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Ownership Reports and Trading By Officers, Directors and Principal Security Holders

AGENCY: Securities and Exchange Commission.

ACTION: Final rules and solicitation of comments.

SUMMARY: The Commission today is adopting amendments to its rules and forms, as well as related disclosure requirements for issuers, regarding the filing of ownership reports by officers, directors, and principal security holders, and the exemption of certain transactions by those persons from the short-swing profit recovery provisions of section 16 of the Securities Exchange Act of 1934 and related provisions of the Investment Company Act of 1940 and the Public Utility Holding Company Act of 1935. The amendments are intended to achieve greater clarity, enhance consistency with the statutory purpose, and improve compliance with the reporting provisions of the rules. The Commission also is soliciting further public comments on the addition of an exit box to Forms 4 and 5.

EFFECTIVE DATE: These amendments are effective May 1, 1991; however, special phase-in provisions are contained in Section VII of this release.

Comment date: Comment letters on the exit box on Forms 4 and 5 should be received on or before March 31, 1991.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth St., NW., Washington, DC 20549. Comments should refer to File No. S7-3-91. All comments received will be available for public inspection and copying in the Commission's Public Reference Room at the same address.

FOR FURTHER INFORMATION CONTACT: Brian J. Lane, Richard P. Konrath, Mark W. Green, or Emanuel D. Strauss, (202) 272-2573, Division of Corporation Finance; Dorothy Donohue (202) 272-2030, Division of Investment Management; or Joanne Rutkowski (202) 504-2267 with respect to the Public Utility Holding Company Act.

SUPPLEMENTARY INFORMATION: The Commission today announced the adoption of revisions to its rules promulgated under section 16 [1] of the Securities Exchange Act of 1934 ("Exchange Act").[2] Every rule under section 16 has been amended, deleted, or reorganized except for Rule 16e-1,[3] and several new Section 16 rules have been added. Further, Exchange Act Rule 12h-2 [4] has been deleted as obsolete and Rule 30f-1 [5] under the Investment Company Act of 1940 ("Investment Company Act") [6] has been amended.

In addition, new Item 405 of Regulation S-K [7] and new Form 5 have been adopted, as have changes to Schedule 14A [8] and Forms 10-K,[9] 3,[10] 4 [11] and N-SAR.[12]

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I. Executive Summary

The beneficial ownership reporting and short-swing profit recovery provisions of section 16 of the Exchange Act apply to every person who is directly or indirectly the beneficial owner of more than ten percent of any class of equity securities that is registered pursuant to section 12 of the Exchange Act ("ten percent holders"),[13]

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[1] 15 U.S.C. 78p (1988).

[2] 15 U.S.C. 78a *et seq.* (1988).

[3] 17 CFR 240.16e-1.

[4] 17 CFR 240.12h-2.

[5] 17 CFR 270.30f-1.

[6] 15 U.S.C. 80a-1 *et seq.* (1988).

[7] 17 CFR 229.10—229.802.

[8] 17 CFR 240.14a-101.

[9] 17 CFR 249.310.

[10] 17 CFR 249.103.

[11] 17 CFR 249.104.

[12] 17 CFR 274.101.

[13] 15 U.S.C. 78l (1988). When referring to an issuer with securities registered under section 12, this release includes securities of closed-end investment companies subject to section 30(f) of the Investment Company Act (15 U.S.C. 80a-29(f) (1988)) and public utility holding companies subject to Section 17 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 79q (1988)). The insiders of a closed-end investment company also include the adviser and any affiliated person of the adviser. Section 2(a)(3) of the Investment Company Act (15 U.S.C. 80a-2(a)(3) (1988)).

and to every director and officer of an issuer with a class of equity securities so registered.[14] Section 16 of the Exchange Act was designed to provide the public with information on securities transactions and holdings of corporate insiders and to deter insiders from speculative short-swing trading in their corporations' securities and from engaging in transactions in their corporations' securities while in possession of material, non-public information. Section 16 is but one weapon against insider trading. Unlike other provisions applicable to insider trading, such as sections 10(b),[15] 14(e) [16] and 21A [17] of the Exchange Act, section 16 is a strict liability provision under which an insider's short-swing profits can be recovered regardless of whether the insider actually was in possession of material, non-public information.

In response to developments in the trading of derivative securities, the growth of complex and diverse employee benefit plans, and substantial filing delinquencies, the Commission undertook a comprehensive review of the rules and forms under section 16. Noting that the regulatory framework had resulted in interpretive uncertainty, substantial litigation, and, in some instances, unnecessary regulatory burdens, the Commission proposed to revise the rules to achieve greater clarity, rescind unnecessary requirements, streamline mandated procedures, increase compliance with the reporting provisions of the rules, and enhance consistency with the statutory purposes of section 16.

The Commission initially proposed comprehensive revisions to the rules promulgated pursuant to section 16 in December 1988; 271 comment letters were received.[18] In response to comments, the Commission revised the proposed amendments and republished the rules for comment in August 1989; 211 comment letters were submitted in response to the reproposal.[19] For the reasons provided in the Proposing and Reproposing Releases, and as further explained in this release, the Commission today is adopting the proposed regulatory scheme, with a number of modifications in response to comments made on the reproposal.

Rule 16b-3, the employee benefit plan rule, has been modified in several respects from that reproposed. The shareholder approval condition to the exemption, applicable to issuer grant plans and other plans unable to satisfy the conditions of former Rule 16a-8,[20] has been retained. The reproposed extension of the required period of disinterested status for plan administrators to one year following the administration of a plan has not been adopted. In response to comments, Rule 16b-3 has been reorganized to clarify the application of the regulatory framework to transactions under broad-based, non-discriminatory plans and the availability of the intra-plan transaction exemption for elections and transactions within a participant-directed plan. The revisions are intended to facilitate compliance with Rule 16b-3 by section 401(k) plans [21] and other similar broad-based participant-directed plans.

In addition to the revisions addressing employee benefit plans, revisions have been made to modify the reproposed conditions under which a trust becomes subject to section 16 where it has an insider trustee; specify the extent of insiders' obligations to disclose on the first Form 5 unreported transactions and holdings that should have been reported prior to the effective date of the rules; delete the former exemption for surrenders of options in a merger as unnecessary; provide a reporting as well as a short-swing profit exemption for non-events such as pro rata stock splits, stock dividends, and similar grants; add an exit box to Forms 4 and 5; add a provision deeming a Form 3, 4 or 5 timely filed if delivered to a third party business that guarantees delivery to the Commission no later than the due date; and clarify the application of the rules to specific situations.[22] Comment is solicited on the exit box, as discussed in section II.C.2 below.

II. Section 16(a) Reporting

A. Who Must Report

1. Officers and Directors

The definition of "officer" has been adopted without substantive change from the reproposal. It is modeled after the definition of "executive officer" used elsewhere in the Exchange Act rules,[23] but also specifically includes principal financial officers and principal accounting officers (or controllers where there is no principal accounting officer), as well as officers of a parent having policy-making functions with respect to the issuer.[24] Thus, persons having policy-making duties, as specified under Rule 3b-7, will be deemed officers for purposes of section 16.[25] A person's title alone should not determine whether that person is subject to section 16; the proper focus should be on whether a person is "a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions." [26] If title were determinative, persons with executive functions could avoid responsibility by forgoing title; moreover, persons with officer titles but no significant managerial or policy-making duties would be subject to the draconian

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[14] Officers, directors, and ten percent holders are referred to throughout this release as "insiders." The term also includes an officer or director who has terminated officer or director status but continues to be subject to reporting under section 16 for six months following his or her last transaction as an officer or director, including the Form 5 filing requirement.

[15] 15 U.S.C. 78j(b) (1988).

[16] 15 U.S.C. 78n(e) (1988).

[17] 15 U.S.C. 78u(a)(1) (1988).

[18] Release No. 34-26333 (December 2, 1988) (53 FR 49997) ("Proposing Release"). The comment letters and a staff summary of the letters may be inspected and copied at the Commission's Public Reference Room (File No. S7-26-88).

[19] Release No. 34-27148 (August 18, 1989) (54 FR 35667) ("Reproposing Release"). The comment letters and a staff summary of the letters may be inspected and copied at the Commission's Public Reference Room (File No. S7-23-89).

[20] 17 CFR 240.16a-8.

[21] I.R.C. 401(k) (26 U.S.C. 401(k) (1988)).

[22] Section VIII, *infra*, contains charts summarizing the changes from the former rules, as well as a chart summarizing changes in staff interpretations enumerated in the section 16 question-and-answer interpretive release, Exchange Act Release No. 18114 (September 24, 1981) (46 FR 48147) ("Release No. 34-18114").

[23] Rule 3b-7 (17 CFR 240.3b-7). The term includes presidents, vice-presidents in charge of a principal business unit, division or function, other persons who perform similar policy-making functions, and executive officers of subsidiaries who perform policy-making functions for the registrant. A technical change is being made to this rule to correct a typographical error.

[24] Rule 16a-1(f). A note has been added to the rule that makes it clear that those persons identified by an issuer as meeting the policy-making definition pursuant to Item 401(b) of Regulation S-K (17 CFR 229.401) (based on the Rule 3b-7 definition) will be presumed to be those persons who, together with the other persons specified in Rule 16a-1(f), are subject to section 16, and the note makes it clear that the term "policy-making function" does not include functions that are not significant. The rule as adopted also clarifies that when an issuer with equity securities registered under section 12 is structured as a trust, employees of the trustee performing policy-making functions with respect to the trust are deemed officers of the trust.

[25] *See C.R.A. Realty Corp.* v. *Crotty*, 878 F.2d 562 (2d Cir. 1989); *Colby* v. *Klune*, 178 F.2d 872 (2d Cir. 1949); *see also Merrill Lynch, Pierce Fenner & Smith, Inc.* v. *Livingston*, 566 F.2d 1119 (9th Cir. 1978); *Pier I Imports of Georgia, Inc.* v. *Wilson*, 529 F. Supp. 239 (N.D. Tex. 1981); *but see National Medical Enterprises, Inc.* v. *Small*, 680 F.2d 83 (9th Cir. 1982).

[26] *Colby* v. *Klune*, *supra* 178 F.2d at 873, *as quoted in C.R.A. Realty Corp.* v. *Crotty*, *supra*, 878 F.2d at 566.

liability of section 16(b). Similarly, in determining whether an advisory, emeritus or honorary director is a director for section 16 purposes, the person's title is not determinative and no change in current staff interpretation is being made.[27]

2. Transactions While not an Officer or Director

Rule 16a-2(a) is adopted substantially as reproposed. Thus, a person will not be required to disclose transactions or be subject to section 16(b) short-swing profit liability for transactions that occurred within six months prior to the date the individual first became an officer or director, except that an officer or director who becomes subject to section 16 as a result of the issuer's registration of a class of equity securities pursuant to section 12 of the Exchange Act will be subject to section 16 with respect to transactions conducted during the six months prior to the first transaction requiring a Form 4 filing.[28]

In contrast, consistent with the prior rules,[29] transactions by officers and directors after termination of employment with an issuer are not necessarily exempt from section 16. In response to commenters' concerns, the rule makes it clear that, as is currently the case, an insider continues to be subject to section 16 for up to six months following termination. However, a transaction occurring after a person has terminated insider status must be reported only if it occurs within six months of a transaction that took place while the person was an officer or director.[30] As a result, a person is required to file on Form 4 to report non-exempt transactions within six months of the last transaction while the person was an officer or director subject to Section 16. In addition, the person is required to file on Form 5 to report transactions on a deferred basis for that portion of the issuer's fiscal year during which the person was an officer or director subject to section 16, and also is required to report exempt transactions occurring within six months of the last transaction while the person was an officer or director subject to section 16.

For example, if an insider executes a transaction on April 28 and terminates officer or director status on April 30, any transaction executed on or before October 28 must be reported, since it occurred within six months following the last transaction prior to termination of officer or director status. If, in this example, the insider filed a Form 5 in June to report exempt acquisitions and dispositions in an employee benefit plan, and in September exercised an option previously granted and reported on a Form 5, the insider must file another Form 5 (or an optional Form 4) to report the exercise, since it occurred within six months following the last transaction prior to termination of officer or director status. In addition, the insider should indicate on the Form 4 or 5 reporting the exercise that insider status has terminated.[31] Where all prior transactions, including transactions otherwise reportable on Form 5, have been reported, and the insider has not had any transactions, including transactions exempt from Section 16(b), in the six months prior to termination, there is no Form 5 filing obligation or other post-termination reporting obligation. In this case, the insider may wish to furnish the issuer with a written representation that no further report on Form 5 is required.

3. Ten Percent Holder

Section 16, as applied to ten percent holders, is intended to reach those persons who can be presumed to have access to inside information because they can influence or control the issuer as a result of their equity ownership. Section 13(d) of the Exchange Act[32] specifically addresses such relationships. As proposed, the rules adopted today[33] define ten percent holders under section 16 as persons deemed ten percent holders under section 13(d) of the Exchange Act and the rules thereunder. The section 13(d) analysis, such as the exclusion of non-voting securities[34] and counting only those derivative securities exercisable or convertible within 60 days,[35] are imported into the ten percent holder determination for section 16 purposes.[36] The section 13(d) definition of beneficial ownership is used only to determine status as a ten percent holder; once status is determined, the reporting and short-swing profit provisions of section 16 apply only to those securities in which the insider has a pecuniary interest.[37]

Under the rule, adopted as reproposed, shares held by institutions eligible to file beneficial ownership reports on Schedule 13G[38] that are held for clients in a fiduciary capacity in the ordinary course of business are not counted for purposes of determining ten percent holder status ("13G exemption").[39] This is a limited

[27] As stated in the Proposing Release, the legal doctrine concerning "deputized" directors is not affected by the rules adopted today and will be left to case law. *See, e.g., Blau* v. *Lehman*, 368 U.S. 403 (1962); *Feder* v. *Martin Marietta*, 406 F.2d 260 (2d Cir. 1969).

[28] For example, a director of a private company purchases common stock in the company on January 1 and March 1. The company registers a class of equity securities under section 12 effective May 1. The director then sells the stock on August 1. The sale is required to be reported on Form 4, triggering the requirement to report any transactions conducted within six months of the first transaction requiring a filing. The purchase made on March 1 would be disclosed because it was conducted within six months of the sale, but the purchase made on January 1 need not be disclosed because it occurred more than six months prior to the sale. In addition, the March 1 purchase could be matched with the August 1 sale for short-swing profit recovery purposes, absent an exemption from section 16(b).

[29] Former Rule 16a-1(e) (17 CFR 240.16a-1(e)); Release 34-18114 Q.35.

[30] Rule 16a-2(b). Transactions occurring after a reduction in beneficial ownership of an issuer's securities to ten percent or less would not be a reportable event, if the person is not also an officer or director, since section 16(b) explicitly provides that short-swing transactions can occur only if there is both a sale and purchase within six months while the person beneficially owned more than ten percent of the issuer. *Foremost-McKesson, Inc.* v. *Provident Securities Co.*, 423 U.S. 232 (1976); *see also* Rule 16a-2(c).

[31] Both Form 4 and Form 5 have an exit box on the face of the Form that should be checked. *See* II.C.2, *infra*. If the exit box is checked to reflect termination of insider status and a subsequent transaction necessitates another filing, the exit box should also be checked on the subsequent filing.

[32] 15 U.S.C. 78m(d) (1988).

[33] Rule 16a-1(a)(1). For a discussion of the application of Section 16 to section 13(d) groups, *see* Section II.B.3, *infra*.

[34] Rule 13d-1(d) (17 CFR 240.13d-1(d)).

[35] Rule 13d-3(d)(1) (17 CFR 240.13d-3(d)(1)).

[36] With respect to derivative securities, Rule 16a-4(a) states that derivative securities are deemed to be the same class of equity securities as the underlying securities. This essentially codifies the holding in *Chemical Fund* v. *Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967). Accordingly, a holder of section 12 debt convertible into Section 12 common stock would not consider the debt itself in the ten percent owner calculation, but rather would consider only the common stock into which the debt was convertible within 60 days.

In contrast to convertible debt, a security that is an equity security in its own right, as well as on account of a conversion feature, would require a double calculation. For example, if a class of voting preferred stock registered under section 12 is convertible into section 12 common stock, the beneficial owner of the preferred stock is deemed the owner of both the preferred stock and the underlying common stock. Accordingly, the ten percent holder calculation must be performed with respect to the preferred stock and the common stock separately. If the convertible preferred stock is non-voting, the preferred stock is not considered a separate class of equity for purposes of the ten percent holder calculation, because Rule 13d-3(d)(1) excludes non-voting securities; therefore, the beneficial owner of the non-voting preferred stock, like a holder of convertible debt, performs the ten percent holder calculation only with respect to the underlying common stock.

[37] Rule 16a-1(a)(2).

[38] 17 CFR 240.13d-102. In order to qualify to use Schedule 13G, the institution must acquire or hold securities of the issuer in the ordinary course of business without the purpose or effect of influencing or changing control. Rule 13d-1(b)(1)(i) (17 CFR 240.13d-1(b)(1)(i)).

[39] Rule 16a-1(a)(1). The rule is modeled after Rule 13d-1(b)(1)(ii) (17 CFR 240.13d-1(b)(1)(ii)).

Continued

departure from the approach under section 13(d). Securities not held in a fiduciary capacity, however, must be counted in determining whether the 13G institution is a ten percent holder. Questions have been raised as to the applicability of the 13G exemption to employee benefit plans and pension funds subject to the Employee Retirement Income Security Act of 1974 ("ERISA").[40] Consistent with current staff interpretation of Section 13(d),[41] a plan will not be deemed the beneficial owner of shares allocated to plan participants over which participants have voting power.[42]

B. What Is Reported—Transactions in Securities in Which Insider has Pecuniary Interest

1. Pecuniary Interest

Section 16(a) reporting obligations and section 16(b) short-swing profit recovery cover only those securities in which insiders have or share a direct or indirect pecuniary interest.[43] The definition of pecuniary interest is adopted as reproposed, with the following modifications to the application of the indirect pecuniary interest standard.

a. *Partnership Holdings.* Under the partnership attribution rule, adopted as reproposed, the beneficial ownership of portfolio securities [44] owned by a general or limited partnership is attributed to the general partners in proportion to the greater of their capital account or interest in the profit of the partnership at the time of the transaction.[45] In the event of a short-swing transaction, a general partner's share of the partnership's capital account or profits is determined by the partnership agreement in effect at the time of the transaction and the partnership's most recent financial statements.

b. *Fee Arrangements.* In the Reproposing Release, the Commission proposed that investment adviser or trustee fee arrangements based on the performance of the portfolio would create a pecuniary interest in the portfolio, except where the fee was calculated on an annual or longer basis and the securities of the issuer did not comprise more than ten percent of the portfolio.[46] Commenters expressed concern that the rule inadvertently implied that fees based upon the amount of assets managed would create a pecuniary interest and that advisers and trustees could not be paid until the end of the year. The rules adopted today clarify that asset-based fees do not create a pecuniary interest in the securities managed and that advisers or trustees may be paid more than once during the year, as long as the fee is related to performance for a year or more.

c. *Corporate Holdings.* A non-exclusive safe harbor governing beneficial ownership of portfolio securities held by a corporation or similar entity [47] has been adopted. The rule adopted today [48] provides a safe harbor from attribution of corporate holdings for shareholders who are not controlling shareholders [49] of the corporation and do not have or share investment control over the corporation's portfolio securities. Unlike the reproposal, the safe harbor does not extend to controlling shareholders and, therefore, the rule does not distinguish between public and nonpublic corporations.

2. Broad-based Stock Indices and Baskets

A new provision has been added to make it clear that beneficial ownership of a broad-based, publicly traded market basket or index security or future does not create a beneficial ownership interest in the component stocks.[50] This provision clarifies that in such a case, the pecuniary interest in one component stock is too remote for the stock to be considered beneficially owned.[51]

3. Section 13(d) Groups

Questions have been raised concerning the application of the reporting and short-swing profit recovery provisions of section 16 to section 13(d) groups.[52] In applying the rules adopted today, only those securities in which a member of a group has a direct or indirect pecuniary interest would be reported and subject to short-swing profit recovery.[53] Thus, while securities holdings of group members may subject the group members to section 16, if the group member does not have or share a pecuniary interest in securities held by other group members, the transactions of the other group members do not create section 16 obligations for that member.[54]

Institutions eligible to use the 13G exemption include specified broker-dealers, banks, insurance companies, investment companies, investment advisers, employee benefit plans, holding companies, and groups consisting of these exempt institutions. Whereas the reproposed rule made reference to Rule 13d-1 (17 CFR 240.13d-1), the rule as adopted enumerates the eligible institutions. It is noted that although securities in life insurance company separate accounts are deemed assets of the insurance company under state law, these assets are held for the exclusive benefit of customer annuitants in a manner comparable to other fiduciary institutions referenced in the rule. Thus, for purposes of section 16, insurance accounts held for the exclusive benefit of customers may be treated, where appropriate, as fiduciary accounts and excluded from the determination as to whether the insurance company is a ten percent holder for purposes of section 16.

[40] Public Law No. 93-406, 88 Stat. 829 (29 U.S.C. 1001 *et seq.* (1988)).

[41] *See Rio Grande Industries, Inc.* (April 5, 1989).

[42] Rule 16a-1(a)(1). A plan trustee's residual or overriding voting or investment control, pursuant to its legally imposed fiduciary duty to act in the best interests of the plan trust beneficiaries under Title I of ERISA, does not create a beneficial ownership interest under Rule 16a-1(a)(1) in securities that are allocated to plan participants having voting power. In addition, a plan trustee does not become a beneficial owner under Rule 16a-1(a)(1) where the trustee gains limited voting authority, such as in circumstances where a plan participant does not give the trustee voting instructions and the trustee must exercise voting power on behalf of the participant. *Compare Rio Grande Industries, Inc., supra* n. 41. Note that while the plan itself has beneficial ownership of unallocated shares over which the trustee has voting or investment power, employee benefit plan trustees that are institutions enumerated in the rule typically would not have beneficial ownership of those shares because they are held in a fiduciary account in the ordinary course of business. For a discussion of trusts, *see* Section II.B.4, *infra.*

[43] Rule 16a-1(a)(2). Rule 16a-8 addresses trust beneficial ownership. Rule 16a-1(a)(4) permits a disclaimer of beneficial ownership to accompany any reported transaction or holding, even where beneficial ownership is deemed to exist under the rules.

[44] The definition of "portfolio securities" has been moved to Rule 16a-1(g).

[45] Rule 16a-1(a)(2)(ii)(B).

[46] Rule 16a-1(a)(2)(ii)(C).

[47] For example, business trusts are treated as corporations for purposes of section 16.

[48] Rule 16a-1(a)(2)(iii).

[49] The reference to "controlling shareholder" applies to shareholders that have the power to exercise control over the corporation by virtue of their securities holdings.

[50] Rule 16a-1(a)(5)(iii).

[51] Broad-based stock indices and baskets also are excluded from the definition of "derivative security." *See* Rule 16a-1(c)(4) and section III.B, *infra.* In essence, broad-based indices and baskets are outside the purview of section 16, both with respect to the indices or baskets and their component securities.

[52] *See* Exchange Act section 13(d)(3) (15 U.S.C. 78m(d)(3) (1988)); Rule 13d-5 (17 CFR 240.13d-5).

[53] Where a member of the group has the ability, through any contract, arrangement, understanding or relationship, to receive a portion of the profits from transactions in any other group member's securities, the member has a pecuniary interest in the securities. In this event, the group member is required to report all holdings and transactions in equity securities to which the arrangement or understanding relates, as well as any other equity securities in which the member has a pecuniary interest, and is subject to short-swing recovery from resulting transactions.

[54] In contrast to section 13(d), which requires a group filing, the group itself would not be a separate person for section 16 purposes. However, for purposes of determining status as a ten percent holder under Section 16, the securities beneficially owned by the group must be included in the calculation by each individual member of the group.

4. Trusts and Trustees

The trust rule adopted today addresses the application of section 16 to trust holdings and transactions substantially as reproposed.[55] There are two changes from the reproposal, discussed below, which limit the circumstances under which a trust becomes subject to section 16 as a result of having an insider trustee.

In addition, the rule has been reorganized for clarity.[56] The first part of the rule addresses circumstances under which a trust, trustee, beneficiary or settlor becomes subject to section 16,[57] while the second part addresses the reporting and short-swing profit obligations of such parties once they are subject to section 16.[58] The first part of the rule is based on the section 13(d) concepts used for determining ten percent holder status generally,[59] while the second part is based on the pecuniary interest concepts used for determining reporting and short-swing profit obligations generally.[60]

a. *Status Under Section 16.* As in the reproposed rules and under current law, the Rule provides that a trust is subject to section 16 if it holds more than ten percent of a class of equity securities of an issuer registered pursuant to section 12. Under the new rule, ten percent ownership by a trust is determined in accordance with the general beneficial ownership rule, Rule 16a–1(a)(1).[61] Employee benefit plan trusts subject to ERISA thus will exclude from the ten percent calculation securities that are allocated to participants with voting control, a result that carries out the purposes of section 16 without unduly interfering with the day-to-day operation of pension and employee benefit plans.[62]

As proposed, a trust also would have become subject to section 16 if the trustee was an insider and had investment control over the trust's portfolio securities. The rule, as adopted, subjects the trust to section 16 only if an insider trustee has or shares investment control and the trustee, or a member of the trustee's immediate family, has a pecuniary interest in the issuer's securities held by the trust.[63] This modification recognizes that the potential for abuse is remote where the trustee has little incentive to abuse inside information. Further, the rule has been modified to state that if a trustee is an institution eligible to file a Schedule 13G, the trustee's insider status does not subject that trust to section 16.[64] Additionally, the service of an officer or director as a trustee of the issuer's employee benefit plan does not in itself subject the plan to section 16, even if the officer or director is a plan participant.[65]

The former rule provided that where the trust was a ten percent holder, each trustee also became subject to section 16. The result is similar under the rule as adopted;[66] whether a trustee is deemed to be the beneficial owner of securities held by the trust for status purposes is governed by the general beneficial ownership rule, Rule 16a–1(a)(1), which focuses on a section 13(d) analysis.[67] Thus, a trustee having or sharing voting or investment control over securities held by a trust would include these securities in the trustee's own ten percent holder calculation.[68] Professional institutional trustees, however, are likely to be able to avail themselves of the 13G exemption provided by Rule 16a–1(a)(1).

The Rule 16a–1(a)(1) analysis also is applicable to beneficiaries or settlors. Under most circumstances such parties are not expected to have either the requisite voting or investment control over the securities, and thus could exclude the securities from the ten percent holder calculation. Where, however, a settlor has the power to revoke the trust without the consent of another person, the settlor will be deemed a beneficial owner of securities held by the trust for determining status as a ten percent holder.[69]

b. *Reporting and Short-Swing Profit Obligations.* The rule separately addresses reporting obligations, and the corollary application of short-swing profit recovery provisions, of trusts, trustees, beneficiaries and settlors.[70] Trust holdings and transactions normally are reported only by the trustee on behalf of the trust,[71] and generally would not be matched for section 16(b) purposes with non-trust transactions of the trustee, beneficiaries and settlors. Four exceptions to this provision are specified in the rule.

First, just as employee benefit plan securities allocated to employees with voting control are excluded from the trust's ten percent holder calculation, securities held by or transactions conducted in an employee benefit plan are excluded from the trust's reporting obligations if the trustee does not exercise investment control with respect to such holdings or transactions.[72] These transactions instead must be reported by employee participants who are subject to section 16. The allocation of securities owned by a trust to a participant account is not a trust transaction subject to section 16, and need not be reported by the trust, but is an acquisition reportable by the insider-participant.

Second, an insider trustee with a pecuniary interest in any holding or transaction of the trust [73] must report such holding or transaction on the trustee's individual form, as well as on the separate form filed on behalf of the trust.[74] Trust transactions in which the insider trustee has a pecuniary interest can be matched with personal transactions of the trustee, as well as other trust transactions. The rule sets forth two non-exclusive situations where the trustee is deemed to have a pecuniary interest: The trustee or an immediate family member is a beneficiary of the trust,[75] or a

[55] Rule 16a–8.

[56] For ease of reference, reproposed Rule 16a–1(a)(5)(i), addressing trust remainder interests, has been redesignated Rule 16a–8(c).

[57] Rule 16a–8(a).

[58] Rule 16a–8(b).

[59] Rule 16a–1(a)(1).

[60] Rule 16a–1(a)(2).

[61] Rule 16a–8(a)(1)(i).

[62] *See* section II.A.3, *supra*.

[63] Rule 16a–8(a)(1)(ii).

[64] Rule 16a–8(a)(1)(ii)(A).

[65] Rule 16a–8(a)(1)(ii)(B). This was added in response to commenter concern that officers acting as trustees for plans of the issuer would subject the plan trust to section 16. For an explanation of the rules concerning employee benefit plans, including plans structured in trust form, *see* section IV, *infra*.

[66] Where a trust is subject to section 16 because an insider trustee has a pecuniary interest in a portion of the trust corpus, other trustees of the trust who are not insiders will not thereby become subject to section 16.

[67] Rule 16a–8(a)(2)(i).

[68] Generally, in determining whether a trustee in his or her individual capacity is a ten percent holder, equity securities individually held over which the trustee has or shares voting or investment control and equity securities of the same class held in one or more trusts (and deemed beneficially owned by the trustee under a section 13(d) analysis) would be aggregated.

[69] Rule 16a–8(a)(2)(ii).

[70] The person required to report a transaction under section 16(a) also is subject to the provisions of sections 16(b) and 16(c). Rule 16a–8(d).

[71] Rule 16a–8(b).

[72] Rule 16a–8(b)(1). Thus, transactions in a typical participant-directed plan would be reported by the employee-participants, not the trust. When a trust does have to file reports with respect to an employee benefit plan, the reporting ordinarily will be on an annual basis since transactions exempt pursuant to Rule 16b–3 are reportable on Form 5. *See* Rule 16a–3(g)(3) and the discussion of employee benefit plans in Part IV, *infra*.

[73] Pecuniary interest includes an interest in the income or the corpus of the trust.

[74] Rule 16a–8(b)(2). In such circumstances, both the trustee and the trust are deemed beneficial owners; however, any short-swing profits would be recoverable only once, as specified in Rule 16a–1(a)(3).

[75] Rule 16a–8(b)(2)(ii). As adopted, the rule clarifies that the trustee has a pecuniary interest in

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performance fee is received that does not satisfy the proviso of Rule 16a-1(a)(2)(ii)(C).[76]

Third, the rule addresses insider beneficiaries specifically, recognizing, as did the former rule, that it is inappropriate to require beneficiaries to incur reporting and short-swing profit obligations for transactions beyond their control. Accordingly, although beneficiaries have a pecuniary interest in trust securities to the extent of their pro rata interest in the trust,[77] they ordinarily would not report trust holdings or transactions. In the usual situation where the trustee makes the investment decisions without the prior approval of or consultation with the beneficiary, only the trust reports the transaction, and the transaction is matchable only with other trust transactions.[78] Where the insider beneficiary has investment control over the transaction and the trustee executes the transaction as directed, the beneficiary rather than the trust reports the transaction, which is matchable with other transactions of the beneficiary.[79] Where investment control is shared, including consultation between the trustee and beneficiary, both the trust and the beneficiary must report the transaction and are responsible for any resulting short-swing profits.[80]

Finally, the rule addresses reporting by insider settlors.[81] Just as a settlor who reserves the right to revoke the trust without the consent of another person is deemed to beneficially own the issuer's securities held by the trust for purposes of determining ten percent ownership status, such a settlor also is viewed as having a pecuniary interest in the securities, and is responsible for reporting and short-swing profit recovery. However, if such a settlor neither has nor shares investment control, it would be inappropriate to require reporting or profit recovery. In this event, the trust rather than the settlor is responsible for reporting and the trust transactions are not matchable against the settlor's transactions, just as for a beneficiary having no investment control.

C. How and When to Report

1. Timing of Reports

As reproposed, option exercises and conversions of derivative securities must be reported on the earlier of the next Form 4 otherwise required or on Form 5.[82] In addition, commenters suggested that reporting earlier on a voluntary basis would facilitate report preparation and section 16(a) compliance. At their suggestion, the rules, as adopted, have been amended to state explicitly that insiders may report exercises and conversions, as well as any other transactions, on a date earlier than that which is required by the rules.[83]

The rules adopted today provide that for purposes of section 16 a form will be deemed timely filed if it is delivered to a third party business, including the postal service, in sufficient time for it to guarantee delivery of the filing to the Commission no later than the specified due date.[84] Accordingly, the insider will not be deemed delinquent on account of the third party's breach of its guarantee. For example, many mail services currently guarantee overnight delivery or delivery within a specified time. An insider required to file a Form 4 with the Commission by the tenth of the month will be deemed to have timely filed the Form 4 if the insider delivers the Form to a mail service guaranteeing delivery to the Commission by the due date. This provision recognizes the large number of individuals that are subject to the reporting requirements of section 16(a), as well as the expectation that forms mailed or delivered by guaranteed delivery services will be filed with the Commission by the specified due date.[85] Insiders must retain a receipt or other writing from the third party evidencing timely receipt by the third party for filing with the Commission by the required date in order to rely on this provision.

2. Revisions to Forms 3, 4, and 5

The annual Form 5 filing requirements have been adopted substantially as proposed, with revisions to facilitate the reporting of securities held in employee benefit plans. A Form 5 must be filed within 45 days of the issuer's fiscal year end by every person who was an insider at any time during the fiscal year to report any securities transactions during that period that have not been reported previously on a Form 4, either because of deferred reporting or failure to file required reports.[86] A Form 5 is not required from an insider with no reportable transactions.

In response to comments that information concerning transactions in employee benefit plans and dividend reinvestment plans ("DRIPs") may not be available from plan administrators to permit timely reporting on Form 5, as well as concern that the information required would be voluminous and not meaningful, two changes to the reporting requirements have been made.[87] First, insiders are permitted to report exempt acquisitions in thrift and stock purchase plans [88] and DRIPs [89] on an aggregate basis, rather than transaction by transaction. Reportable dispositions may not be aggregated. Second, insiders must report plan transactions on the Form 5 as of the most recent date for which such data is reasonably available to the reporting person.[90] Plan information for the fiscal year not reported on the Form 5 filed for that year would be reportable on the Form 5 for the next fiscal year (or may be filed on a Form 4 or an amended Form 5 promptly after becoming available).

Commenters were concerned that the Form 5 requirement to report any unreported transactions, including those made prior to the adoption of Form 5, would place insiders at risk of committing reporting violations by failing to report earlier transactions that they in good faith did not recollect. In response to these concerns, the rule adopted today requires an insider, in completing the first Form 5 or making the first written representation that no Form 5 is required, to report transactions not previously reported for each of the issuer's two past fiscal years, rather than for an indefinite period. For calendar year companies this will mean that the Form 5 will

the proportionate holdings of the family member, rather than all holdings of the trust.

[76] Rule 16a-8(b)(2)(i). For a discussion of performance fees, *see* Section II.B.1.b, *supra*.

[77] Rule 16a-8(b)(3)(iii).

[78] This is consistent with former Rule 16a-8(b) (17 CFR 240.16a-8(b)).

[79] Rule 16a-8(b)(3)(ii).

[80] Rule 16a-8(b)(3)(i). Under former Rule 16a-8(d) (17 CFR 240.16a-8(d)), the trustee was permitted to file a single report on behalf of all beneficiaries. However, as proposed, this provision has been deleted; under the new regulatory framework the person who has the pecuniary interest must report. *See* Rule 16a-1(a)(3).

[81] Rule 16a-8(b)(4).

[82] Rule 16a-4. *See* Section III.D, *infra*, for a discussion of exercises and conversions.

[83] Rules 16a-3(a) and 16a-3(g)(3) permit the early reporting of transactions on Form 4.

[84] Rule 16a-3(h).

[85] The Commission's position regarding the timely filing of forms required by section 16 and the rules thereunder does not apply to filings required under other provisions of the federal securities laws. *See, e.g.*, Exchange Act Rule 0-3 (17 CFR 240.0-3).

[86] Rule 16a-3(f)(1).

[87] Instruction 4(a)(ii) of Form 5.

[88] For a discussion of the exemption from liability for transactions in ongoing stock acquisition plans, *see* section IV.D, *infra*.

[89] Consistent with current interpretation, only the reinvestment of dividends or interest is exempt, not additional securities acquired through voluntary cash contributions under such plans. *See* Release No. 34-18114, Q. 78. Any such additional purchases thus must be reported on Form 4 and may not be aggregated.

[90] The Form must specify the period for which plan information is disclosed.

include transactions in 1990 and 1991. As another example, an insider of a company with a June 30 fiscal year end would include transactions for the year ending June 30, 1990, and 1991. The rule also provides that the insider need only have a reasonable good faith belief that all transactions in the period prior to the effective date of the rules have been reported or are reported on the Form 5.[91] The limitation of insider review to the prior two fiscal years is not an amnesty for earlier violations of section 16(a). Likewise, late disclosure of any transactions, on any form, does not cure the original violation.

In subsequent years, Form 5 will relate only to transactions during the most recent fiscal year and DRIP and employee benefit plan transactions from the prior fiscal year for which information was not available at the time of the prior report and not previously reported. Insiders will be responsible for determining whether all required reports and transactions during such periods have been reported.[92]

In response to commenters' concerns, Forms 3, 4, and 5 and related instructions have been revised to simplify the forms and facilitate completion and reporting.[93] General revisions include reformatting the forms (*i.e.*, combining columns and eliminating others as unnecessary) to create additional space for reporting transactions, and changing transaction codes to specify in greater detail the types of transactions reported. Minor changes also have been made to form instructions to clarify reporting obligations.

At the suggestion of commenters, boxes have been added to Forms 4 and 5 that insiders must check to indicate termination of insider status. Completing these boxes will facilitate Commission and investor monitoring of insider reports. Comment is solicited on the usefulness of this approach.

Forms 4 and 5 also have been amended to contain, next to the exit box, a reminder that subsequent reports may be required to be filed by persons who were insiders at any time during the issuer's fiscal year. Of course, as discussed above,[94] even after a person ceases to be an officer or director, the person may have subsequent filing obligations (*i.e.*, a Form 4 for post-termination transactions or a Form 5 at the end of the year to reflect option exercises, employee benefit plan transactions, other transactions exempt from section 16(b), small acquisitions or other previously unreported transactions).[95] Insiders who wish to file reports of exempt transactions early, at the time of their ceasing to be officers or directors subject to Section 16, may do so on either a Form 4 or Form 5.

III. Derivative Securities

A. Conceptual Framework

Given the uncertainty surrounding the application of section 16 to derivative securities under the former rules and existing case law, the Commission is adopting a comprehensive regulatory framework, in order to effect the purposes of section 16 and to address the proliferation of derivative securities and the popularity of exchange-traded options. This framework recognizes that holding derivative securities is functionally equivalent to holding the underlying equity securities for purposes of section 16, since the value of the derivative securities is a function of or related to the value of the underlying equity security. Consequently, both types of securities can be used to engage in the kind of short-swing profit taking that Congress sought to prevent.[96]

Section 16 was enacted by Congress to provide a prophylactic measure against insider trading by allowing the corporation to recapture the profit derived by one of its insiders who engages in two transactions in the company's equity securities within a six-month period of time. Just as an insider's opportunity to profit commences when he purchases or sells the issuer's common stock, so too the opportunity to profit commences when the insider engages in transactions in options or other derivative securities that provide an opportunity to obtain or dispose of the stock at a fixed price.[97] The holder of a call option not only knows that he will be able to obtain the stock, but also knows the price at which it will be obtained. Thus, whether or not the holder chooses to exercise his right to obtain the stock, the extent of his profit is determinable, when compared with a transaction in the underlying equity security or a derivative security related to that underlying equity security.[98]

The functional equivalence of derivative securities and their underlying equity securities for section 16 purposes requires that the acquisition of the derivative security be deemed the significant event, not the exercise. Failure to recognize that derivative securities are functional equivalents of the underlying securities for Section 16 purposes would permit insiders to evade disgorgement of short-swing profits simply by buying call options and selling the underlying stock, or buying underlying stock and buying put options. Potential abuse with derivative securities is demonstrated by the many enforcement actions involving the purchase of derivative securities, rather than common stock, to misuse inside information.[99]

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[91] Rule 16a-3(f)(1). A review of records available without undue burden or expense would be an adequate basis for such belief.

[92] The good faith belief standard is not applicable for transactions subsequent to the effective date. If an insider does not report a Form 4 transaction until a subsequent fiscal year, there would be two violations, a failure to file a timely Form 4 and a failure to report the transaction on Form 5; there would not be an additional violation each subsequent year.

[93] As a matter of policy, the Commission will accept computer generated Forms 3, 4, or 5 if the computer generated facsimile is identical in format and is limited to 8½" x 11" paper. These forms must be signed manually.

[94] *See* section II.A.2, *supra*.

[95] In addition, ten percent holders while not subject to section 16 after termination of status, may have a Form 5 filing obligation as to unreported transactions that occurred during the period the person was a ten percent holder.

[96] For a discussion of option pricing and the relationship between an option's price and the price of the underlying security, *see generally* J. Cox and M. Rubenstein, "Options Markets" (Prentice-Hall Inc. 1985); J. Cox, S. Ross, & M. Rubinstein, "Option Pricing: A Simplified Approach," "Journal of Financial Economics," 229-263 (Sept. 1979); M. Brennan & E. Schwartz, "The Valuation of American Put Options," "Journal of Finance," 449-462 (May 1977); F. Black and M. Scholes, "The Valuation of Option Contracts and a Test of Market Efficiency," "Journal of Financial Economics," 399-418 (May 1972).

[97] The definition of "derivative security" in Rule 16a-1(c) excludes those securities without a fixed exercise price. *See* sections III.B and III.D, *infra*.

[98] For example, if an insider who owns 1000 shares of stock acquires call options giving him the right to obtain 1000 shares of the company's stock at $100 a share, and the stock price rises to $120, the insider knows that he can sell his stock and replace that holding for $20,000 less than the sale price. The insider is at no risk that subsequent events will place that profit in danger, if he sells the stock but chooses not to exercise the call options immediately.

[99] *See, e.g., SEC* v. *Tome*, 833 F.2d 1086 (2d Cir. 1987); *SEC* v. *Foundation Hai*, 736 F. Supp. 465 (S.D.N.Y. 1990); *SEC* v. *Raab*, Litigation Release No. 12709 (Nov. 20, 1990); *SEC* v. *Finacor Anstalt and Certain Purchasers of Call Option Contracts for the Common Stock of Combustion Engineering, Inc.*, Litigation Release No. 12603 (Sept. 6, 1990); *SEC* v. *Bushman*, Litigation Release No. 12594 (Aug. 27, 1990); *SEC* v. *Certain Purchasers*, Litigation Release No. 12542 (July 13, 1990); *SEC* v. *Godfrey*, Litigation Release No. 12420 (March 22, 1990); *SEC* v. *O'Hagan*, Litigation Release No. 12344 (Jan. 10, 1990); *SEC* v. *Musella*, 748 F. Supp. 1028 (S.D.N.Y. 1989); *SEC* v. *Shiffman*, Litigation Release No. 12175 (July 24, 1989); *SEC* v. *Iseppi*, Litigation Release No. 11964 (Jan. 17, 1989), *SEC* v. *Levine*, Litigation Release No. 11095 (May 12, 1986); and *SEC* v. *Reed*, Litigation Release No. 9537 (December 23, 1981). Congressional concern about this problem is further evidenced by the enactment of the Insider Trading Sanctions Act of 1984 amendment to section 20(d) of the Exchange Act. *See* Public Law No. 98-376, 98 Stat. 1264 (1984); 15 U.S.C. 78t(d) (1988).