under general antifraud provisions,<sup>14</sup> Section 16(b) operates without consideration of whether an insider actually was aware of material non-public information.<sup>15</sup> Section 16(b) operates strictly, providing a private right of action to recover short-swing profits by insiders, on the theory that short-swing transactions (a purchase and sale within six months) present a

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<sup>8</sup> 15 U.S.C. 78p(a).

<sup>9</sup> Insiders file these reports on Form 3 [17 CFR 249.103].

<sup>10</sup> As defined in Section 206B of the Gramm-Leach-Bliley Financial Modernization Act of 1999, as amended by H.R. 4577, P. L. No. 106-554, 114 Stat. 2763.

<sup>11</sup> Insiders file transaction reports on Form 4 [17 CFR 249.104] and Form 5 [17 CFR 249.105].

<sup>12</sup> 15 U.S.C. 78p(b).

<sup>13</sup> The first sentence of Section 16(b) begins with “For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer [...]”

<sup>14</sup> E.g., Exchange Act Section 10(b) [15 U.S.C. 78j(b)] and Exchange Act Rule 10b-5 [17 CFR 240.10b-5].

<sup>15</sup> This type of remedy was described by its drafters as a “crude rule of thumb.” Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 1<sup>st</sup> Sess. Pt. 15,6557 (1934) (testimony of Thomas Corcoran as spokesman for the drafters of the Exchange Act).

sufficient likelihood of involving abuse of inside information that a strict liability prophylactic approach is appropriate.

Since the enactment of the Exchange Act, we have adopted a number of exemptive rules, including Rule 16b-3 – “Transactions between an issuer and its officers or directors,” and Rule 16b-7 – “Mergers, reclassifications, and consolidations.”<sup>16</sup> These exemptive rules provide that transactions that satisfy their conditions will not be subject to Section 16(b) short-swing profit recovery.

The recent opinion of the U.S. Court of Appeals for the Third Circuit (the “Third Circuit”) in Levy v. Sterling Holding Company, LLC. (“Levy v. Sterling”),<sup>17</sup> 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. At the outset of its analysis, the Third Circuit noted that Section 16(b) “explicitly authorizes” the Commission to exempt “any transaction . . . as not comprehended within the purpose of” the statute. “This section,” the Third Circuit pointed out, “is critical for courts defer to an agency’s interpretation of statutes, particularly where the statute provides the agency with the authority to make the interpretation.” The Third Circuit declared, therefore, that its “threshold challenge” was to “ascertain what in fact was [the Commission’s] interpretation” when it adopted Rules

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<sup>16</sup> Section 16(b) grants the Commission authority to exempt, by rules and regulations, “any transaction or transactions . . . not comprehended within the purpose of this subsection.” 15 U.S.C. §78p(b).

<sup>17</sup> 314 F.3d 106 (3d. Cir. 2002), cert. denied, Sterling Holding Co. v. Levy, 124 S. Ct. 389 (U.S., Oct. 14, 2003).

16b-3 and 16b-7.<sup>18</sup> Despite explicit interpretations to the contrary,<sup>19</sup> the Third 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 in the initial public offering.

In particular, the Levy v. Sterling opinion read Rules 16b-3 and 16b-7 to require satisfaction of conditions that were neither contained in the text of the rules nor intended by the Commission. The resulting uncertainty regarding the exemptive scope of these rules has made it difficult for issuers and insiders to plan legitimate transactions, and may discourage participation by officers and directors in issuer stock ownership programs or employee incentive plans. With the clarifying amendments to Rules 16b-3 and 16b-7 that we adopt today, we resolve any doubt as to the meaning and interpretation of these rules by reaffirming the views we have consistently expressed previously regarding their appropriate construction.<sup>20</sup> Consistent with our previously expressed views:

- the amendments to Rule 16b-3 clarify the regulatory conditions that have applied to transactions that rely on this exemption since its adoption effective August 15, 1996; and

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<sup>18</sup> 314 F.3d at 112 (citing Chevron, U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 843-44 (1984)). See also National Cable & Telecommunications v. Brand X Internet Service, \_\_\_ U.S. \_\_\_, 125 S.Ct. 2688, 2700 (June 27, 2005) (“A court’s prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.”)

<sup>19</sup> See discussion below.

<sup>20</sup> See the discussions of previous Commission releases in Sections II and III, below, and the Proposing Release. See also Memorandum of the Securities and Exchange Commission, Amicus Curiae, in Support of Appellees’ Petition for Rehearing or Rehearing En Banc (Feb. 27, 2003). This brief is posted at [www.sec.gov/litigation/briefs/levy-sterling022703.htm](http://www.sec.gov/litigation/briefs/levy-sterling022703.htm).

- the amendments to Rule 16b-7 clarify the regulatory conditions that have applied to transactions that rely on this exemption since it was amended effective May 1, 1991.<sup>21</sup>

These amendments are adopted substantially as proposed, with some language changes as discussed below.<sup>22</sup>

Item 405 of Regulations S-K and S-B requires issuer disclosure of Section 16 reporting delinquencies. This disclosure is required in the issuer's proxy or information statement<sup>23</sup> for the annual meeting at which directors are elected, and its Form 10-K,<sup>24</sup> 10-KSB<sup>25</sup> or N-SAR.<sup>26</sup> 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 Commission 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 we are amending Item 405 to rescind it, as proposed.

## **II. RULE 16b-3**

Rule 16b-3 exempts from Section 16(b) certain transactions between issuers of securities and their officers and directors. In its Levy v. Sterling opinion, the Third

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<sup>21</sup> We note in this regard that, consistent with the Administrative Procedure Act, the effective date of Rules 16b-3 and 16b-7 is less than 30 days after publication because the rule recognizes an exemption and contains interpretative rules. See 5 U.S.C. 553(d)(1) and (d)(2).

<sup>22</sup> See Section II below regarding Rule 16b-3 and Section III regarding Rule 16b-7.

<sup>23</sup> 17 CFR 240.14a-101, Item 7.

<sup>24</sup> 17 CFR 249.310.

<sup>25</sup> 17 CFR 249.310b.

<sup>26</sup> 17 CFR 249.330; 17 CFR 274.101.

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. Specifically, since “grants” and “awards” are compensation-related, the Third Circuit reasoned that “other acquisitions” also must be compensation-related in order to be exempted by Rule 16b-3(d). This construction of Rule 16b-3(d) is not in accord with our clearly expressed intent in adopting the rule.

The current version of Rule 16b-3 was adopted in 1996, and implemented substantial revisions designed to simplify the conditions that must be satisfied for the exemption to apply. In contrast to prior versions of Rule 16b-3, which had exempted only employee benefit plan transactions, the 1996 revisions broadened the Rule 16b-3 exemption and extended it to other transactions between issuers and their officers and directors. The revisions focused on the distinction between market transactions by officers and directors, which present opportunities for profit based on non-public information that Section 16(b) is intended to discourage, and transactions between an issuer and its officers and directors, which are subject to fiduciary duties under state law.<sup>27</sup> In adopting the revised rule, we explicitly stated 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.”<sup>28</sup>

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 Act if the

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<sup>27</sup> Exchange Act Release No. 36356 (Oct. 11, 1995) [60 FR 53832] (“1995 Proposing Release”).

<sup>28</sup> Exchange Act Release No. 37260 (May 31, 1996) [61 FR 30376] (“1996 Adopting Release”).

transaction satisfies the applicable conditions set forth in this section.” As this makes clear, the only limitations on the exemption for transactions between the issuer and its officer or director are the objective conditions set forth in later subsections of the rule, each of which applies to a different category of transactions.

As adopted in 1996, Rule 16b-3(d), entitled “Grants, awards and other acquisitions from the issuer,” exempted from Section 16(b) liability “Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction)”<sup>29</sup> if any one of three alternative conditions 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;<sup>30</sup>
- approval or ratification of the transaction, in compliance with Exchange Act Section 14,<sup>31</sup> by the issuer’s shareholders,<sup>32</sup> or

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<sup>29</sup> “Discretionary Transaction” is defined in Rule 16b-3(b)(1). Generally, a Discretionary Transaction is an employee benefit plan transaction that is at the volition of a plan participant and 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. However, the definition excludes such transactions that are made in connection with the 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. A Discretionary Transaction is exempted by Rule 16b-3 only if it satisfies the conditions of Rule 16b-3(f).

<sup>30</sup> Rule 16b-3(d)(1). “Non-Employee Director” is defined in Rule 16b-3(b)(3).

<sup>31</sup> 15 U.S.C. 78n.

<sup>32</sup> Rule 16b-3(d)(2). With respect to shareholder, board and Non-Employee Director committee approval, Rule 16b-3(d) requires approval in advance of the transaction. Shareholder approval must be by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of the majority of the securities of the issuer entitled to vote. Shareholder ratification, consistent with the same procedural conditions, may confer the exemption only if such ratification occurs no later than the date of the next annual meeting of shareholders following the transaction.

- the officer or director to hold the acquired securities for a period of six months following the date of acquisition.<sup>33</sup>

Consistent with the terms of Rule 16b-3 and statements in the 1996 Adopting Release and 1995 Proposing Release regarding the meaning of the rule, the Commission staff has interpreted the Rule 16b-3(d) exemption to include a number of transactions outside of the compensatory context, such as:

- the acquisition of acquiror equity securities (including derivative securities) by acquiror officers and directors through the conversion of target equity securities in connection with a corporate merger;<sup>34</sup> and
- an officer's or director's indirect pecuniary interest in transactions between the issuer and certain other persons or entities.<sup>35</sup>

The application of Rule 16b-3(d) to such transactions also has been recognized in Section 16(b) litigation. In its 2002 opinion in Gryl v. Shire Pharmaceuticals Group PLC,<sup>36</sup> 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. Although the securities acquired in Gryl were options, the Second Circuit's holding in no way relied upon a compensatory purpose. Instead, Gryl construed Rule 16b-3(d)(1) to require only that the transaction involve an acquisition of

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<sup>33</sup> Rule 16b-3(d)(3).

<sup>34</sup> Division of Corporation Finance interpretive letter to Skadden, Arps, Slate, Meagher & Flom LLP (Jan. 12, 1999).

<sup>35</sup> Division of Corporation Finance interpretive letter to American Bar Association (Feb. 10, 1999). The other persons or entities are immediate family members, partnerships, corporations and trusts, in each case where rules under Section 16(a) require the officer or director to report an indirect pecuniary interest in the transaction.

<sup>36</sup> 298 F.3d 136 (2d Cir. 2002).

issuer equity securities from the issuer, the acquirer be a director or officer of the issuer at the time of the transaction, and the transaction be approved in advance by the issuer's board of directors.<sup>37</sup>

To eliminate the uncertainty generated by the Levy v. Sterling opinion, we proposed to amend Rule 16b-3(d) so that this paragraph would be entitled "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. Because the exemptive conditions of Rule 16b-3(e), which exempts an officer's or director's disposition to the issuer of issuer equity securities, are identical to the advance approval conditions of Rule 16b-3(d)<sup>38</sup> and were intended to operate the same way, we proposed to clarify both rules consistently by adding a Note to Rule 16b-3.<sup>39</sup>

The majority of commenters addressing the Rule 16b-3 proposals, other than attorneys who represent plaintiffs in Section 16(b) cases, supported them. Most commenters stated that the proposals would accomplish the goal of clarifying the exemptive scope of Rule 16b-3 as the Commission originally intended the rule to apply, and would preclude the restrictive and unintended construction applied in the Levy v. Sterling opinion. Commenters generally expressed the view that the exemptive

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<sup>37</sup> Id. at 141. Rule 16b-3(d)(1) also permits approval by "a committee of the board of directors that is composed solely of two or more Non-Employee Directors." Gryl noted that "[t]hat aspect of the Board Approval exemption is not at issue in this appeal." Id. at n. 2.

<sup>38</sup> Although shareholder ratification after the transaction exempts an acquisition under Rule 16b-3(d), it does not exempt a disposition under Rule 16b-3(e).

<sup>39</sup> Proposed Note 4 stated that these exemptions apply to any securities transaction by the issuer with its officer or director that satisfies the specified conditions of Rule 16b-3(d) or Rule 16b-3(e), as applicable, and are not conditioned on the transaction being intended for a compensatory or other particular purpose.

conditions of Rule 16b-3(e) should remain identical to the Rule 16b-3(d)(1) or Rule 16b-3(d)(2) advance approval conditions. In response to our questions, most commenters also stated that it would not be appropriate to limit either Rule 16b-3(d) or Rule 16b-3(e) to transactions that have a compensatory purpose or to “extraordinary” transactions, such as the reclassification at issue in Levy v. Sterling. For example, one commenter stated that “the key consideration of the statute is the absence of the ability to take advantage of the other party on the basis of inside information.”<sup>40</sup>

Some commenters suggested, however, that it would be clearer that the exemptive scope of Rules 16b-3(d) and 16b-3(e) is not limited to transactions with a compensatory or other particular purpose if this were stated in the text of Rules 16b-3(d) and 16b-3(e) instead of a Note to Rule 16b-3.<sup>41</sup> We have decided to apply this suggested approach in the amendments as adopted.<sup>42</sup>

Rule 16b-3(d), as adopted, exempts any transaction, other than a Discretionary Transaction, involving an acquisition by an officer or director<sup>43</sup> 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 Rule’s three alternative conditions is satisfied. Rule 16b-3(e), as adopted, exempts any transaction, other than a Discretionary Transaction, involving the disposition by an officer or director to the issuer of issuer equity securities,

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<sup>40</sup> Letter of American Bar Association (Aug. 16, 2004).

<sup>41</sup> Letters of New York State Bar Association (Aug. 9, 2004) and Sullivan & Cromwell LLP (Aug. 9, 2004).

<sup>42</sup> We note, however, that the Notes to our rules are integral parts of our regulations.

<sup>43</sup> Note 4 as proposed referred to transactions by an officer or director satisfying the conditions of the rule. Because that language essentially mirrored language already contained in the text of Rule 16b-3(a) itself, we have not adopted that portion of proposed Note 4.

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 either Rule 16b-3(d)(1) or Rule 16b-3(d)(2).

In their comment letters, attorneys who represent plaintiffs in Section 16(b) cases (“the Section 16(b) Lawyers”) asserted that the premise that there is no opportunity for speculative abuse in transactions between an issuer and its officers and directors is faulty and without support.<sup>44</sup> This assertion is misplaced, however. As we explained in 1996, “[transactions between an issuer and its officers and directors] do not appear to present the same opportunities for insider profit on the basis of non-public information as do market transactions by officers and directors. Typically, where the issuer, rather than the trading markets, is on the other side of an officer or director’s transaction in the issuer’s equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute.”<sup>45</sup>

Section 16(b) specifically states that it is “for the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer.” This statement should be construed in light of the stated purpose of the Exchange Act, inter alia, “to insure the maintenance of fair and honest markets in [securities] transactions.”<sup>46</sup> As the Second Circuit stated in

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<sup>44</sup> Letter of Abraham Fruchter & Twersky LLP (Aug. 5, 2004); Letter of Bragar Wexler Eigel & Morgenstern, P.C. (Jul. 30, 2004); and Letter of Sirianni Youtz Meier & Spoonemore (Aug. 9, 2004).

<sup>45</sup> 1996 Adopting Release.

<sup>46</sup> Section 2 of the Exchange Act, 15 U.S.C. 78b.

Blau v. Lamb, “Section 16(b) helps to implement this overriding purpose by making it unprofitable for ‘insiders’ to engage in short-swing speculation.”<sup>47</sup>

The legislative history of Section 16(b) makes it clear that the “unfair use of information” that concerned Congress was insiders’ transactions with investors who were at an informational disadvantage. In a report summarizing the findings of its extensive investigation, the Senate Committee on Banking and Currency, in a section entitled “Market Activities of Directors, Officers, and Principal Shareholders of Corporations,” stated:

Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities.<sup>48</sup>

In construing Section 16(b), the Supreme Court has relied on a consistent understanding of Congressional intent:

Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public. By trading on this information, those persons could reap profits at the expense of less well informed investors. In Section 16(b) Congress sought to “curb the evils of insider trading [by] ... taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.”<sup>49</sup>

The purpose expressed in the legislative history and acknowledged in the judicial construction of Section 16(b) thus demonstrates that the exemptions provided by Rules 16b-3(d) and 16b-3(e), as adopted in 1996 and as clarified today, do not conflict with

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<sup>47</sup> Blau v. Lamb, 363 F.2d 507, at 514 (2d Cir. 1966).

<sup>48</sup> Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934).

<sup>49</sup> Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. 232 (1976), at 243 (quoting Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, at 422 (1972)). The Supreme Court quoted the same Reliance Electric Co. language in Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, at 592 (1972).

Section 16(b). As a different commenter observed, “Rule 16b-3 is entirely consistent with the intent of Congress in enacting Section 16(b), since it exempts only transactions involving parties on an equal footing from the standpoint of knowledge of inside information.”<sup>50</sup>

The Section 16(b) Lawyers also questioned our authority to adopt Rule 16b-3 and these clarifying amendments. Because Section 16(b) can be harsh in imposing liability without fault, “Congress itself limited carefully the liability imposed by Section 16(b),”<sup>51</sup> including by granting the Commission specific exemptive authority. By its terms, Section 16(b) provides that it does not cover “any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.” The legislative history explains that:

The expressed purpose of this provision is to prevent the unfair use of inside information. The Commission may exempt transactions not falling within this purpose.<sup>52</sup>

Insider trading is rooted in inequality of information between persons who are aware of it and the persons they transact with. The inequality of information contemplated by Section 16(b) generally does not exist when an officer or director acquires securities from, or disposes of them to, the issuer. In both the 1996 adoption of Rule 16b-3 and the clarifications adopted today, we carefully considered Congress’s purpose for enacting Section 16(b), and, in light of the strict remedy imposed by Section 16(b), whether the exempted transactions actually pose a significant risk of the abuses the

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<sup>50</sup> Letter of New York State Bar Association (Aug. 9, 2004).

<sup>51</sup> Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. at 252.

<sup>52</sup> S.Rep. No. 792, 73d Cong., 2d Sess., 21 (1934).

statute was concerned with. We concluded that it is not appropriate to impose Section 16(b) liability on the exempted acquisitions and dispositions because the risk of unfair use of information in these transactions is generally diminished.<sup>53</sup>

Because the transactions exempted by the rule are not of the type contemplated by the statute, our 1996 adoption of Rule 16b-3 and the clarifications adopted today clearly are within our specific exemptive authority provided by Section 16(b), as well as other statutory authority. We are clarifying our own rule and resolving any ambiguity that might exist. In addition to the specific exemptive authority provided by Section 16(b), the Commission also has authority under our general rulemaking authority in Section 23(a) of the Exchange Act<sup>54</sup> and general exemptive authority in Section 36 of the Exchange Act.<sup>55</sup>

The Section 16(b) Lawyers further asserted that this rulemaking is an unlawful attempt to engage in retroactive rulemaking, rather than a clarification. This assertion also is misplaced. The clarifications adopted today do not deprive issuers and

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<sup>53</sup> Of course, Section 16(b) is not the sole Exchange Act deterrent to insider trading. Moreover, the strict liability imposed by Section 16(b) is distinguishable from the prohibitions of Section 10(b) and Rule 10b-5 and the remedies that attach to violations of those prohibitions. In light of these distinctions, and the application of Section 10(b) and Rule 10b-5 to the transactions exempted by Rule 16b-3, the Rule 16b-3(d) and 16b-3(e) exemptions do not impair the protection of investors.

<sup>54</sup> In pertinent part, Section 23(a) authorizes the Commission “to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title ... or for the execution of the functions vested in [the Commission] by this title, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within [its] jurisdiction[], and prescribe greater, lesser, or different requirements for different classes thereof.”

<sup>55</sup> Section 36 generally provides that “the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.” For the reasons discussed in the Proposing Release and this release, the Commission believes that the Rule 16b-3 exemption (as well as the exemption in Rule 16b-7 discussed below) is necessary or appropriate in the public interest and is consistent with the protection of investors.

shareholders of short-swing profit recovery to which they were intended to be entitled. The clarifications are consistent with the terms of Rule 16b-3 and our statements in the 1996 Adopting Release regarding the scope of Rules 16b-3(d) and 16b-3(e),<sup>56</sup> and our amicus brief in Levy v. Sterling.<sup>57</sup> The clarifications also are consistent with the August 2002 construction of Rule 16b-3(d) by the U.S. Court of Appeals for the Second Circuit in Gryl v. Shire Pharmaceuticals Group PLC.<sup>58</sup> The clarifying nature of the amendments is not a sudden and unexplained change in our regulations (indeed, our interpretation has been consistent since the rule was adopted in 1996) and neither creates nor removes any rights or duties.

### **III. 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. 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

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<sup>56</sup> For example, the 1996 Adopting Release stated, with respect to Rule 16b-3(e), “In the context of a merger, the new rule will exempt the disposition of issuer equity securities (including derivative securities) solely to the issuer, provided the conditions of the rule are satisfied.”

<sup>57</sup> The clarifications also are consistent with staff interpretations of these rules. See text at nn. 34 and 35, above.

<sup>58</sup> See text at n. 37, above.

- 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 these 85% ownership tests. These transactions do not significantly alter in an economic sense the investment the insider held before the transaction.

While the Levy v. Sterling opinion acknowledged that Rule 16b-7 could exempt a reclassification, it 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 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 opinion thus imposed upon reclassifications exemptive conditions that are not found in the language of Rule 16b-7 and would not apply to a merger or consolidation relying upon the rule. Moreover, these conditions significantly restrict the exemption'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. Imposing these conditions is inconsistent with the terms of Rule 16b-7, the rule's interpretive history and the Commission's intent.

Although Rule 16b-7 as originally adopted in 1952 only applied to “mergers” and “consolidations,”<sup>59</sup> the Commission staff construed it as also applying to reclassifications. In a 1981 interpretive release, the staff stated that “Rule 16b-7 does not require that the security received in exchange be similar to that surrendered, and the rule can apply to transactions involving reclassifications.”<sup>60</sup> In 1991, the Commission amended the title of Rule 16b-7 to include “reclassifications,” explaining that this amendment was not intended to effect any “substantive” changes to the rule, and reaffirmed the staff statement in the 1981 Release that Rule 16b-7 applies to reclassifications.<sup>61</sup>

Although the rule as amended in 1991 did not contain specific standards for exempting reclassifications, the staff applied to reclassifications the same standards as for mergers and consolidations. In relevant respects a reclassification is little different from a merger exempted by Rule 16b-7. In a merger exempted by the rule, the transaction satisfies either 85% ownership standard, so that the merger effects no major change in the issuer’s business or assets. Similarly, in a reclassification the issuer owns all assets involved in the transaction and remains the same, with no change in its business or assets. The similarities are readily illustrated by the fact that an issuer also could effect a reclassification by forming a wholly-owned “shell” subsidiary, merging the issuer into the subsidiary, and exchanging subsidiary securities for the issuer’s securities.

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<sup>59</sup> Exchange Act Release No. 4696 (Apr. 3, 1952) [17 FR 3177] (proposing Rule 16b-7), and Exchange Act Release No. 4717 (Jun. 9, 1952) [17 FR 5501] (adopting Rule 16b-7).

<sup>60</sup> Exchange Act Release No. 18114 (Sept. 24, 1981) [46 FR 48147] (“1981 Release”), at Q. 142.

<sup>61</sup> Exchange Act Release No. 28869 (Feb. 8, 1991) [56 FR 7242] (“1991 Release”). More recently, in a 2002 proposing release we expressly described reclassifications as among the transactions exempted by Rule 16b-7. Exchange Act Release No. 45742 (Apr. 12, 2002) [67 FR 19914], at n. 56.

Consistent with the 1981 and 1991 Releases and our amicus brief in Levy v. Sterling, to eliminate uncertainty regarding Rule 16b-7 generated by the Levy v. Sterling opinion, we proposed to amend Rule 16b-7 so that, consistent with the rule’s title, the text states “merger, reclassification or consolidation” each place it previously stated “merger or consolidation.” To further clarify the rule’s consistent application, we proposed an additional paragraph to specify 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.<sup>62</sup>

The majority of commenters addressing the Rule 16b-7 proposals, other than the Section 16(b) Lawyers, supported them. Most commenters stated that the proposals would accomplish the goal of clarifying the exemptive scope of Rule 16b-7, and are consistent with our previous statements regarding the scope of this rule. We are adopting the Rule 16b-7 amendments as proposed.

Some commenters suggested that the rule should include a definition of “reclassification.” Other commenters suggested that the rule should exempt transactions that are substantively similar to reclassifications, and transactions in foreign jurisdictions that use different names, such as “amalgamations” or “schemes of arrangement,” that are substantively equivalent to transactions named in the rule.

In order to preserve flexibility to apply the rule appropriately to evolving forms of transactions, the rule as adopted does not define “reclassification.” However, 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

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<sup>62</sup> Rule 16b-7(c). Former Rule 16b-7(c) is redesignated as Rule 16b-7(d).

are replaced with securities of a different class or series of securities of the company,<sup>63</sup> and all holders of the reclassified class or series are entitled to receive the same form and amount of consideration per share. Rule 16b-7 also applies in such transactions where shareholders have the right to receive cash instead of stock by exercising their dissenters' appraisal rights, or the option to surrender their shares for stock or for cash in certain circumstances.<sup>64</sup>

These transactions, which do not involve a substantial change in the business owned, do not involve the holders' payment of consideration in addition to the reclassified class or series of securities, and have the same effect on all holders of the reclassified class or series, do not present insiders the significant opportunities to profit by advance information that Section 16(b) was designed to address. A transaction that has the same characteristics and effect as a reclassification, whether domestic or foreign, is exempt without regard to its formal name, including but not limited to a statutory exchange,<sup>65</sup> conversion to a different form of entity,<sup>66</sup> and redomicile or continuance in a different jurisdiction.<sup>67</sup> Similarly, a transaction that has the same characteristics and

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<sup>63</sup> For a transaction to be a reclassification exempted by Rule 16b-7, it is not necessary for the class or series of security that is surrendered to have been previously convertible into the class or series of security to be received.

<sup>64</sup> These respective factual circumstances were discussed in Division of Corporation Finance letters to Pan American World Airways, Inc. (May 28, 1984) and Public Service Electric and Gas Co. (Apr. 28, 1986).

<sup>65</sup> The staff has stated that "the acquisition and disposition of stock in a statutory exchange would be exempt under Rule 16b-7, assuming all of the conditions of the rule are satisfied." 1981 Release, at Q. 142.

<sup>66</sup> Some state statutes allow a corporation to convert to a different form of organization, such as a partnership, limited liability company or business trust, and vice versa, without merging into a newly-formed entity. See e.g., Del. Code Ann. Title 8 §§ 265 and 266.

<sup>67</sup> Some state statutes allow a corporation incorporated a different jurisdiction to register within the state and become a domestic corporation within the state, or continue as if incorporated in the state, without merging into a newly-formed entity. See e.g., Wyoming Statutes §§17-16-1701, 17-16-1702 and 17-16-1710.

effect as a merger or consolidation, whether domestic or foreign, is exempt without regard to its formal name, including but not limited to an amalgamation or scheme of arrangement.<sup>68</sup>

The exercise or conversion of a derivative security, however, is not exempted by Rule 16b-7, but instead must satisfy the conditions of Rule 16b-3 or Rule 16b-6(b). Similarly, a stock split, stock dividend, or the acquisition of shareholder rights is not exempted by Rule 16b-7, but instead must satisfy the conditions of Rule 16a-9.<sup>69</sup> The amendments adopted today do not change this analysis.

The comment letters of the Section 16(b) Lawyers also questioned our authority to apply Rule 16b-7 to reclassifications and to adopt these clarifying amendments, and asserted that this rulemaking is an unlawful attempt to engage in retroactive rulemaking, rather than a clarification. As our previous releases have explained, Rule 16b-7 is based on the premise that the exempted transactions are of relatively minor importance to the shareholders of a particular company and do not present significant opportunities to insiders to profit by advance information concerning the transaction. Indeed, as noted above, by satisfying either of the rule's 85% ownership tests, an exempted transaction

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<sup>68</sup> For example, Division of Corporation Finance interpretive letter to Manpower PLC (Mar. 14, 1991), expressing the view that Rule 16b-7 would exempt an exchange offer and subsequent compulsory acquisition that were the substantive equivalent of a merger, consolidation or sale of assets, recognized that "English law does not have the equivalent to a merger or consolidation statute." See also Division of Corporation Finance letter to Varsity Corporation (Oct. 15, 1981), expressing the staff's view that the acquisition and disposition of securities pursuant to an amalgamation would fall within the operation of Rule 16b-7.

<sup>69</sup> 17 CFR 240.16a-9.

does not significantly alter the economic investment held by the insider before the transaction.<sup>70</sup>

Exempting these transactions from Section 16(b) is consistent with Congressional intent that the Commission exempt transactions that do not fall within the statute's purpose of preventing the unfair use of inside information.<sup>71</sup> Because the form of insiders' holdings changes without affecting the substance of their interest in the issuer, it is not in accordance with the purpose of Section 16(b) to treat the transaction as involving a purchase or sale.<sup>72</sup> Further, the clarifications adopted today do not deprive issuers and shareholders of short-swing profit recovery to which they were intended to be entitled. The clarifications are consistent with our statements in adopting Rule 16b-7, and our amicus brief in Levy v. Sterling.<sup>73</sup> As with the Rule 16b-3 amendments adopted today, the clarifying nature of the Rule 16b-7 amendments is not a sudden and unexplained change in our regulations (indeed our interpretation has been consistent since at least 1991) and neither creates nor removes any rights or duties.

#### **IV. ITEM 405 OF REGULATIONS S-K AND S-B**

As noted above, issuers must disclose their insiders' Section 16 reporting delinquencies as required by Item 405 of Regulations S-K and S-B. Previously, Item 405(b)(1) provided that "a form received by the registrant within three calendar days of the required filing date may be presumed to have been filed with the Commission by the

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<sup>70</sup> See Exchange Act Release No. 4696, Exchange Act Release No. 4717, and the 1981 Release.

<sup>71</sup> As discussed above, the Commission has exemptive authority under Section 16(b). In addition, the Commission has general rulemaking authority in Section 23(a) of the Exchange Act and general exemptive authority in Section 36 of the Exchange Act. See nn. 54 and 55 and related text, above.

<sup>72</sup> Exchange Act Release No. 4696.

<sup>73</sup> The clarifications also are consistent with staff interpretations of this rule.

required filing date.” When Item 405 was adopted in 1991,<sup>74</sup> Form 4 was due within ten days after the close of the calendar month in which the reported transaction took place. Further, all Section 16 reports were filed on paper, since we did not permit insiders to file Section 16 reports electronically on EDGAR on a voluntary basis until 1995.<sup>75</sup>

However, the Sarbanes-Oxley Act of 2002<sup>76</sup> amended Section 16(a) to require two-business day reporting of changes in beneficial ownership, effective August 29, 2002.<sup>77</sup> The Sarbanes-Oxley Act also amended Section 16(a) to require insiders to file these reports electronically, and the Commission and issuers with corporate Web sites to post these reports on their Web sites not later than the end of the business day following filing.<sup>78</sup> We adopted rules to implement these requirements effective June 30, 2003.<sup>79</sup>

In adopting the Web site posting requirement, we noted that Rule 16a-3(e)<sup>80</sup> requires an insider, not later than the time a Section 16 report is transmitted for filing with the Commission, to send or deliver a duplicate to the person designated by the issuer to receive such statements, or absent such designation, to the issuer’s corporate secretary

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<sup>74</sup> Item 405 was adopted in the 1991 Release.

<sup>75</sup> Securities Act Release No. 7241 (Nov. 13, 1995) [60 FR 57682].

<sup>76</sup> P.L. No. 107-204, 116 Stat. 745.

<sup>77</sup> Section 16(a)(2)(C), as amended by Section 403 of the Sarbanes-Oxley Act. Effective on the same date, the Commission adopted rule amendments to implement the accelerated Form 4 due date. Exchange Act Release No. 46421 (Aug. 27, 2002) [67 FR 56462].

<sup>78</sup> Section 16(a)(4), as amended by Section 403 of the Sarbanes-Oxley Act.

<sup>79</sup> Securities Act Release No. 8230 (May 7, 2003) [68 FR 25788, with corrections at 68 FR 37044] (“Mandated EDGAR Release”). Recognizing that insiders may experience temporary difficulties in transitioning to mandated electronic filing, Section II.E of the Mandated EDGAR Release provided Item 405 disclosure relief for a Form 4 that is (i) filed not later than one business day following the regular due date, and (ii) filed during the first 12 months following the effective date of mandated electronic filing. This limited relief applies only to Forms 4 filed between June 30, 2003 and June 30, 2004.

<sup>80</sup> 17 CFR 240.16a-3(e).

or person performing equivalent functions. We stated that we would expect an issuer, in making this designation, also to designate an electronic transmission medium compatible with the issuer's own systems, so that a form sent by that medium at the time specified by Rule 16a-3(e) would be received by the issuer in time to satisfy the Web site posting deadline.<sup>81</sup>

In light of the Section 16(a) amendments enacted by the Sarbanes-Oxley Act, the presumption of timeliness for a Section 16(a) report received by the issuer within three calendar days of the required filing date no longer is appropriate or necessary. 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 Web site by the end of the business day following filing should not be presumed to have been timely filed. Accordingly, we proposed to amend Item 405 of Regulations S-K and S-B to delete the former three-calendar day presumption, without substituting a different presumption or otherwise modifying the substance of Item 405.

This proposal generated minimal comments, all of which were favorable. We adopt the amendments to Item 405 as proposed.

## **V. PAPERWORK REDUCTION ACT**

Forms 3 (OMB Control No. 3235-0104), 4 (OMB Control No. 3235-0287) and 5 (OMB Control No. 3235-0362) prescribe transaction and beneficial ownership

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<sup>81</sup> Mandated EDGAR Release at Section II.B. To assure that insiders are aware of the designated person and electronic transmission medium, we encouraged issuers to post this information on their Web sites together with the Section 16 filings. We also noted that the concern about timely obtaining an electronic copy of a filing would not arise for issuers that rely on a hyperlink (for example, to EDGAR) to satisfy their Web site posting requirement.

information that an insider must report under Section 16(a). Preparing and filing a report on any of these forms is a collection of information.

The clarifying amendments to Rule 16b-3 and Rule 16b-7 adopted today do not change the transaction and beneficial ownership information that insiders currently are required to report on these forms. We therefore believe that the overall information collection burden remains the same because the same information remains reportable.

The deletion of the Item 405 presumption of timeliness for a Section 16 report received by the issuer within three calendar days of the required filing date may result in some companies reporting more Section 16 reports as delinquent in their Forms 10-K (OMB Control No. 3235-0063), 10-KSB (OMB Control No. 3235-0420) or N-SAR (OMB Control No. 3235-0330), and proxy (OMB Control No. 3235-0059) or information statements (OMB Control No. 3235-0057) for the annual meeting at which directors are elected. However, we believe that any such increased collection burden associated with those filings will be so minimal that it cannot be quantified.

## **VI. COST-BENEFIT ANALYSIS**

The Rule 16b-3 and Rule 16b-7 amendments adopted today clarify existing rules. The Levy v. Sterling opinion created uncertainty whether Rules 16b-3 and 16b-7 exempt transactions that they previously were commonly understood to exempt, making it difficult for issuers to plan legitimate transactions in reliance on these rules. The amendments clarify the exemptive scope of Rules 16b-3 and 16b-7, consistent with statements in our previous releases and our amicus brief in Levy v. Sterling. Without such clarification, insiders may be exposed unnecessarily to significant potential costs to the extent that a private action under Section 16(b) recovers short-swing profits with

respect to a transaction that either of these rules was intended to exempt. These costs also include potential litigation costs, and costs incurred to postpone a legitimate non-exempt transaction, such as an initial public offering, more than six months following a transaction that properly is exempted by Rule 16b-3 or Rule 16b-7. The comments we received also noted increased legal costs to analyze the availability of an exemption,<sup>82</sup> and that the legal uncertainty generated by the Levy v. Sterling opinion affects a large percentage of U.S. public companies.<sup>83</sup>

Because the amendments clarify the exemptive scope of Rules 16b-3 and 16b-7 consistent with the terms of these rules and our previous statements, issuers and insiders will not incur additional costs to effect legitimate transactions in reliance on the rules as amended. Issuers and shareholders also will not incur additional costs because the amendments do not deprive issuers and shareholders of short-swing profit recovery to which they were intended to be entitled. Likewise, clarification of the rules should reduce litigation risk, and therefore costs, of some actions seeking short-swing profits.

Conversely, the amendments should improve the ability to plan legitimate transactions with a clear understanding whether they will be exempt under Rule 16b-3 or Rule 16b-7, thereby providing significant benefits. These benefits, like the costs, are difficult to quantify. The comments that we received did not quantify costs or benefits.

The amendment to Item 405 of Regulations S-K and S-B to delete the presumption of timeliness for a Section 16 report received by the issuer within three calendar days of the required filing date may result in some issuers reporting more

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<sup>82</sup> Letter of Goodwin Procter (Aug. 9, 2004).

<sup>83</sup> Letter of New York State Bar Association (Aug. 9, 2004).

Section 16 reports as delinquent in their Forms 10-K, 10-KSB or N-SAR, and their proxy or information statements for the annual meeting at which directors are elected.

However, Section 16 reports are posted on EDGAR, and thus are readily available to issuers to evaluate their timeliness. Further, because Section 16 requires an issuer to post a Section 16 report on its Web site by the end of the business day following filing, issuers are able to evaluate filing timeliness on an on-going basis. Consequently, deletion of the Item 405 timeliness presumption does not impose significant additional costs on issuers. The benefit of the amendment will be to provide investors with Item 405 disclosure that is fully consistent with accelerated reporting, mandatory electronic filing and Web site posting amendments to Section 16(a) effected by the Sarbanes-Oxley Act.

## **VII. EFFECT ON EFFICIENCY, COMPETITION AND CAPITAL FORMATION**

Section 23(a)(2) of the Exchange Act<sup>84</sup> requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Furthermore, Section 2(b) of the Securities Act,<sup>85</sup> Section 3(f) of the Exchange Act<sup>86</sup> and Section 2(c) of the Investment Company Act of 1940<sup>87</sup> require us, when engaging in rulemaking where we are required to consider or determine whether an

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<sup>84</sup> 15 U.S.C. 78w(a)(2).

<sup>85</sup> 15 U.S.C. 77b(b).

<sup>86</sup> 15 U.S.C. 78c(f).

<sup>87</sup> 15 U.S.C. 80a-2(c).

action is necessary or appropriate in the public interest, to consider whether the action will promote efficiency, competition, and capital formation.

The Levy v. Sterling opinion created uncertainty whether Rules 16b-3 and 16b-7 exempt transactions that the Commission intended to exempt, making it difficult for issuers to plan legitimate transactions in reliance on these rules. This uncertainty generated economic inefficiency by introducing potential litigation costs, and costs incurred to postpone a non-exempt transaction more than six months following a transaction that properly is exempted by Rule 16b-3 or Rule 16b-7.

The amendments clarify the exemptive scope of Rules 16b-3 and 16b-7, consistent with the terms of these rules, statements in our previous releases and our amicus brief in Levy v. Sterling. This will improve issuers' and insiders' ability to plan transactions with a clear understanding whether either rule will provide an exemption. Informed transactional decisions generally promote market efficiency and capital formation. We believe the amendments to Rules 16b-3 and 16b-7 will not impose a burden on competition. The amendment to Item 405 of Regulations S-K and S-B to delete the timeliness presumption also will not impose a burden, since issuers are readily able to evaluate the timeliness of Section 16 reports by examining the reports as filed on EDGAR.

In the proposing release, we requested comments on whether the proposed amendments, if adopted, would impose a burden on competition. We also requested comment on whether the proposed amendments, if adopted would promote efficiency, competition and capital formation. The comments we received suggested that adoption of the proposed amendments would eliminate a burden on competition, and promote

efficiency, competition and capital formation by eliminating legal uncertainty that makes it difficult to plan legitimate business transactions.<sup>88</sup> Finally, we requested commenters to provide empirical data and other factual support for their views, if possible. The comments we received noted that the legal uncertainty generated by the Levy v. Sterling opinion affects a large percentage of U.S. public companies.<sup>89</sup>

### **VIII. FINAL REGULATORY FLEXIBILITY ACT ANALYSIS**

We have prepared a Final Regulatory Flexibility Analysis, in accordance with 5 U.S.C. 603, concerning the amendments adopted today.

#### **A. Reasons for and Objectives of the Proposed Amendments**

The purpose of the amendments is to clarify the exemptive scope of Rules 16b-3 and 16b-7, and, consistent with the Sarbanes-Oxley Act amendments to Section 16(a), to delete the timeliness presumption in Item 405 of Regulations S-K and S-B.

#### **B. Legal Basis**

The amendments to Item 405 of Regulations S-K and S-B and Exchange Act Rules 16b-3 and 16b-7 are adopted pursuant to Section 19(a) of the Securities Act,<sup>90</sup>

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<sup>88</sup> Letter of Allen & Overy (Aug. 27, 2004), Letter of American Society of Corporate Secretaries (Aug. 9, 2004), and Letter of Securities Industry Association (Aug. 10, 2004).

<sup>89</sup> Letter of New York State Bar Association (Aug. 9, 2004).

<sup>90</sup> 15 U.S.C. 77s(a).

Sections 3(a)(11),<sup>91</sup> 3(a)(12),<sup>92</sup> 3(b),<sup>93</sup> 10(a),<sup>94</sup> 12(h),<sup>95</sup> 13(a),<sup>96</sup> 14,<sup>97</sup> 16, 23(a)<sup>98</sup> and 36<sup>99</sup> of the Exchange Act, Sections 17<sup>100</sup> and 20<sup>101</sup> of the Public Utility Holding Company Act of 1935, Sections 30<sup>102</sup> and 38<sup>103</sup> of the Investment Company Act of 1940, and Section 3(a)<sup>104</sup> of the Sarbanes-Oxley Act of 2002.

### **C. Significant Issues Raised by Public Comment**

The Initial Regulatory Flexibility Act Analysis (“IRFA”) appeared in the Proposing Release. We requested comment on any aspect of the IRFA, including the number of small entities that would be affected by the proposals, the nature of the impact, and how to quantify the impact of the proposals.

One commenter suggested that we extend the requirements of Section 16 to corporate insiders of publicly traded securities that are not registered under Section 12 of

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<sup>91</sup> 15 U.S.C. 78c(a)(11).

<sup>92</sup> 15 U.S.C. 78c(a)(12).

<sup>93</sup> 15 U.S.C. 78c(b).

<sup>94</sup> 15U.S.C. 78j(a).

<sup>95</sup> 15 U.S.C. 78l(h).

<sup>96</sup> 15 U.S.C. 78m(a).

<sup>97</sup> 15 U.S.C. 78n.

<sup>98</sup> 15 U.S.C. 78w(a).

<sup>99</sup> 15 U.S.C. 78jj .

<sup>100</sup> 15 U.S.C. 79q.

<sup>101</sup> 15 U.S.C. 79t.

<sup>102</sup> 15 U.S.C. 80a-29.

<sup>103</sup> 15 U.S.C. 80a-37.

<sup>104</sup> 15 U.S.C. 7202(a).

the Exchange Act,<sup>105</sup> an action that would affect many small entities. Such an extension of Section 16 was not the purpose of this rulemaking, which merely clarifies existing Rules 16b-3 and 16b-7 and amends Item 405. We did not receive other comments in response to our request.

#### **D. Small Entities Subject to the Amendments**

The proposed amendments affect companies that are small entities. Exchange Act Rule 0-10(a)<sup>106</sup> defines an issuer, other than an investment company, to be a “small business” or “small organization” if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 2,500 issuers, other than investment companies, that may be considered small entities. For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year. As of December 2004, we estimate that there were 28 registered closed-end investment companies, and 68 business development companies that are small entities. The Item 405 amendments apply to all of these small entities.

#### **E. Reporting, Recordkeeping and Other Compliance Requirements**

The amendments to Item 405 may impose additional disclosure requirements to the extent that issuers may be required to disclose additional untimely Section 16 filings by their insiders. However, we assume that this burden is very small, if it exists at all, because the changes effected by the Sarbanes-Oxley Act likely made the presumption irrelevant. No other new reporting, recordkeeping or compliance requirements are

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<sup>105</sup> Letter of Pink Sheets LLC (Sept. 27, 2004).

<sup>106</sup> 17 CFR 240.0-10(a).

imposed. Other than the potential additional Item 405 disclosure, the primary impact of these amendments relates to clarifying the exemptive scope of Rules 16b-3 and 16b-7, which should not have any new impact.

**F. Overlapping or Conflicting Federal Rules**

We do not believe that any current federal rules duplicate, overlap or conflict with the amendments.

**G. Significant Alternatives**

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant adverse impact on small businesses. We considered the following types of alternatives:

1. The establishment of different compliance or reporting requirements or timetables that take into account the resources available to small entities;
2. The clarification, consolidation or simplification of compliance and reporting requirements under the rule for such small entities;
3. The use of performance rather than design standards; and
4. An exemption from coverage of the rule, or any part thereof, for small entities.

Regarding Alternative 1, we believe that differing compliance or reporting requirements for small entities would be inconsistent with Section 16, the Commission's intent when it adopted these rules, and the Commission's purpose of making the application of these rules more uniform. Regarding Alternative 2, the amendments are concise and clarify the Rule 16b-3 and Rule 16b-7 exemptive conditions and amend the Item 405 reporting requirement for all entities, including small entities. Regarding Alternative 3, we believe that design rather than performance standards are appropriate

because use of performance standards for small entities would not be consistent with the statutory purpose of Section 16. Finally, an exemption for small entities is not appropriate because these amendments are designed to harmonize the application of the exemptive rules.

## **IX. STATUTORY BASIS**

The amendments contained in this release are adopted under the authority set forth in Section 19(a) of the Securities Act, Sections 3(a)(11), 3(a)(12), 3(b), 10(a), 12(h), 13, 14, 16, 23(a) and 36 of the Exchange Act, Sections 17 and 20 of the Public Utility Holding Company Act of 1935, Sections 30 and 38 of the Investment Company Act of 1940, and Section 3(a) of the Sarbanes-Oxley Act of 2002.

## **TEXT OF RULE AMENDMENTS**

### **List of Subjects in 17 CFR Parts 228, 229 and 240**

Reporting and recordkeeping requirements, Securities.

For the reasons set forth above, we amend title 17, chapter II of the Code of Federal Regulations as follows.

### **PART 228 – INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS**

1. The authority citation for Part 228 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350.

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2. Amend §228.405 by revising the introductory text to paragraph (a), paragraph (a)(2) and paragraph (b) to read as follows:

**§228.405 (Item 405) Compliance With Section 16(a) of the Exchange Act.**

\* \* \* \* \*

(a) Based solely upon a review of Forms 3 and 4 (17 CFR 249.103 and 249.104) and amendments thereto furnished to the registrant under 17 CFR 240.16a-3(e) during its most recent fiscal year and Forms 5 and amendments thereto (17 CFR 249.105) furnished to the registrant with respect to its most recent fiscal year, and any written representation referred to in paragraph (b)(1) of this section:

\* \* \* \* \*

(2) For each such person, set forth the number of late reports, the number of transactions that were not reported on a timely basis, and any known failure to file a required Form. A known failure to file would include, but not be limited to, a failure to file a Form 3, which is required of all reporting persons, and a failure to file a Form 5 in the absence of the written representation referred to in paragraph (b)(1) of this section, unless the registrant otherwise knows that no Form 5 is required.

\* \* \* \* \*

(b) With respect to the disclosure required by paragraph (a) of this section, if the registrant:

(1) Receives a written representation from the reporting person that no Form 5 is required; and

(2) Maintains the representation for two years, making a copy available to the Commission or its staff upon request, the registrant need not identify such reporting

person pursuant to paragraph (a) of this section as having failed to file a Form 5 with respect to that fiscal year.

**PART 229 – STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 – REGULATION S-K**

3. The authority citation for Part 229 continues to read, in part, as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c, 78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 79e, 79j, 79n, 79t, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

4. Amend §229.405 by revising the introductory text to paragraph (a), paragraph (a)(2) and paragraph (b) to read as follows:

**§229.405 (Item 405) Compliance with section 16(a) of the Exchange Act.**

\* \* \* \* \*

(a) Based solely upon a review of Forms 3 and 4 (17 CFR 249.103 and 249.104) and amendments thereto furnished to the registrant under 17 CFR 240.16a-3(e) during its most recent fiscal year and Forms 5 and amendments thereto (17 CFR 249.105) furnished to the registrant with respect to its most recent fiscal year, and any written representation referred to in paragraph (b)(1) of this section.

\* \* \* \* \*

(2) For each such person, set forth the number of late reports, the number of transactions that were not reported on a timely basis, and any known failure to file a

required Form. A known failure to file would include, but not be limited to, a failure to file a Form 3, which is required of all reporting persons, and a failure to file a Form 5 in the absence of the written representation referred to in paragraph (b)(1) of this section, unless the registrant otherwise knows that no Form 5 is required.

\* \* \* \* \*

(b) With respect to the disclosure required by paragraph (a) of this section, if the registrant:

(1) Receives a written representation from the reporting person that no Form 5 is required; and

(2) Maintains the representation for two years, making a copy available to the Commission or its staff upon request, the registrant need not identify such reporting person pursuant to paragraph (a) of this section as having failed to file a Form 5 with respect to that fiscal year.

**PART 240 – GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

5. The authority citation for Part 240 continues to read, in part, as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

6. Amend §240.16b-3 by revising the introductory text of paragraph (d) and paragraph (e) to read as follows:

**§240.16b-3 Transactions between an issuer and its officers or directors.**

\* \* \* \* \*

(d) Acquisitions from the issuer. Any transaction, other than a Discretionary Transaction, involving an acquisition from the issuer (including without limitation a grant or award), whether or not intended for a compensatory or other particular purpose, shall be exempt if:

\* \* \* \* \*

(e) Dispositions to the issuer. Any transaction, other than a Discretionary Transaction, involving the disposition to the issuer of issuer equity securities, whether or not intended for a compensatory or other particular purpose, shall be exempt, provided that the terms of such disposition are approved in advance in the manner prescribed by either paragraph (d)(1) or paragraph (d)(2) of this section.

\* \* \* \* \*

7. Section 240.16b-7 is revised to read as follows:

**§240.16b-7 Mergers, reclassifications, and consolidations.**

(a) The following transactions shall be exempt from the provisions of section 16(b) of the Act:

(1) The acquisition of a security of a company, pursuant to a merger, reclassification or consolidation, in exchange for a security of a company that before the merger, reclassification or consolidation, owned 85 percent or more of either:

(i) The equity securities of all other companies involved in the merger, reclassification or consolidation, or in the case of a consolidation, the resulting company;  
or

(ii) The combined assets of all the companies involved in the merger, reclassification or consolidation, computed according to their book values before the merger, reclassification or consolidation as determined by reference to their most recent available financial statements for a 12 month period before the merger, reclassification or consolidation, or such shorter time as the company has been in existence.

(2) The disposition of a security, pursuant to a merger, reclassification or consolidation, of a company that before the merger, reclassification or consolidation, owned 85 percent or more of either:

(i) The equity securities of all other companies involved in the merger, reclassification or consolidation or, in the case of a consolidation, the resulting company;  
or

(ii) The combined assets of all the companies undergoing merger, reclassification or consolidation, computed according to their book values before the merger, reclassification or consolidation as determined by reference to their most recent available financial statements for a 12 month period before the merger, reclassification or consolidation.

(b) A merger within the meaning of this section shall include the sale or purchase of substantially all the assets of one company by another in exchange for equity securities which are then distributed to the security holders of the company that sold its assets.

(c) The exemption provided by this section applies to any securities transaction that satisfies the conditions specified in this section and is not conditioned on the transaction satisfying any other conditions.

(d) Notwithstanding the foregoing, if a person subject to section 16 of the Act makes any non-exempt purchase of a security in any company involved in the merger, reclassification or consolidation and any non-exempt sale of a security in any company involved in the merger, reclassification or consolidation within any period of less than six months during which the merger, reclassification or consolidation took place, the exemption provided by this section shall be unavailable to the extent of such purchase and sale.

By the Commission.

Jill M. Peterson  
Assistant Secretary

August 3, 2005