
CHAPTER

2

**Federal Securities Law
Considerations for
Equity Compensation Plans**

Eric Orsic and William J. Quinlan, Jr.

Contents

- 2.1 Impact of the 1934 Act on Equity Compensation Plans 33
 - 2.1.1 In General 33
 - 2.1.2 Definition of "Public Company" 34
 - 2.1.3 Options as Equity Securities 34
 - 2.1.4 Foreign Private Issuers 36
 - 2.1.5 Definition of "Reporting Persons" 37
 - 2.1.6 Beneficial Ownership 38
- 2.2 Reporting Requirements Under Section 16(a) of the 1934 Act 39
 - 2.2.1 Form 3 39
 - 2.2.2 Forms 4 and 5 40
 - 2.2.3 Electronic Filing of Section 16 Reports 41
 - 2.2.4 Web Site Posting of Section 16 Reports 42
 - 2.2.5 Transactions Required to Be Reported 43
 - 2.2.6 Issuer Reporting of Noncompliance 47
 - 2.2.7 Reporting Recommendations 48
- 2.3 Six-Month "Short-Swing" Profit Recapture Under Section 16(b) of the 1934 Act 48
 - 2.3.1 Section 16(b) Exemptions 51
- 2.4 Trading While in Possession of Inside Information 59
 - 2.4.1 Backdating of Stock Option Grants 62
- 2.5 1933 Act Registration Requirements; Resales by Plan Participants 64
 - 2.5.1 Registration Requirements 64

Excerpted from the book *Selected Issues in Equity Compensation*, 5th ed., published by the National Center for Employee Ownership (see www.nceo.org). © 2008 by NCEO. Do not redistribute without permission.

2.5.2	Rule 701	67
2.5.3	Sales Under Rule 144	72
2.5.4	Sales Under Regulation S	78
2.6	2007 Executive Compensation Disclosure Rules	78
2.6.1	Form 8-K Reporting Requirements and Corporate Governance Shareholder Approval Rules	80
2.7	Conclusion	81
Appendix A: The Sarbanes-Oxley Act of 2002: Impact on Executive Compensation Plans		82
Appendix B: Section 16 Mandatory Pre-clearance Policy		91
Appendix C: Excerpts from <i>Current Issues and Rulemaking Projects Outline</i> Dated March 31, 2001		92
Appendix D-1: Memorandum to Company Regarding Continuing Reporting Obligations with Respect to a Departing Officer or Director of the Company		94
Appendix D-2: Exit Memorandum		97
Appendix D-3: Summary of Rule 144 Under the New Rules		100
Appendix D-4: Comparison of Old Rule 144 with New Rule 144		101
Appendix D-5: SEC Summary of Rule 144 from Final Release		102

FOR A VARIETY OF REASONS, company stock continues to be one of the more popular forms of compensation. Most public companies maintain some form of stock benefits plan for their directors, officers, and/or key employees. In addition, many public companies are granting stock benefits at multiple levels within the organization, with some offering stock benefits to all full-time employees. Equity compensation plans are not, however, exclusive to public companies. In order to attract and/or retain talented individuals, many privately held entities and foreign issuers with operations in the United States are offering stock benefits to their key employees.

In recent years, the most common practice has been to adopt an omnibus-type equity compensation plan that covers not only stock options but also restricted stock (including restricted stock units and deferred stock units), stock appreciation rights, performance shares, performance units, and cash awards, along with deferred compensation arrangements. This chapter will focus on the securities law aspects of the foregoing benefits payable in stock.

Although equity compensation plans are exempt from the burdensome requirements of the Employee Retirement Income Security Act of 1974 (ERISA), there are still a number of important rules and regulations

that apply. In particular, equity compensation plans maintained by “public companies” are subject to the Securities Exchange Act of 1934 (the “1934 Act”), which imposes various reporting requirements and restricts transactions in issuer securities by, among others, designated executive officers, directors, and persons with material non-public information. In addition, all equity compensation plans are potentially subject to the Securities Act of 1933 (the “1933 Act”), which requires registration of offers to sell securities unless a specific exemption from registration is available.

This chapter focuses on compliance with the federal securities laws rather than on enforcement. Suffice it to say that noncompliance can result in serious penalties and liabilities, including fines, forfeiture of profits, treble damages, and federal criminal prosecution, not to mention the adverse publicity and embarrassment to the corporation and the individuals involved. State securities laws must also be considered, but they are beyond the scope of this chapter. In addition, appendix A to this chapter discusses the executive compensation impact of the corporate reform and governance law known as the Sarbanes-Oxley Act of 2002.

This chapter also focuses briefly on the executive compensation rules made effective in 2007.

This chapter does not focus on Section 409A of the Internal Revenue Code of 1986, as amended, and its related IRS regulations, which may have a substantial impact on stock options, restricted stock, and all forms of deferred compensation for public and private companies.

2.1 Impact of the 1934 Act on Equity Compensation Plans

2.1.1 In General

An equity compensation plan maintained by a “public company” must be administered in light of Section 16 of the 1934 Act and the rules promulgated thereunder (the “Section 16 Rules”). The Section 16 Rules essentially consist of two parts. The first part is Section 16(a) and its related rules, which require directors, certain officers, and principal shareholders of “public companies” to report to the Securities and Exchange Commission (SEC) all transactions in the issuer’s securities.¹ The second part is Section 16(b) and its related rules, which require such persons

1. 1934 Act, § 16(a) and Rules 16a-1 to 16a-13.

to disgorge any “short-swing profits” received from transactions in the issuer’s securities.²

2.1.2 Definition of “Public Company”

As indicated above, the Section 16 Rules apply only to “public companies.”³ For these purposes, a “public company” includes any corporation whose stock is *listed* on a national securities exchange, including NASDAQ, which became a national securities exchange in August 2006, but excluding a “foreign private issuer” as described below. A “public company” can also include non-listed companies. Specifically, if a U.S. corporation has more than \$10 million in assets (see SEC Rule 12g-1) and 500 or more shareholders, it will be considered a “public company” subject to the Section 16 Rules, regardless of whether its stock is listed on a national securities exchange or traded over-the-counter.

Becoming a “public company” due to size and the number of shareholders is an important consideration for non-listed companies that maintain equity compensation plans. If a corporation becomes a “public company” under the 500 shareholder/\$10 million asset value rule, it must comply with the registration requirements under Section 12(g) of the 1934 Act, as well as the 1934 Act’s proxy solicitation, periodic reporting, and short-swing trading provisions. Accordingly, non-listed corporations that grant stock options and other forms of equity compensation need to closely monitor the number of employees to whom shares are issued or sold to ensure that when and if outstanding awards are exercised or shares are otherwise delivered, the corporation will either stay below the 500-shareholder limit or will otherwise be in full compliance with the requirements of the 1934 Act.

2.1.3 Options as Equity Securities

The SEC takes the position that an option (but not a stock appreciation right) is an equity security for purposes of the 500-shareholder test. This means that, absent relief via a no-action letter or an exemption (see below), a private company can find itself subject to the 1934 Act if it grants options to more than 500 employees and/or consultants (and has more than \$10 million in assets). At the present time, the SEC staff is not mix-

2. 1934 Act, § 16(b) and Rules 16b-1 to 16b-8.

3. 1934 Act, §§ 12(a) and 12(g)(1).

ing equity holders with option holders. For example, this means that a corporation could have 499 equity holders and up to 499 option holders without having to register under the 1934 Act.

Prior No-action Letter Relief. To get around this option problem, the Division of Corporation Finance issued a set of guidelines in its Current Issues and Rulemaking Projects Outline dated March 31, 2001 (an excerpt is included as appendix C to this chapter). The guidelines were not self-executing, which meant that a company with 500 or more holders of stock options had to seek no-action letter relief. One of the most recent no-action letters is AMIS Holdings, Inc. (July 30, 2001). This no-action letter contains an analysis of each of the guidelines required by the Division of Corporation Finance.

Failure to obtain a no-action letter on a *timely* basis resulted in the staff of the SEC refusing to grant a no-action letter request, thus requiring the corporation to register as a public company. To be timely, the no-action letter request must be made within 120 days of the end of the fiscal year in which the 500-option holder limit has been exceeded. This became a very serious problem for companies (with large groups of option holders) that were planning to go public. It resulted in rescission rights when the corporation did go public and missed the 120-day deadline.⁴

Exemption for Compensatory Employee Stock Options. On November 15, 2007, the SEC voted to adopt amendments to Rule 12h-1 of the 1934 Act to provide two exemptions for compensatory employee stock options. The first amendment provides an exemption for private non-reporting issuers from registration under Section 12(g) of the 1934 Act solely for compensatory employee stock options issued under employee stock option plans. Many of the concepts discussed in the Current Issues and Rulemaking Projects Outline mentioned above and in the AMIS Holdings, Inc., no-action letter are embodied in this exemption.

4. See, for example, the Google registration statement and prospectus. As a condition to Google's going public, and to remedy various state blue sky violations, the SEC required Google to prepare and distribute a rescission offer prospectus to all of its employees and other holders of stock options. The offer fixed as a rescission price that would be paid to accepting option holders the amount of 25% of the exercise price times the number of options granted. As one can imagine, no option holder accepted the rescission offer made by Google, but this process greatly complicated Google's ability to go public.

The second amendment provides an exemption for issuers that have been required to register under the 1934 Act and are required to file reports under Section 13 or 15(d) of the 1934 Act solely because they did not obtain a timely no-action letter. They are now exempt from the reporting requirements of the 1934 Act as long as they qualify for the new exemption from registration of compensatory stock options under Section 12(g) of the 1934 Act.

These exemptions apply only to an issuer's compensatory employee stock option program and do not extend to any class of securities underlying those options. These amendments became effective on December 7, 2007, upon publication in the Federal Register. The SEC has published the final release on its Web site. See Release No. 34-56887 for the specific requirements of these exemptions.

2.1.4 Foreign Private Issuers

Publicly listed securities of a foreign private issuer, as defined in SEC Rule 3b-4(c), are exempt from Section 16 pursuant to Rule 3a12-3(b) under the 1934 Act.⁵ The term "foreign private issuer" is defined in Rule 3b-4(c) to mean any foreign issuer *except* an issuer meeting the following conditions:

1. More than 50% of the outstanding voting securities of such issuer are held of record either directly or through voting trust certificates or depositary receipts by residents of the United States; and
2. Any of the following:
 - (a) The majority of the executive officers or directors are United States citizens or residents,
 - (b) More than 50% of the assets of the issuer are located in the United States, or
 - (c) The business of the issuer is administered principally in the United States.

For these purposes, the term "resident," as applied to security holders, means any person whose address appears on the records of the is-

5. The exemption in Rule 3a12-3(b) under the 1934 Act reads as follows: Securities registered by a foreign private issuer, as defined in Rule 3b-4, shall be exempt from sections 14(a), 14(b), 14(c), 14(f) and 16 of the Act.

suer, the voting trustee, or the depository as being located in the United States. Note that there is no exemption for shareholders of foreign private issuers from the reporting obligations under Regulation 13D-G or for liability under Rule 10b-5, as described below.

2.1.5 Definition of “Reporting Persons”

The Section 16 reporting and short-swing profit rules do not apply to all transactions in issuer securities. Rather, only transactions by those individuals who are either “designated executive officers” of the public company⁶ or members of its board of directors⁷ (collectively “reporting persons”) are subject to the information reporting requirements and short-swing trading restrictions contained in Section 16 of the 1934 Act.⁸

“Designated executive officers” for these purposes includes only those officers of the issuing corporation with certain high level, policy-making responsibilities who are designated as such by the corporation’s board of directors (or a committee thereunder) and are listed each year in the issuer’s Form 10-K (annual report).⁹ For purposes of the Section 16 Rules, an “officer” has been judicially defined as “a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information that would aid him if he engaged in personal market transactions.”¹⁰ Merely having the title of an officer does not, by itself, cause an individual to become a “designated executive officer” for purposes of the Section 16 Rules. Instead, the determining factor is whether the individual’s duties are commensurate with those of a policy-making position.

The term “officer” includes the following positions: president (CEO and COO); principal financial officer; principal accounting officer (or if there is no such accounting officer, the controller); any vice-president in charge of a principal business unit, division, or function; and any other officer or other person who performs a significant policy-making func-

6. 1934 Act, § 16(a), Rule 16a-1(f).

7. 1934 Act, § 3(a)(7).

8. The application of the Section 16 Rules to “principal shareholders” who are neither designated executive officers nor directors is beyond the scope of this chapter.

9. Rule 16a-1(f).

10. *Colby v. Klune*, 178 F.2d 872, 873 (2d Cir. 1949).

tion. This can include officers of a parent or subsidiary corporation if they perform a policy-making function for the entity that issues the stock in question.¹¹ The issuing corporation should notify every director or designated officer who becomes subject to the Section 16 Rules of his or her status as a Section 16 reporting person. The definition of “officer” in Rule 16a-1(f) contains a footnote instruction that has been interpreted to mean that, if the board of directors adopts a resolution naming its Section 16 officers, the list will be presumed exclusive and correct.

2.1.6 Beneficial Ownership

It is important to note that in most circumstances, a reporting person is presumed to be the owner of all securities in which the reporting person has a “pecuniary interest”—that is, the opportunity to profit or share in any profit, either directly or indirectly.¹² This includes securities held by a spouse, children, grandchildren, parent, grandparent, sibling, and other relatives *sharing the same household*, including step-, in-law, and adoptive relationships, and children living away from home while attending college (“household relatives”).¹³ For example:

Officer “B” has a daughter who is in college, is financially dependent on “B,” and owns Company X stock. “B’s” daughter sells her stock in September. “B” must report the daughter’s sale to the SEC on “B’s” Form 4 within two business days of the sale.

Even if the reporting person and a relative are not sharing the same household, the reporting person will be deemed the beneficial owner of securities if he or she actually controls the purchase and sale of securities owned by the relative or if the relative is a minor child.

A reporting person may also be deemed to be the beneficial owner of any stock held by a trust, corporation, partnership, or other entity over which he or she has a controlling influence.¹⁴ Special rules exist for trusts in which the reporting person acts as trustee and a member of his or her family (even if such person does not reside in the reporting person’s household) has a pecuniary interest in the securities held by the trust.¹⁵

11. Rule 16a-1(f).

12. Rule 16a-1(a)(2).

13. Rule 16a-1(a)(2)(ii)(A), Rule 16a-1(e).

14. Rule 16a-1(a)(2)(ii)(B), (E), and (F).

15. See Rule 16a-8.

The potential application of the Section 16 Rules to shares held by household relatives and entities over which the reporting person has a controlling influence needs to be closely monitored to avoid inadvertent violation of the Section 16 Rules. If a question exists as to whether an individual is the beneficial owner of certain stock, a statement similar to the following can be included on the SEC stock ownership forms: “Reporting person expressly disclaims beneficial ownership of these shares. Reporting person cannot profit, directly or indirectly, from transactions in these securities.”

2.2 Reporting Requirements Under Section 16(a) of the 1934 Act

Since August 29, 2002, all transactions (with certain limited exceptions) have been required to be reported within two business days of the date of the transaction. (See appendix A to this chapter, which provides more information on the Sarbanes-Oxley Act of 2002.)

Section 16(a) of the 1934 Act and the rules promulgated thereunder require reporting persons to report to the SEC all transactions in the issuer’s securities. As described below, reporting persons must file three kinds of SEC stock ownership forms:

- Initially, a statement of beneficial ownership of issuer stock when the person first becomes subject to Section 16 (Form 3);
- Periodic, as-needed, statements of changes in beneficial ownership (Form 4); and
- Annual statements of changes in beneficial ownership, if needed (Form 5).

2.2.1 Form 3

A reporting person must file a statement of beneficial ownership of issuer stock on Form 3 when the person first becomes a director or designated executive officer of the issuer.¹⁶ If the issuer is already a “public company,” Form 3 must be filed—meaning received by the SEC—within 10 days after appointment or designation of the individual as a director or designated executive officer. Otherwise, Form 3 must be filed on or before the date the issuer becomes a public company.

16. 1934 Act, § 16(a), Rule 16a-3.

2.2.2 Forms 4 and 5

A reporting person is also required to file periodic statements of changes in beneficial ownership of issuer securities on Form 4 or Form 5, as applicable. Form 4 reports must be filed within two business days after the occurrence of the transaction resulting in a change in the reporting person's beneficial ownership (unless Form 4 is being used on a voluntary basis, as described below).¹⁷ This would include changes in direct ownership of issuer securities, as well as changes in beneficial ownership by reason of transactions involving household relatives or entities over which the reporting person has a controlling interest.

Form 5 must be filed by a reporting person within 45 days after the end of the issuer's fiscal year and must report (1) transactions or changes in beneficial stock ownership not required to have been reported earlier on Form 4, and (2) transactions or changes that should have been reported earlier on Form 4 but were not ("delinquent filings").¹⁸ A Form 5 would not be required from a reporting person who had no reportable transactions during the preceding year (Rule 16a-3(f)(2)). Any transaction normally reportable on Form 5 at year-end may be voluntarily reported on an earlier Form 4 filed at any time before the due date of the Form 5.¹⁹ To avoid confusion and the risk of late or non-filing, it is recommended that transactions which are reportable on the year-end Form 5 be nevertheless reported as soon as possible on a voluntary Form 4 using the "V" code.

SEC Staff Same-Day Non-Aggregation Interpretation. For several years, U.S. stock markets have been using a decimal trading system. This means that transactions on the same day may differ by very small fractions. Until recently, many reporting persons have been reporting their same-day transactions on Form 4 using one line with a weighted average price. Unfortunately, in May 2007, the SEC staff issued an interpretation that requires each transaction to be reported on a separate line of the Form 4. (See Q&A 133.08.) For the following reasons, the SEC staff has been urged to reconsider this interpretation. It can lead to a confusing analysis of the transactions and can result in serious preparation errors. It also can make the two-business day reporting requirement very difficult to meet. For example, a recent reporting person had 191 sales transactions on

17. Rule 16a-3(a).

18. Rule 16a-3(f)(1)(ii).

19. Rule 16a-3(g)(5).

one day and 221 sales transactions on the next day. In each instance, the sales were made within 50 cents of each other. To comply with the SEC interpretation, the reporting person would have had to file 14 Form 4s because only 30 Table 1 transactions can be reported on a single Form 4. Complying with the two-business day rule would have been almost impossible. Instead the reporting person reported each day's transactions on a single line and used a weighted average price with an explanatory footnote. It is suggested that, in extreme situations when compliance with the two-business day rule would be very difficult, the weighted average price/explanatory note procedure should be used. The footnote should be worded as follows:

“Weighted average from ___ transactions with prices ranging from \$_____ to \$_____.”

2.2.3 Electronic Filing of Section 16 Reports

The SEC has emphasized the importance of timely filing stock ownership forms. Before June 30, 2003, a document was deemed timely filed with the SEC for purposes of Section 16(a) only if it could be established that it was deposited with a delivery service in time for guaranteed delivery on or before the SEC deadline.²⁰ Effective June 30, 2003, all Section 16 filings must be made electronically. See SEC Release No. 34-47809 (May 7, 2003). In most instances, this filing must be made no later than 10 p.m. Eastern time on the second business day after the date of the transaction. To become fully versed in the electronic filing process, the following steps should be taken:

1. *Determine whether the Section 16 reporting persons already have EDGAR access codes, and if not, apply for them immediately.* A company's Section 16 reporting officers are not likely to have obtained SEC access codes through another source except for the CEO, who may be serving on other boards of directors that have already obtained the access codes. It is important not to apply for a second set of access codes for any reporting person who has already obtained an access code. Obtaining new codes will deactivate previous codes.

Once the list of persons needing access codes has been obtained, prepare a Form ID for each insider. The Form ID must be filed

20. Rule 16a-3(h).

electronically and signed by the actual person unless a power of attorney has been obtained. A notarized copy of the Form ID must be faxed to the SEC at 202-504-2474. Turnaround time is one to two days. The SEC responds in email with the CIK code. One uses the CIK code and the passphrase, which is created during the electronic Form ID process, to electronically generate the remaining access codes.

2. *Determine which electronic filing system will be used.* Many companies are using software-based systems that have to be loaded on a computer or computers on the company's network. Examples of these systems include the Romeo & Dye Section 16 Filer (<http://www.section16.net/Filer/>) and Equity Edge (<https://us.etrade.com/e/t/corporateservices>). In addition, the SEC offers an online service, and the major printers are all offering Web-based systems for specific fees. These include:

- Bowne & Co., Inc. (<https://www.bownefile16.com/bownefile16/>)
- Merrill Corporation (http://www.merrillcorp.com/cps/rde/xchg/SID-53E1EF62-CC66DF3D/merrillcorp/hs.xml/565_569.htm)
- RR Donnelley (<http://www.rrd.com/wwwRRD/Tools/DocumentManagement/NETfiler/NETfiler.asp>)

The local computer-based systems and the printers' Web-based systems both allow the continuing storage and retrieval of information about the issuer and the reporting persons and a general body of footnotes. The SEC's online system does not allow for the storage and retrieval of past information. This means that in the SEC's system, you start from scratch each time you use it.

3. *Start doing test filings immediately.* Once a particular system has been selected, the person designated as the Section 16 filing agent for a particular company should begin test filings immediately to work out the bugs contained in all of these systems with respect to the reporting of different types of ownership, the reporting of different classes of stock, and the use of footnotes and exhibits.

2.2.4 Web Site Posting of Section 16 Reports

The SEC has mandated (Rule 16a-3(k)) that on and after June 30, 2003, all Section 16 reports must be posted on the Web sites of public issuers that maintain Web sites (Release No. 34-47809). Failure to comply with these

requirements could result in civil penalties under the general remedies provisions of Section 21 of the 1934 Act. The SEC has indicated three alternatives:

1. Direct posting on the issuer's Web site. Most companies have set up separate sections of their Web sites to hold just their Section 16 reports.
2. Linking to a third-party Web site. This can be accomplished as long as it contains all of the forms in segregated fashion and gives free access; for example, www.10KWizard.com.
3. Linking directly to the SEC's Web site. The SEC suggests in footnote 54 to its final release on electronic filings that the issuer can just use a hyperlink to the SEC's Web site dedicated to Section 16 filings. Footnote 54 indicates how that link should be worded and reads as follows:

For example, an issuer could use a link such as the following where the issuer's Central Index Key (CIK) code is 0000906648: <http://www.sec.gov/cgi-bin/browse-edgar?company=&CIK=0000906648&owner=only&action=getcompany>

The instructions to Forms 3, 4, and 5 require that these forms must also be filed with the stock exchange on which the issuer's securities are listed, if any. Now that the forms are required to be filed electronically, they will be deemed filed with the exchanges as well as with NASDAQ (which is now considered a securities exchange) without any additional filings with the exchanges or NASDAQ. This relief comes from SEC staff no-action letters to the exchanges dated July 22, 1998, and a no-action letter issued to NASDAQ dated August 1, 2006.

2.2.5 Transactions Required to Be Reported

Before the Sarbanes-Oxley Act, Forms 3, 4, and 5 were last revised in 1996, and the exemptions to such filings were broadened substantially. Certain stock transactions are now completely exempt from the reporting requirements of Section 16(a). The following will serve as a general guide for reporting transactions in issuer stock that may arise pursuant to a typical equity compensation plan:²¹

21. Rule 16a-4.

Transactions Required to Be Reported on Form 4 (Within Two Business Days):

- Grant or exercise of a stock option or stock appreciation right.
- Delivery of stock to issuer to pay for exercise price of an option (i.e., pursuant to a stock-for-stock exercise) or to pay taxes.
- Amendment of a stock option (including the repricing of an outstanding option and the grant of replacement option upon exercise of predecessor option) or stock appreciation right.
- Grant of stock awards in the form of restricted stock, restricted stock units, deferred stock units, certain performance shares, or performance units.
- Withholding of stock by the issuer to satisfy taxes required to be withheld on the exercise of an option or a stock appreciation right, or upon the vesting of a stock award or performance share award.
- Sale of stock acquired pursuant to the exercise of a stock option or stock appreciation right into the open market, including the sale of stock pursuant to a “cashless” option exercise arrangement.²²
- Sale of stock received in connection with a stock award or a performance share award.
- Purchases and sales.
- Any of the foregoing transactions by a reporting person’s spouse or other “household relatives,” or by an entity over which the reporting person has a controlling interest.

Transactions Required to Be Reported on Form 4 Within Up to Five Business Days:

- Transactions under a Rule 10b5-1 plan (see appendix A).
- Discretionary transactions as defined in Rule 16b-3(f).

22. A “cashless exercise” is an arrangement under which a stock brokerage firm agrees to pay the issuer the funds required for the exercise of a stock option. The broker provides the funds either in the form of a loan to the option holder from a margin account in which the shares acquired are held as collateral or as an advance on the proceeds from the sale of some or all of the shares acquired on the exercise. Most brokers offer this service. See the discussion of cashless exercises in appendix A.

Transactions Required to Be Reported on Year-End Form 5 (But It Is Recommended That These Transactions Be Reported Earlier on a Voluntary Form 4):

- Gifts to anyone, including family members, public charities, and private foundations (Rule 16b-5).
- Transfers of stock or options to family members, or to a family-controlled entity for estate planning purposes (Rule 16b-5).
- Small acquisitions (not exceeding \$10,000 in market value), but not from the issuer or an issuer sponsored stock benefit plan (Rule 16a-6).

Transactions That Are Not Required to Be Reported:

- Expiration or cancellation of stock options where no consideration is received by the reporting person (Rule 16a-4(d) and Rule 16b-6(d)).
- Vesting of an outstanding stock option, stock appreciation right, stock award, or certain performance shares.
- Change in beneficial ownership, i.e., from direct to indirect or vice versa (this exemption is strictly construed to require that the person's pecuniary interest does not change; for example, a gift to a minor child is not covered by this exemption even though the reporting person is deemed to have an indirect beneficial interest; such a gift must be reported on a voluntary Form 4 or a mandatory Form 5) (Rule 16a-13).
- Transfer of an option, SAR, stock award (including restricted stock units and deferred stock units), or performance shares pursuant to a domestic relations order, including any order entered pursuant to a divorce decree (Rule 16a-12).
- Dividend reinvestment plans or their equivalents, provided the issuer has a dividend reinvestment plan generally available to all its shareholders (Rule 16a-11).
- Transactions in "tax-conditioned plans" (other than "discretionary transactions"), including routine purchases under the payroll deduction provisions of a 401(k) plan, excess benefit plan, employee stock ownership plan (ESOP), or employee stock purchase plan (Rule 16b-3(c)).

- Stock splits, reverse stock splits, and other recapitalizations, including possibly pro-rata distributions from limited partnerships and limited liability companies (Rule 16a-9).
- Dividend reinvestments and other stock activities in a rabbi trust.

Note that while the above-listed events do not have to be reported as transactions on the Section 16 stock ownership forms, the SEC does require that the net result of the transactions (other than transactions in a rabbi trust) be reported in the total ownership column with a footnote explanation at least once a year. Failure to do so does not, however, make the reporting person a delinquent filer.

As a general rule, reporting persons should assume that any transaction in issuer stock must be reported to the SEC, even if the transaction is involuntary on the part of the reporting person or, when combined with another transaction, results in no net change in ownership. Because of the new two-business day reporting requirement, reporting persons should be counseled to contact a designated representative of the issuer regarding any potential transaction involving the issuer's securities, no matter how minor it may seem, before consummating the transaction, to receive assistance in filing any needed SEC forms, as well as information regarding the potential Section 16(b) implications, which are described below. See the discussion in appendix A to this chapter concerning a mandatory pre-clearance policy and appendix B for the suggested form of pre-clearance policy.

Also, a reporting person who has retired, terminated employment, or otherwise ceased to be a reporting person continues to have reporting obligations for a limited period following cessation of "insider" status.²³ Such a person is still required to report opposite-way matchable non-exempt transactions on a Form 4 for six months after the last change in beneficial ownership while he or she was still a Section 16 reporting person. If a reporting person has not had any non-exempt transactions for the six months before his or her termination, then no further reporting obligation continues except for possible Form 5 filing requirements; i.e., a gift made while still employed and deferred to Form 5 reporting will still be required to be filed. See appendix D to this chapter for an explanation of exit strategies and a form of exit memorandum to be given to departing Section 16 reporting persons.

23. Rule 16a-2(b).

In addition, opposite-way non-exempt transactions made during the six months following cessation of insider status can be matched (for Section 16(b) purposes) with transactions made while an insider to find short-swing profits owed to the issuer. For example:

“A” will cease to be a director of Company X on October 1. On September 20, “A” sells Company X stock. “A” not only must report this sale on a Form 4 by September 22 (two business days) but also must continue to file Form 4s to report any non-exempt purchases that occur before the next March 20, and any such purchases will be matched with the September 20 sale.

Opposite-way exempt transactions and same-way non-exempt transactions made during the six months following cessation of insider status are not reportable.

2.2.6 Issuer Reporting of Noncompliance

As indicated above, the SEC is serious about compliance with the Section 16(a) reporting requirements. Accordingly, public companies are required to report any noncompliance pursuant to Item 405 of Regulation S-K.²⁴ This report is set out in the issuer’s proxy statement for its annual meeting under an appropriate and discrete caption that reads “Section 16(a) Beneficial Ownership Reporting Compliance.” The Section 16 Rules also clarify that the issuer is entitled to rely on the Forms 3, 4, and 5 furnished to it, as well as written representations by a reporting person that no Form 5 is required.²⁵ Also, the SEC can impose fines for late filings or enjoin the late filer from serving as a director or officer of the issuer and/or other public companies, although the SEC typically employs this additional penalty only in egregious cases.

The Section 16 Rules make it clear that the issuer is obligated to consider the absence of certain forms. Specifically, the absence of a Form 3 filing by a Section 16 reporting person is an indication that disclosure is required. Similarly, the absence of a Form 5 is an indication that disclosure is required, unless the issuer has received a written representation that no Form 5 is required, or the issuer otherwise knows that no such filing is required.²⁶ A “safe harbor” from disclosure is available for an issuer who receives a written representation from the reporting person

24. Item 405(a)(1), Regulation S-K (amended to eliminate the three-day mailing presumption).

25. Item 405(a)(2), Regulation S-K.

26. SEC Release No. 34-37260.

that no Form 5 was required.²⁷ This representation is usually set out in an officers and directors questionnaire, which the issuer should send out annually.

The SEC has recently amended Item 405 to eliminate the presumption that a Form 4 received by the issuer within three calendar days of the required transaction may be presumed to have been filed with the SEC by the required filing date. Because all Section 16 reports are required to be filed electronically, issuers are able to review the filings on EDGAR and determine whether a report was timely filed.

2.2.7 Reporting Recommendations

In light of the complexity of the Section 16 rules, the following recommendations will help in the administration of stock benefit plans (see appendix A to this chapter for recommendations covering all types of benefit plans):

- Have a mandatory pre-clearance policy for all transactions as to which the timing is within the control of the Section 16 reporting person.
- Establish a cashless exercise policy for Section 16 reporting persons in which the Section 16 reporting person obtains any credit extension from the broker or other third party of his or her choice (and not the issuer) and results in the issuer being paid the exercise price on the day of exercise. See appendix A for more information on this subject.
- Educate all Section 16 reporting persons by a memorandum, which they should read, sign, and return.
- Obtain powers of attorney with multiple attorneys-in-fact from all Section 16 reporting persons.

2.3 Six-Month “Short-Swing” Profit Recapture Under Section 16(b) of the 1934 Act

To deter insiders from profiting on short-term trading in the securities of their company, Section 16(b) of the 1934 Act requires a public company to recover from any such person the “statutory profit” realized by him or her in either a purchase and sale, or a sale and purchase (or any number

27. Item 405(b)(2), Regulation S-K.

of these transactions) which take place within a six-month period. It is important to note that the actual possession of inside information regarding the issuer is *not* a precondition to the recovery of short-swing profits under Section 16(b). This recoverable profit is not necessarily based on economic realities, and there have been situations where an individual actually lost money on a transaction but was held accountable for the return of “profits.”

In determining whether there has been a purchase and sale within the meaning of Section 16(b), it is not necessary to establish that the same shares were purchased and sold, or sold and purchased, within the six-month period. Instead, all that needs to be established is that issuer stock (or warrants or similar rights to buy or sell issuer stock) was either purchased and sold, or sold and purchased, during a six-month period. The identity of the particular shares is irrelevant for determining Section 16(b) liability.

Like the reporting requirement under Section 16(a), Section 16(b) may apply to transactions made after an individual ceases having reporting-person status. That is, a purchase (or sale) after retirement or termination of employment from the issuer can be matched against any sale (or purchase) effected less than six months earlier at the time the individual was still a reporting person. See appendix D for more information on this subject.

To compute statutory short-swing profits, the highest sale price and lowest purchase price during the six-month period are matched, regardless of whether the sale and purchase involved the same shares. For a series of transactions, the difference between the highest sale price and the lowest purchase price during the period is computed (regardless of the order in which they occur), then the difference between the next highest sale price and the next lowest purchase price, and so forth. These differences are then totaled to determine the “profit realized” in a series of transactions. For example:

Director “D” effects the following 100-share lot transactions of Company X stock within a six-month period:

		<i>Price per Share</i>			
Purchases	\$100	\$80	\$50	\$30	
Sales	90	70	40	40	

Applying the method of calculation used under Section 16(b), the recoverable “profit realized” would be \$8,000:

<i>Transaction</i>	<i>Profit</i>
Purchase at \$30 and sale at \$90 × 100 shares	\$6,000
Purchase at \$50 and sale at \$70 × 100 shares	+2,000
	<hr/> \$8,000

For purposes of Section 16(b), it does not matter that Director “D” actually sustained an economic loss of \$2,000 during the period:

Total of sale prices	\$24,000
Total of purchase prices	– 26,000
Actual loss	<hr/> ((\$2,000))

As with Section 16(a), the director or officer is considered the beneficial owner of stock held by certain family members for short-swing profit purposes. For example:

Officer “E” purchased Company X stock in September. His spouse, Mrs. “E,” sold some shares of Company X stock in December. Despite the fact that Mrs. “E’s” accounts were separate from her husband’s, her sale would be matched with his purchase; consequently, Officer “E” is liable for any short-swing profit on the matched transactions.

The recovery for short-swing profits belongs to the issuer and cannot be waived by it. If an issuer fails or refuses to collect or sue a reporting person for short-swing profits within 60 days of demand by a shareholder, the shareholder may bring suit in the issuer’s name for recovery. Courts have regularly awarded attorney’s fees to the plaintiff’s counsel in these actions based upon the amount recovered. As a result, there are “strike lawyers” who carefully review SEC reports for violation of Section 16(b), with the intention of bringing lawsuits against the reporting person and/or the directors of the issuer if the issuer’s directors fail to do so after demand. These lawyers receive a percentage of the recovery (up to 30%) as a reward for bringing the action and obtaining a recovery for the issuer. Any unpaid Section 16(b) liability in excess of \$120,000 must be shown as an indebtedness of the reporting person to the issuer in the issuer’s proxy statement (Item 404(a) of Regulation S-K).

Computation of Six-Month Period. Profits are recoverable under Section 16(b) of the 1934 Act only if the transactions being matched occurred “within any period of less than six months.” The computation of this period has been the subject of considerable litigation. For planning purposes we recommend making the computation by looking forward and

backward six calendar months plus one day to the first transaction. For example, a purchase on January 1 will not be matched with a sale on July 2, nor will the sale on July 2 be matched with a purchase on the following January 3. This method of computation will avoid any possible litigation. We feel the only reason for using a more aggressive approach is if a particular Section 16 reporting person has bought and sold within a tighter timeframe.

Romeo & Dye's Section 16 Deskbook, which is the standard reference in the field, recommends using a less conservative approach, based on a line of cases beginning with *Stella v. Graham-Paige Motors Corp.*²⁸ looking forward and backward six calendar months minus a day (compare our more conservative approach above, which is six months plus a day). Using Romeo and Dye's approach, a purchase on January 1 will not be matched with a sale on June 30 (i.e., January 1 to July 1 minus a day), nor will the sale on June 30 be matched with a purchase on the following December 29 (i.e., June 30 to December 30 minus a day). This topic is thoroughly covered in Part III-F-1 of *Romeo & Dye's Section 16 Deskbook*.

The date of purchase or sale is based on the existence of an irrevocable commitment, not the formalities of stock transfer, such as the delivery of stock certificates or the payment of the purchase price. See Part III-F-2 of *Romeo & Dye's Section 16 Deskbook*.

2.3.1 Section 16(b) Exemptions

Not every transaction in issuer securities is considered a "purchase" or "sale" for purposes of the short-swing trading prohibition. There are several important exclusions and exemptions from Section 16(b) for certain kinds of stock transactions, which are described below. The exclusions are set forth in Rule 16b-3, which is designed to facilitate the receipt of stock-based compensation by reporting persons without incurring liability under Section 16(b).²⁹

Under Rule 16b-3, a transaction between the issuer and a reporting person that involves issuer equity securities will be exempt from the short-swing profit rules of Section 16(b) if it satisfies the appropriate conditions set forth in one of four categories: (1) tax-conditioned plans; (2) discretionary transactions; (3) grants, awards, and other acquisitions

28. 132 F. Supp. 100 (S.D.N.Y. 1955), *remanded on other grounds*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

29. 1934 Act, Rule 16b-3.

from the issuer; and (4) dispositions to the issuer.³⁰ The exemptions for tax-conditioned plans and discretionary transactions (with respect to profit sharing and 401(k) plans) generally are not available for discretionary equity compensation plan transactions³¹ and are not described herein. The third and fourth exemptions are the ones that provide the relevant exemptions for equity compensation plan transactions and therefore are discussed below in greater detail.

Grants, Awards, and Other Acquisitions from the Issuer. Any grant or award of issuer stock from the issuer to a reporting person is an exempt transaction under Section 16(b) if it satisfies any one of the three conditions described below. Grant and award transactions are those that provide issuer stock to participants on a basis that does not require either the contribution of assets or the exercise of investment discretion by participants. Examples of grant and award transactions that are not participant-directed include grants of stock options, stock appreciation rights, restricted stock (including restricted stock units and deferred stock units), or performance share awards. A participant-directed transaction, on the other hand, requires the participant to exercise investment discretion as to either the timing of the transaction or the assets into which the investment is made. Examples of participant-directed transactions include the exercise of an option or stock appreciation right or the sale of shares acquired thereunder. Participant-directed dispositions to the issuer are potentially eligible for the “dispositions” exemption described below.

Any transaction involving a grant, award, or other acquisition by a reporting person from the issuer (other than a transaction meeting the definition of a discretionary transaction) will be exempt from Section 16(b) if any one or more of the following conditions are met:

-
30. The Section 16 Rules exempt only transactions between a reporting person and the issuer and not between the issuer and persons who are subject to Section 16 solely because they beneficially own greater than 10% of the issuer’s equity securities.
 31. This assumes the option plan is not an employee stock purchase plan that satisfies the relevant provisions of Section 423 of the Internal Revenue Code. Under the tax-conditioned plan exemption, certain transactions in issuer securities in connection with an employee stock purchase plan governed by Code Section 423 are exempt without further condition from Section 16(b).

- The issuer's board of directors or a committee of the board comprised of two or more "non-employee directors"³² approves the acquisition in advance,³³
- The issuer's shareholders approve the acquisition in advance or ratify it not later than the date of the next annual meeting of shareholders;³⁴ or
- The insider holds the securities acquired for six months following the date of acquisition.³⁵

Thus, exercises of stock options or stock appreciation rights will be exempt from Section 16(b) if approved by the issuer's board of directors, by a committee consisting of two or more non-employee directors, or by the issuer's shareholders.

The SEC has made clear that this approval requirement relates to each specific transaction and is not satisfied by approval of a plan in its entirety, except for plans where the terms and conditions of each transaction are fixed in advance, such as a formula plan.³⁶ Where the terms of a subsequent transaction are provided at the time a transaction is initially approved, the subsequent transaction does not require further specific approval. For example, the acquisition of common stock that occurs upon the exercise of a stock option or stock appreciation rights is exempt as long as the exercise is pursuant to the express terms provided for in the option as originally approved.³⁷ Similarly, if an option as originally ap-

32. Under Rule 16b-3(b)(3), a "non-employee director" is defined as a director who (1) is not currently an officer or otherwise employed by the issuer, or a parent or subsidiary of the issuer; (2) does not receive compensation directly or indirectly from the issuer, its parent, or subsidiary for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount (currently \$120,000) for which disclosure would not be required pursuant to Item 404(a) of Regulation S-K; and (3) does not possess an interest in any other transaction for which disclosure would be required pursuant to Item 404(a) of Regulation S-K (amended as part of the current executive compensation rules).

33. 1934 Act, Rule 16b-3(d)(1).

34. 1934 Act, Rule 16b-3(d)(2).

35. 1934 Act, Rule 16b-3(d)(3).

36. SEC Release No. 34-37260, Part II, D.

37. The disposition of the option that occurs upon exercise would be exempt pursuant to the rule relating to dispositions described below. In the same manner, if the terms of an award of stock options, as approved, provide for

proved specifically provides for the automatic grant of “reload” options, reload grants pursuant to those terms would not require subsequent approval. Conversely, if a reload option was not specifically contemplated at the time of approval of the initial option grant, the replacement grant would require approval in advance of the grant.

Note that if an option, SAR, or stock award does not satisfy one of the approval requirements, it may in any event qualify for an exemption from Section 16(b) under the six-month holding period rule. This rule provides that the acquisition of a security will be exempt from Section 16b-3 if the security is held by the recipient for six months following the acquisition or, in the case of a derivative security, if the underlying security is held for six months after the acquisition of the derivative security.³⁸ In the case of a stock option, this means that the grant will be an exempt *purchase* of issuer securities if the option (or the underlying issuer stock) is held for at least six months from the date of grant. For example, if an option is granted on May 1, 2005, and the option is exercised on or after November 1, 2005, the exercise of that option will be an exempt purchase that cannot be matched up with any other nonexempt sales. However, if the option is exercised earlier and the underlying stock is sold before November 1 (in this example), the option grant itself can be treated as a nonexempt purchase of issuer stock matchable against the subsequent sale.

Dispositions to the Issuer. In addition to the potential Section 16(b) impact of the grant or exercise of an option, the disposition of shares in connection with an option also must be considered. The issue here is whether or not a disposition of issuer securities in connection with or following the exercise of a stock option will be an exempt or nonexempt sale. In this regard, all dispositions of issuer securities by a reporting person pursuant to open market transactions will be treated as *nonexempt* sales that can potentially be matched against any nonexempt purchases occurring within six months of the sale. As a result, sales of issuer securities into the open market pursuant to a “cashless exercise” arrangement with

a stock-for-stock exercise (a “stock swap”), the disposition of company stock in connection with the subsequent stock swap would be exempt without further condition if effected pursuant to those terms. Conversely, if a stock swap was not approved at the time of the initial grant, it would require subsequent approval before exercise.

38. Rule 16b-3(d)(3), Note (3).

a broker or other third party will result in nonexempt sales of issuer securities by a reporting person.

However, dispositions of issuer securities *back to the issuer* will be exempt if approved in advance by the issuer's board of directors, by a committee of the board comprised of two or more non-employee directors, or by the shareholders.³⁹ Note that these are the same approval requirements described above in connection with grants, awards, and other acquisitions. Unlike the exemptions for "acquisitions," however, the six-month holding period rule does *not* apply to "dispositions" of issuer securities.

Thus, as long as the approval requirements are met, the Section 16(b) Rules will exempt a disposition of issuer stock by a reporting person *back to the issuer* pursuant to (1) the right to have securities withheld, or to deliver securities already owned, either in payment of the exercise price of an option or to satisfy the tax withholding consequences of an option exercise; (2) the expiration, cancellation, or surrender to the issuer of a stock option or stock appreciation right (SAR) in connection with the grant of a replacement or reload option;⁴⁰ or (3) the election to receive, and the receipt of, cash in complete or partial settlement of an SAR.⁴¹ Additionally, the Section 16 Rules will give the issuer the flexibility to redeem its equity securities from reporting persons in connection with nonexempt replacement grants and in discrete compensatory situations such as individual buy-backs.

For issuers that intend to provide reporting persons with the ability to engage in share-for-share exercises or the delivery of issuer securities to satisfy tax withholding, it is recommended that these features be included in the original option grant so as to avoid the need for additional approval of the disposition of securities at the time of option exercise. Also, it is important to note that the sale of shares to pay the exercise price of an option under a cashless exercise program will be exempt from Section 16(b) *only* if the issuer is the purchaser, and not if the shares are sold on the open market by a broker or other third party.

39. SEC Release No. 34-37260, Part II, E.

40. A "reload option" generally means an option that is granted in replacement of shares purchased upon the exercise of a prior granted option. Reload option programs generally work in tandem with a stock-for-stock exercise feature. If the optionee exercises his or her option by delivering previously owned issuer shares, the issuer may grant a new option replacing the number of shares delivered to exercise the prior option.

41. SEC Release No. 34-37260, Part II, E.

SEC Revisions to Rule 16b-3 and Rule 16b-7.⁴² The SEC amended Rules 16b-3 and 16b-7 under the 1934 Act in light of the decision of the U.S. Court of Appeals in *Levy v. Sterling Holding Company, LLC*, 314 F.3d 106 (3d Cir. 2002), cert. denied, 124 S. Ct. 389 (2003). In *Levy*, the court held that the provisions of these rules were not available to exempt from Section 16(b) of the 1934 Act acquisitions of issuer securities in a reclassification undertaken by the issuer before its initial public offering (IPO). The court's position permitted matching of those acquisitions with subsequent sales made within six months of the IPO, thus creating substantial Section 16(b) liability. As indicated above, Rule 16b-3(d) exempts from the application of Section 16(b) any transaction involving a

42. Rule 16b-7 exempts from Section 16(b) acquisitions and dispositions in transactions that are mergers, reclassifications, or consolidations that do not involve a significant change in the issuer's business or assets and that comply with an 85% continuing ownership test. The rule is typically relied on where a company reincorporates in a different state or reorganizes its corporate structure. The court in *Levy* held that Rule 16b-7 did not exempt an acquisition pursuant to a reclassification that resulted in an insider owning equity securities (common stock) with different risk characteristics from the securities (preferred stock) extinguished in the transaction and thus involved an increase in the percentage of the insider's common stock ownership where the preferred stock previously had not been convertible into common stock. To eliminate uncertainty generated by the court's ruling that Rule 16b-7 imposed different requirements for reclassifications than for mergers or consolidations, the SEC has revised Rule 16b-7 so that it states "merger, reclassification or consolidation" in each place it previously stated "merger or consolidation." In addition, the SEC has clarified that the exemption provided by Rule 16b-7 applies to any securities transaction that satisfies the conditions of the rule and is not conditioned on the transaction satisfying any other conditions. Revised Rule 16b-7 became 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. The SEC has made clear that a reclassification includes any transaction in which the terms of the entire class or series of securities are changed, or the securities of the entire class or series are replaced with securities of a different class or series of securities of the company, 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. The SEC has also clarified that a transaction that has the same characteristics and effect as a reclassification, merger, or consolidation, whether domestic or foreign, is exempt without regard to its formal name.

grant, award, or other acquisition from the issuer if specified conditions are satisfied. The court in *Levy* held that the Rule 16b-3(d) exemption was applicable only if the grants, awards, or other acquisitions had some compensation-related aspect. To eliminate the uncertainty created by the court's ruling, the SEC has revised Rule 16b-3(d) to make it clear that any acquisition from the issuer (other than a discretionary transaction), including without limitation an award or grant, *whether or not intended for a compensatory or other particular purpose*, is exempt if any one of the Rule's three existing alternative conditions is satisfied. A similar revision has been made to Rule 16b-3(e) (dispositions to the issuer) since it has the same conditions as Rule 16b-3(d) and operates in the same way. The provisions of revised Rule 16b-3(d) became effective August 9, 2005, but because they clarify regulatory conditions that applied to this exemption since it 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. See SEC Release 33-8600.

Merger No-Action Letter. In 1999, the SEC issued a no-action letter setting forth how shares acquired by officers and directors of a public company within six months of that company being acquired for cash or stock in a merger can be protected from the short-swing profit recapture under Section 16(b) pursuant to the exemption in Rule 16b-3.⁴³ This no-action letter has become the standard under which these transactions are being conducted. It relies on the exemption for dispositions to the issuer in Rule 16b-3(e). Language should be put in merger documents to protect the directors and executives of public target companies referencing the procedures in this no-action letter.

Drafting and Other Considerations. Under the Section 16 Rules, it is no longer necessary that an employee benefit plan be in writing or that the plan receive shareholder approval in order to qualify for the Section 16b-3 exemptions. The shareholder approval element of the Section 16 Rules relates to each individual option grant rather than the plan in its entirety and therefore is not needed. As a result, most issuers will rely on the board of directors' or the committee's approval to satisfy an exemption under Section 16(b). However, most issuers have continued to seek shareholder approval of their equity compensation plans to satisfy other requirements, such as requirements of the stock exchanges, NAS-

43. See *Skadden, Arps, Slate, Meagher & Flom*, SEC No-Action Letter (April 28, 1999).

DAQ, state corporate law, Internal Revenue Code Section 162(m) (which requires shareholder approval of an option plan to qualify for one of the exemptions to the \$1 million deduction limitation for compensation paid by public corporations), or Internal Revenue Code Section 422 (which requires shareholder approval of an equity compensation plan). Effective June 30, 2003, most equity compensation plans are required to be shareholder-approved under stock exchange and NASDAQ rules. See SEC Release 34-48108 (June 30, 2003).

Under Rule 16b-3 before the 1996 amendments, amending a stock option plan required shareholder approval if the amendment would (1) materially increase the benefits accruing to participants under the plan, (2) materially increase the number of securities that could be issued under the plan, or (3) materially modify the requirements for participation in the plan. Following the 1996 amendments, shareholder approval of plan amendments is not required, except for increases in shares to satisfy stock exchange rules, etc., as described above.

Employers with equity compensation plans adopted before the 1996 amendments to the Section 16 Rules may wish to amend their plans to remove some of the restrictions imposed by Rule 16b-3 before the 1996 amendments. For example, provisions requiring disinterested administration, restrictions on transferability of options, or shareholder approval of plan amendments (unless required by other rules or regulations) may be removed. Likewise, to the extent that the plan mandates a six-month holding period, this restriction may be removed, unless the issuer otherwise desires to retain the holding period to ensure the availability of an exemption under the Section 16 Rules without the need for shareholder, director, or committee approval. Note, however, that effective June 30, 2003, most of these changes require shareholder approval under NASDAQ and stock exchange rules.

Transaction Review and Assistance. Because of the complexities involved in reporting under Section 16(a) and the danger of short-swing recapture under Section 16(b), most companies have developed programs to assist directors and officers in complying with these federal statutes. The compliance program usually consists of the following:

- All directors and designated officers must contact the issuer's designated compliance officer before they, a family member, or a trust or other entity which they control engage in any transactions in company stock, including gifts, purchases, sales, etc.

- The designated compliance officer usually prepares the Section 16 reports and files them with the SEC.
- All directors and designated officers are requested to execute a power of attorney enabling the designated compliance officer to sign and file the necessary forms with the SEC.
- Brokers representing directors and designated officers are informed of the company's policies concerning insider trading and Section 16 reporting.

See the model pre-clearance policy included as appendix B to this chapter.

2.4 Trading While in Possession of Inside Information

As a general rule, any person with material non-public information about the issuer is obligated under Rule 10b-5 under the 1934 Act to refrain from purchasing or selling common stock until such information has been released into the marketplace.⁴⁴ Although stock options or stock appreciation rights may be exercised at any time even if the holder has material non-public information about the issuer, such person is obligated under Rule 10b-5 to refrain from selling common stock acquired upon exercise of an option or stock appreciation right until the material non-public information has been released into the marketplace.

To be found liable for insider trading, the reporting person must have benefited from material, non-public information in connection with a purchase or sale of a security. (Using material, non-public information to refrain from a purchase or sale does not violate Rule 10b-5.) Information is considered "material" for these purposes if there is a substantial likelihood that a reasonable investor would consider it important in arriving at a decision to buy, sell, or hold stock of the issuer. Examples of inside information that might be deemed material include:

44. Also, the Insider Trading and Securities Fraud Enforcement Act provides civil penalties for insider trading in the amount of the greater of \$1 million or three times the profit gained or loss avoided. It also prescribes criminal penalties of a maximum 10-year jail term and a maximum fine of \$1 million for individuals.

- Actual or projected sales or earnings (including changes of previously announced estimates).
- Actual or projected significant capital expenditures.
- Actual or projected significant borrowings.
- Public or private sale of a significant amount of additional securities of the company, or major financings or refinancings.
- Non-business matters affecting the market for company securities (such as upcoming research, brokerage firm recommendations, or the intention of parties to buy or sell an abnormal amount of securities).
- A proposed merger, acquisition, joint venture, or disposition of stocks or assets, or a tender offer for another company's securities.
- Any action or event that could have a significant effect on annual sales or earnings.
- Any action or event that may result in a special or extraordinary charge against earnings or capital, or significant changes in asset values or lines of business.
- A significant change in capital investment plans.
- Major new products, discoveries, or services.
- A call of securities for redemption or a program to repurchase company shares.
- A change in control or significant management changes.
- Significant litigation and changes in pending litigation.
- Significant changes in operating or financial circumstances.
- Significant labor disputes or other pay-related issues.
- Significant actions by regulatory bodies.
- Prohibited information on other companies learned through special business relationships with them.
- Dividend increases or decreases.
- Rating agency upgrades or downgrades.

The foregoing list is for illustration only and is not exhaustive; other types of information may be material at particular times, depending upon all the circumstances.

Insider Trading Policies. The most dangerous time to engage in a purchase or sale of issuer stock is shortly in advance of the public release by the issuer of important financial information, such as quarterly or year-end results, or other important news. Many companies impose blackouts on their officers and directors beginning 15 days before the end of the quarter or fiscal year and ending 2 or 3 days after the releases of earnings. The safest time to engage in purchases or sales is the period—commonly referred to as a window period—shortly following the release and publication of such information. However, even engaging in transactions during a window period presumes that the person is not aware of any other material information which has not been made public. Even after such information has been released, it is important to be sure that sufficient time has elapsed to enable the information to be disseminated to and considered by investors.

Stock Transactions During Blackout Periods. Insider trading policies generally prohibit cashless exercises of stock options (involving open market sales through a broker or other third party) while in possession of material non-public information, but they do not prohibit stock-for-stock exercises or share withholding to pay taxes where the issuer is the purchaser. These transactions are with the issuer, which is the ultimate insider and is presumed to have full knowledge. If the issuer is holding back on “good news,” these transactions will be at a bargain price to the issuer and will not create insider trading liability as long as the person exercising the option has full knowledge of the “good news.” If the issuer is holding back on “bad news,” the person exercising the option by the delivery of previously owned shares is getting the benefit of too high a price for those shares, but once again this should not create insider trading liability. At worst, it creates a claim of corporate waste by the shareholders if they become aware of the transaction. This claim should be defended against on the basis of the “business judgment rule” that it was in the best interest of the company to permit the transaction. Given the shareholder and SEC activity in the area of option exercises, the authors now believe the safer practice would be to *prohibit* stock-for-stock exercises and share withholding to pay taxes during the company’s traditional black-out periods. See further discussion in the following paragraphs.

In a 2005 SEC investigation involving Analog Devices, Inc. (NYSE: ADI), the SEC appeared to be concerned about a company granting stock options to its directors and executive officers immediately before

the announcement of good news. In connection with the settlement, ADI consented to a cease-and-desist order under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, paid a civil money penalty of \$3 million, and repriced options granted to the CEO and other directors in certain years. Options granted to all other employees were excluded from the repricing. The CEO consented to a cease-and-desist order under Sections 17(a)(2) and (3) of the Securities Act, paid a civil money penalty of \$1 million, and made a disgorgement payment with respect to options granted in certain years.

Taking this SEC concern to the next level could lead one to conclude that the SEC would be equally concerned with a company permitting the delivery of previously owned shares to pay the exercise price of a stock option or related taxes at a time when the company was in a blackout involving the nondisclosure of material adverse information. In light of the SEC's activity in this area, it may be sensible for a public company's insider trading policy to include the delivery of shares to pay the exercise price or related taxes.

2.4.1 Backdating of Stock Option Grants

On an almost daily basis, corporations are announcing their involvement in investigations concerning the timing of stock option grants made to senior executives. These investigations—which are being separately pursued by the SEC and the U.S. Department of Justice (DOJ)—have prompted financial restatements by some corporations and in some instances have led to the resignations of senior corporate officials.

The issue catalyzing these investigations is whether corporations used stock option grants to improperly enrich their senior executives. These investigations focus on two main issues:

- Whether options were “backdated,” or retroactively granted on a date when the stock price was low in order to build in a profit for the executives
- Whether the options were “spring-loaded,” or granted immediately before corporate announcements that were likely to increase the price of the shares

The options backdating investigations raise both civil and criminal issues for corporations and their executives. The SEC is investigating whether companies backdated options to provide undisclosed compen-

sation to senior executives and whether the failure to disclose this practice constituted securities fraud. Thus, these recent investigations focus on how companies report and disclose backdated options for financial and tax reporting purposes.

Similarly, the DOJ is also looking at these cases from a criminal standpoint, i.e., was there fraud? Were documents altered or misdated as a part of the fraud? Finally, were shareholders told the truth about the option grants and the compensation of corporate officials? The corporations and executives involved in improperly backdating options may face securities, mail, and wire fraud charges as well as tax charges. Private civil litigation involving these same issues also has been filed against some companies.

Because of the potential civil and criminal liability that companies and their officers may face, corporations suspecting they may have problems relating to the backdating of options need to evaluate a number of possible compliance issues and should consult counsel. In some instances, corporations acting through special committees of the board of directors may want to seek independent counsel to investigate such problems.

It should be noted that options backdating can occur without any intentional wrongdoing merely due to failures in corporate procedures. Even though such inadvertent errors are uncommon, the consequences can be serious.

The current executive compensation rules discussed below address this issue of option backdating in a disclosure manner. If the options are not granted at the “closing market price” (last sales price), an extra column must be added in the proxy statement in the table disclosing option grants showing the difference between the grant price and the closing market price. Many omnibus plans have a definition of fair market value related to the average of the high and low prices on either the date of grant or the date preceding the date of grant. This definition will trigger the disclosure discussed above. Many public companies are either amending their plans or adopting compensation committee resolutions providing that options will only be granted at the closing market price (last sales price) on the date of grant. This concept of last sales price is also applicable to any use of fair market value for equity compensation plans; i.e., for the delivery of previously owned shares to pay the exercise price or for share withholding to pay taxes.

The SEC’s website (sec.gov) contains a link entitled “Stock Options Backdating” (on the left-hand side of the SEC home page at the time of this writing) which presents considerable information on this subject,

including enforcement actions, Commission speeches, Commission Staff speeches, and listing of complaints brought by the SEC.

2.5 1933 Act Registration Requirements; Resales by Plan Participants

The 1933 Act makes it unlawful for any person to sell or to offer to sell any security unless an effective registration statement has been filed and declared effective with respect to such security or the offer (sale) is pursuant to an available exemption from registration.⁴⁵ There are a number of exemptions from the registration rules listed below that may be available for stock issued pursuant to an employer-sponsored equity compensation plan. Failure to comply with the registration requirements may give the purchaser of securities a rescission right.⁴⁶ In order to allow for marketability of shares acquired in connection with an equity compensation plan, it is important to make sure the shares have been properly registered or an exemption from registration is available.

2.5.1 Registration Requirements

Section 5 of the 1933 Act provides that it is unlawful for any person, directly or indirectly, to use any form of interstate transportation or communication or the mails to offer a security for sale unless a registration statement has been filed with respect to such security or to sell, carry, or deliver for sale any security unless a registration statement is in effect for such security.⁴⁷ Thus, in implementing an equity-based compensation arrangement, an employer must consider whether the arrangement involves the issuance of a security and, if so, whether the security to be issued under such plan should be registered pursuant to the provisions of the 1933 Act, or whether one or more exemptions from registration may be available.

Even if an exemption from registration is applicable, the employer should also consider whether participants in the plan are, without violation of federal securities laws, free to sell securities received under such a plan. The latter consideration, of course, relates to the value of the plan benefits to employees as an incentive compensation device.

45. 1933 Act, § 5.

46. 1933 Act, § 12.

47. 1933 Act, § 5(a)(1).

Registration on Form S-8. If an issuer is subject to the reporting requirements of the 1934 Act—that is, the issuer is a “public company” (including, in this instance, a foreign private issuer)—registration of stock to be issued to officers, directors, and employees under any employee benefit plan of the employer can be accomplished very simply by filing Form S-8 with the SEC.⁴⁸ The Form S-8 consists of a prospectus and a registration statement. This registration statement registers a fixed number of shares for use with respect to the benefit plan. When those shares are used up, a new registration statement should be filed. The registration statement incorporates by reference the employer’s current and future 1934 Act reports, including certain information incorporated into such reports to satisfy certain Form S-8 updating requirements. The prospectus is not filed with the SEC. Thus, the registration statement can remain “alive” for a number of years (until the registered shares are used up) without any need to rewrite and redistribute the prospectus. Most changes to the information in the prospectus can be made by means of a prospectus supplement or appendix. Not only does registering the stock on Form S-8 satisfy the employer’s requirements under Section 5 of the 1933 Act, it also permits all plan participants, except “affiliates,” to sell stock received under the registered plan freely and immediately. It also preempts filing requirements in most states.

- *Sales by Affiliates.* As a result of their control relationship with the employer, affiliates⁴⁹ may be deemed to be acting as the corporate issuer when they sell the issuer’s stock. Thus, even though stock issued pursuant to an equity compensation plan may be registered on Form S-8, an affiliate may not freely sell such stock unless an exemption applies or unless the affiliate’s sale itself is registered.⁵⁰ In most cases, resales by affiliates are made pursuant to the exemption from registration provided by SEC Rule 144.⁵¹ If the shares being sold by the affiliate have been registered under the 1933 Act (on Form S-8, for example), the six-month holding period requirement (previously

48. SEC Release No. 33-6188, Part VI, A.

49. An “affiliate” is defined as any person in control or sharing control of the issuer. All directors, the CEO, CFO, and general counsel are presumed to be affiliates. Other vice presidents are presumed *not* to be affiliates. This is a question of fact to be determined by each company and its counsel.

50. SEC Release No. 33-6188, Part VI, A.

51. For a more detailed discussion of Rule 144, see “1933 Act Registration Requirements; Resales by Plan Participants—Sales Under Rule 144” below.

one year) of Rule 144 does not apply. However, the other conditions of Rule 144 continue to apply.

As an alternative to Rule 144, an affiliate's shares can be registered for resale, either by means of a separate registration statement or by means of a resale prospectus filed together with the plan's registration statement on Form S-8. A resale prospectus filed with Form S-8 may under certain circumstances be prepared in accordance with the requirements of Form S-3, even though the issuer is not otherwise eligible to use that abbreviated form. Most companies do not use this resale prospectus because of the negative impact it has on the trading market for the stock: the public shareholders could construe it as a vote of no confidence by the company's affiliates.

Finally, an affiliate may be able to sell stock received under a stock plan in a privately negotiated transaction. However, the various considerations that apply to such sales under the securities laws are complex, and careful consultation with counsel is recommended before any such transaction is undertaken.

Issuance of Stock Without Registration. In certain instances, stock can be issued pursuant to an equity compensation plan without registration of the stock or the plan. However, under most of the available exemptions from registration, the participant will receive stock that is not freely tradable. Some of the exemptions from registration do not require the employer to provide specified information; nevertheless, sales under any of these exemptions will remain subject to the antifraud provisions of the 1933 and 1934 Acts. Several of the commonly used exemptions from registration for equity compensation plans are briefly described below.

- *Non-public Offering.* Section 4(2) of the 1933 Act provides an exemption for a "private placement" of securities, which is an offering of stock to a limited number of investors who have access to the same information normally provided in a public offering *and* who are sophisticated enough both to assess and bear the risks of investing in the issuer's securities. No specific information is required to be disclosed to purchasers, but their access to information about the employer is generally considered to be an element of the exemption. This exemption may be available for the issuance of stock to the employer's top executives, but it is less likely to be available for a broad-based stock compensation program.

- *Regulation D Offerings.* Regulation D contains three alternative exemptions from registration under Section 3(b) of the 1933 Act, set forth as Rules 504, 505, and 506.⁵² All of the Regulation D exemptions require the filing of a relatively simple form with the SEC. Rule 505 provides an exemption to offerings of up to \$5 million in any 12-month period to as many as 35 nonaccredited investors. Note that the \$5 million limit during any such 12-month period is reduced by the amount of any other offerings exempt under Section 3(b) of the 1933 Act.

Rule 504 exempts an offering of up to \$1 million of stock in any 12-month period, again reduced by the amount of any other offerings exempt under Section 3(b) of the 1933 Act. The Rule 504 exemption does *not* require that offerees be sophisticated or knowledgeable about the issuer or that specific information about the issuer be disclosed. However, the dollar limitation of Rule 504 can be a significant problem in the case of a stock option plan because the offering is deemed to be continuing for the entire period during which the options are exercisable.

The final Regulation D exemption from registration is found in Rule 506. Rule 506 does not limit the size of the offering but instead limits the number of purchasers and requires that purchasers, either alone or with a financial advisor, be capable of evaluating the investment. Under both Rule 505 and Rule 506, specific disclosures are required unless the offering is made exclusively to “accredited investors” (which term includes executive officers, directors, and as well as individuals meeting specified income or net worth tests).

- *Rule 701.* Rule 701 (as described in greater detail below) can also exempt sales under compensatory benefit plans if certain conditions are met.⁵³ This exemption is non-exclusive and can be used in conjunction with Regulation D and other exemptions. In the authors’ view, an exemption under Rule 701 is preferable to Regulation D, and in many cases an exemption under Regulation D is a fallback to qualifying under Rule 701.

2.5.2 Rule 701

For certain compensatory issuances of stock or stock options to employees and other service providers, Rule 701 provides an exemption from the

52. 1933 Act, Rules 504-506.

53. 1933 Act, Rule 701.

registration requirements of the 1933 Act for offers and sales of securities. The primary features of Rule 701 are as follows:

- The purpose of the issuance must be compensation. If the purpose of the plan is to circumvent registration requirements and is not for compensation purposes, then the exemption is not available.
- Rule 701 is an exemption from federal securities laws and does not provide an exemption from applicable state securities laws. Many states, however, have adopted equivalent exemptions that either specifically provide for issuances made pursuant to Rule 701 or generally exempt issuances that are made for compensatory purposes.
- The issuer cannot be a reporting company under Section 13 or 15(d) of the 1934 Act nor an investment company required to be registered under the Investment Company Act of 1940.⁵⁴
- The participants may be employees, directors, general partners, trustees (if the issuer is a business trust), officers, or consultants and advisors, and their family members who acquire such securities through gifts or domestic relations orders.⁵⁵ Further limitations on the participants are detailed below.
- Limitations are imposed on the sales price or amount of securities that can be issued pursuant to Rule 701. Basically, the limitation is that during any 12-month period the aggregate sales price or amount of securities sold in reliance on Rule 701 cannot exceed the greatest of (1) \$1 million, (2) 15% of the total assets of the issuer, or (3) 15% of the outstanding amount of the class of securities being offered and sold in reliance on Rule 701. Further details are provided below.
- Although this is an issuer-only exemption, Rule 701 also provides special rules for resale after the company has gone public. Further resale details are provided below.

54. A privately held subsidiary of publicly held parent may rely on Rule 701, and may issue securities to its publicly held parent or other majority-owned subsidiaries of its parent. *American Bar Association*, SEC No-Action Letter [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,604 at 76,132 (Aug. 3, 1999).

55. Former employees, directors, general partners, trustees, officers, or consultants and advisors can participate only if they were employed by or provided services to the issuer at the time the securities were offered.

- No SEC notice is necessary for an issuance pursuant to Rule 701. Notice requirements, however, exist under some state securities regulations.
- The issuance must be made pursuant to a written compensation contract or written compensatory plan.⁵⁶
- Disclosures must be provided. The issuer must deliver to investors a copy of the benefit plan or contract. If the aggregate sales price or amount of securities sold exceeds \$5 million in a consecutive 12-month period, then certain other disclosures (including U.S. GAAP financial statements of the issuer) must be made within a reasonable period before the date of sale, as detailed below.
- Rule 701 transactions are not integrated with other exempt transactions.⁵⁷
- Rule 701 is not exclusive, so that other exemptions may be claimed.

Participants. As noted above, the participants may be employees, directors, general partners, trustees (if the issuer is a business trust), officers, or consultants and advisors, and their family members who acquire such securities through gifts or domestic relations orders. In a 1999 amendment of Rule 701, the SEC significantly restricted the definition of “consultants and advisors” who may participate in a Rule 701 issuance and harmonized the Rule 701 interpretation of the phrase with the Form S-8 interpretation.⁵⁸ Consultants and advisors must be natural persons and provide bona fide services to the issuer, its parents, or their majority-owned subsidiaries.

In addition to the above basic requirements to be a consultant or advisor, securities promoters may not participate under the exemption because they do not qualify as consultants or advisors. This exclusion covers people whose services are inherently capital-raising or promotional, such as brokers, dealers, those who find investors, those who provide shareholder communications services, and those who arrange

56. A compensatory benefit plan is defined as any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension, or similar plan.

57. A general solicitation in connection with a Rule 701 transaction, however, may cause an integration problem with respect to exemptions that do not permit general solicitation.

58. SEC Release No. 33-7646 (April 7, 1999).

for mergers or take the company private. Business advisors whose activities are not inherently capital-raising or promotional would be allowed to participate in an offering under Rule 701.

Independent agents, franchisees, and salespersons that do not have an employment relationship with the issuer are also not within the scope of “consultant or advisor.” A person in a *de facto* employment relationship with the issuer, however, such as a non-employee providing services that traditionally are performed by an employee, with compensation paid for those services being the primary source of the person’s earned income, would qualify as an eligible person under the exemption. Other persons displaying significant characteristics of “employment,” such as the professional advisor providing bookkeeping services, computer programming advice, or other valuable professional services may qualify as eligible consultants or advisors, depending upon the particular facts and circumstances.

The term “employee” specifically includes insurance agents who are exclusive agents of the issuer, its subsidiaries or parents, or derive more than 50% of their annual income from those entities.

Limitations on Issuances. During any 12-month period the aggregate sales price or amount of securities sold in reliance on Rule 701 cannot exceed the greatest of (1) \$1 million, (2) 15% of the total assets of the issuer (or of the issuer’s parent if the issuer is a wholly owned subsidiary and the parent fully and unconditionally guarantees the obligations of the issuer), or (3) 15% of the outstanding amount of the class of securities being offered and sold in reliance on Rule 701. Both the total assets and outstanding amount of securities are measured at the issuer’s most recent annual balance sheet date, if it is no older than its last fiscal year end.

The aggregate sales price means the sum of all cash, property, notes, cancellation of debt, or other consideration received or to be received by the issuer for the sale of the securities. Non-cash consideration must be valued by reference to bona fide sales of the consideration made within a reasonable time or, in the absence of such sales, on the fair value as determined by an accepted standard. The value of services exchanged for securities issued must be measured by reference to the value of the securities issued. Thus, compensatory arrangements for consultant and employee services must be valued, and they cannot be valued at “zero” or as a gift. Options must be valued based on the exercise price of the option, and if options are subsequently repriced, then a recalculation of the aggregate sales price under Rule 701 must be made. The aggregate sales

price of options is determined upon the grant of the options, regardless of when the options become exercisable or are exercised. Deferred compensation and similar plans are measured as of the date an irrevocable election to defer compensation is made. The aggregate sale price of other securities not mentioned above is determined on the date of sale.

The total assets of the issuer for the 15%-of-total-assets test are determined by using the calculation of assets on the balance sheet of the issuer. While not specifically mandated by the SEC, in applying for an exemption under Rule 701, companies use the assets total from their balance sheets.

The amount of outstanding securities for the 15% of the outstanding class of securities test is calculated by including all currently exercisable or convertible options, warrants, rights, or other securities. This amount does not include options, warrants, or rights that are not presently exercisable, and it also does not include presently non-convertible securities.⁵⁹ “When these securities become exercisable or convertible, subsequent calculations may consider such securities.” The amount of outstanding securities does not include securities issuable pursuant to Rule 701. That is, the amount of outstanding securities does not include exercisable options, warrants, or rights issued pursuant to Rule 701 that have not yet been exercised.

In relation to the 15%-of-outstanding-class-of-securities test, for the purposes of determining the number of outstanding shares of a class, separate classes of common stock may be considered as a single class if the rights of such separate classes are nearly identical.⁶⁰

Resale Limitations. Securities issued under Rule 701 are “restricted securities” as defined in Rule 144. Resales of securities issued pursuant to Rule 701 must be in compliance with the registration requirements of the 1933 Act or an exemption from those requirements. Ninety days after the issuer becomes subject to the reporting requirements of Section 13 or 15(d) of the 1934 Act, securities issued under Rule 701 may be resold by persons other than affiliates of the issuer, subject to certain limitations, and by affiliates subject to further limitations.⁶¹

59. *American Bar Association Subcommittee on Employee Benefits and Executive Compensation*, SEC No-Action Letter, LivedGAR (September 6, 1988).

60. *Osler Health, Inc.*, SEC No-Action Letter (February 11, 1998).

61. See Rule 701(g).

Disclosures. If the aggregate sales price or amount of securities sold exceeds \$5 million in a consecutive 12-month period, then certain other disclosures must be made within a reasonable period before the date of sale, which are in addition to the disclosure of the written benefit plan or contract. These additional disclosures include (1) if the plan is subject to ERISA, a copy of the summary plan description required by ERISA, or, if the plan is not subject to ERISA, a summary of the material terms of the plan; (2) information about the risks associated with investment in the securities sold pursuant to the compensatory benefit plan or compensation contract; and (3) U.S. GAAP financial statements as of a date no more than 180 days before the sale of securities in reliance on Rule 701. If the issuer relies on its parent's total assets to determine the amount of securities that may be sold, the parent's financial statements, which must meet certain standards if the parent is a reporting company under Section 13 or 15(d) of the 1934 Act, must be delivered. If the sale involves a stock option or other derivative security, the issuer must deliver disclosures a reasonable period of time before the date of exercise or conversion.

2.5.3 Sales Under Rule 144

U.S. securities laws are based on the premise that every person who wants to sell a security must establish an exemption from applicable federal and state securities law registration requirements or must comply with such registration requirements. When a normal investor wishes to sell IBM or General Motors securities, he or she can rely on the exemption in Section 4(1) of the 1933 Act, but what if the selling shareholder is an affiliate of the issuer or has acquired the securities from the issuer or an affiliate of the issuer in a transaction not registered under the 1933 Act? To answer this question, one must understand Rule 144 promulgated under the 1933 Act. It covers sales of unregistered securities ("restricted stock") by non-affiliates and sales of all securities by affiliates of the issuer.

Under the 1933 Act, an "affiliate" of the issuer (which includes all directors and certain executive officers) may not sell issuer securities unless the sale is covered by a registration statement or falls within an exemption from the registration requirements of the 1933 Act. The exemption most frequently used by directors and officers is SEC Rule 144.⁶²

62. 1933 Act, Rule 144.

Rule 144 serves as a safe harbor, allowing directors and officers to sell securities without complying with the SEC's registration requirements, provided that certain specific conditions are met.

For purposes of Rule 144, "restricted stock" is stock acquired from the issuer or an affiliate of the issuer in a transaction *not* involving a public offering. Unless shares of common stock issued upon exercise of stock options have been registered under the 1933 Act on a Form S-8, such stock will be considered restricted stock. No shares of restricted stock may be sold unless either the sale of such stock is registered with the SEC or the sale is exempt from the registration requirements, as in the case of a sale that falls within the provisions of Rule 144. Rule 144 is not the only exemption available. Private sales in particular may be eligible for other exemptions. Also, sales to large institutional buyers may be permitted under Rule 144A. However, Rule 144 provides essentially the only way to sell restricted shares in the public market.

In general, "affiliates" are persons in control of the issuer. The term "affiliate" includes *all* directors and certain key executive officers of the issuer. In 1997 the SEC proposed a bright-line test for the definition of affiliate that would indicate that a person would not be deemed to be an affiliate if the person is not (1) a 10% owner, (2) a Section 16 reporting person, or (3) a director of the issuer. While this proposal has not yet been enacted, it is indicative of what the SEC is thinking.⁶³

Affiliates usually sell issuer securities under SEC Rule 144. Generally speaking, a Rule 144 transaction is an unsolicited broker's transaction on a stock exchange (including NASDAQ). Rule 144 requires that the issuer be current in its filings with the SEC, and it limits the amount to be sold in any three-month period. A Rule 144 transaction also requires the advance filing of SEC Form 144.

As indicated above, a designated executive officer or director of the issuer is considered an "affiliate" of the issuer. All issuer stock held by such affiliates is "control stock," which generally can be sold only (1) pursuant to a 1933 Act registration statement (as a "selling shareholder"), (2) pursuant to the private placement exemption, or (3) pursuant to Rule 144. If an affiliate received the stock from the issuer or another affiliate in a non-registered transaction, it is also "restricted stock." Stock received through the exercise of a registered stock option is not restricted stock. Such shares are, however, considered "control" stock.

63. SEC Release No. 33-7391 (February 20, 1997) (10% ownership creates a rebuttable presumption of affiliate status).

Control stock includes all issuer stock owned by an affiliate, regardless of how the stock was acquired. This includes stock purchased in the open market or received under a registered or unregistered employee stock option plan. Under Rule 144, stock held by any household relative of an affiliate, as well as any stock held by a corporation or trust in which an affiliate has a 10% ownership or beneficial interest, is attributable to the affiliate, and the holder of such stock must also comply with Rule 144 in connection with its sale. Stock received by others by gift or bona fide pledge from an affiliate or a household relative retains its restrictions and must be sold under Rule 144 by the donee or pledgee, except that all Rule 144 restrictions lapse in the hands of the donee or pledgee once the holding period has passed since the date of acquisition of the stock by the donor.

Rule 144 essentially does two things. First, it sets forth the circumstances under which restricted stock may be sold, and second, it sets forth the circumstances under which affiliates may sell *any* shares of common stock (restricted or unrestricted). Persons who own restricted stock but are not affiliates of the issuer and who have not been affiliates during the three months preceding a sale may freely sell restricted stock under Rule 144 so long as they have held the stock for the requisite holding period. (The holding period is determined using the rules described below.) Unlike sales by affiliates and sales of restricted stock held for less than the requisite holding period, these sales may be made *without* complying with the other requirements of Rule 144 described below, and the shares need not bear a restrictive legend.

On November 15, 2007, the SEC voted to approve amendments to Rule 144 that:

- shorten the holding period for restricted securities of reporting companies to six months;
- simplify Rule 144 compliance for non-affiliates by allowing non-affiliates of reporting companies to freely resell restricted securities after satisfying a six-month holding period (subject only to the Rule 144(c) public information requirement until the securities have been held for one year) and by allowing non-affiliates of non-reporting companies to freely resell restricted securities after satisfying a 12-month holding period;
- for affiliates' sales, revise the manner of sale requirements for equity securities and eliminate them for debt securities and relax the volume limitations for debt securities;

- for affiliates' sales, raise the thresholds that trigger Form 144 filing requirements from 500 shares or \$10,000 to 5,000 shares or \$50,000;
- simplify and streamline the Preliminary Note to and other parts of Rule 144; and
- codify certain staff interpretations relating to Rule 144.

These amendments will be effective on February 15, 2008. The actual language of the amendments as approved by the SEC is available on the SEC's Web site (sec.gov). See Release No. 33-8869. Once effective, the new rules will apply retroactively to any situation in which the new rules will be of benefit; i.e., the reduced holding period and the favorable treatment to non-affiliates. The analysis that follows and the summary of Rule 144 in Appendix D-3, D-4, and D-5 all assume that the new rules are in effect.

Restricted stock and any stock held by affiliates may be sold under Rule 144 pursuant to the following requirements:

Availability of Current Public Information. The issuer must have been subject to the reporting requirements of Section 13 of the 1934 Act for a period of at least three months and must have filed the SEC reports required of it for at least 12 months before the sale of securities (or for such shorter period as the issuer was required to file such reports).⁶⁴ Potential sellers are entitled to rely on a statement made on the facing sheet of the most recent Form 10-Q or Form 10-K to the effect that required reports have been filed, or upon a written statement from the issuer that all reporting requirements have been met, unless they know or have reason to know that the issuer has not complied with such requirements.

This requirement applies only to affiliates and non-affiliates who have held the stock for less than one year.

Holding Period for Restricted Securities. Restricted stock must have been "beneficially owned" for at least six months.⁶⁵ (Affiliates selling unrestricted shares are not subject to this requirement.) To be beneficially owned, restricted stock that was purchased (rather than obtained, e.g., by gift) must have been fully paid for. Securities received in certain stock splits, stock dividends, recapitalizations, and conversions are deemed to have been acquired when the underlying securities were acquired, but

64. 1933 Act, Rule 144(c)(1).

65. 1933 Act, Rule 144(d)(1).

securities received upon exercise of warrants are generally deemed to be acquired when the warrants were exercised and the exercise price paid. Securities being sold by a bona fide pledgee, donee, trust, or estate will in certain circumstances be deemed to have been held from the dates of acquisition by the pledgor, donor, settlor, or decedent, as the case may be. Each shareholder's shares must be analyzed separately in order to determine when they become eligible for sale under Rule 144.

Quantity. Rule 144 also places an upper limit on the amount of securities that may be sold by a single shareholder in any three-month period.⁶⁶ The maximum number of shares that may be sold is limited to the greater of (1) 1% of the total number of shares outstanding as last reported or (2) the average weekly reported volume of trading in the issuer's common stock during the four calendar weeks preceding notice of the sale. Sales of this amount may be made in successive three-month periods. For an affiliate these limitations apply to total sales of *both* restricted securities and unrestricted securities. For non-affiliates, the volume limitations apply only to sales of restricted securities made during the first six months after such securities were acquired.

In determining amounts that may be sold by a shareholder (affiliate or non-affiliate), sales by the following are deemed made by the shareholder:⁶⁷ (1) relatives living in the same home, (2) trusts or estates in which the shareholder or such relatives collectively have 10% or more of the beneficial interest or act as trustee or executor, and (3) corporations and other organizations in which the shareholder or such relatives collectively own 10% or more of any class of equity securities. In addition, in determining amounts that may be sold by a bona fide pledgee, donee, estate, or trust, sales by the pledgor, donor, decedent, or settlor during the same three-month period must be included if the securities being sold were acquired by the pledgee, donee, estate, or trust within one year (previously two years) before the date of the intended sale. Persons agreeing to act in concert for the purpose of selling stock in the issuer must aggregate their sales in determining whether or not the quantity limitations are met. Stock sold pursuant to a registration statement or another exemption is not aggregated.

Manner of Sale. Sales can be made only in "brokers' transactions," i.e., transactions in which the broker merely executes an order to sell without

66. 1933 Act, Rule 144(e).

67. 1933 Act, Rule 144(a)(2).

compensation exceeding normal brokers' commissions.⁶⁸ The seller may not solicit orders for the stock or make payments to any person other than the broker. The broker may not solicit or arrange for the solicitation of orders to buy in connection with the transaction. In addition, the broker must satisfy himself or herself after reasonable inquiry that the sale is being made pursuant to the provisions of Rule 144. This requirement only applies to affiliates.

Notice. Notices of intended sales must be filed with the SEC, except for transactions that do not exceed 5,000 shares or \$50,000 in proceeds during any three-month period (previously 500 shares or \$10,000).⁶⁹ Three copies of a notice on Form 144 must be transmitted to the SEC concurrently with the placing of an order with a broker to execute a sale under Rule 144. This requirement applies only to affiliates.

Departing Director or Executive Officer. A departing director or executive officer should be guided by Section 16, insider trading, and Rule 144 considerations, as more fully explained in appendix D, which contains a memorandum on exit strategies, a sample exit memorandum, and a Rule 144 summary. As to Rule 144, control stock can be sold immediately subject to insider trading considerations (Rule 10b-5). As to restricted stock, a departing director or executive officer who is considered an affiliate (the CEO, COO, and CFO are presumed to be affiliates) needs to sell under the conditions of Rule 144 for three months and then can use Rule 144(k) as to restricted stock held for one year. Rule 144(k) permits the sale of restricted stock without compliance with any of the other conditions of Rule 144 as long as the stock has been held for one year and the seller has not been an affiliate for three months. If the restricted stock has been held for less than one year but more than six months, some Rule 144 conditions must be satisfied. If the restricted stock has been held for less than six months, no sales may be made. (These rules apply to any holder of restricted stock.)

As a general rule, it is suggested that the departing director or executive officer comply with the issuer's insider trading policy for three months after departure to allow his or her insider knowledge to go stale. The 90-day period is based on analogy to the three-month period in Rule 144(k).

68. 1933 Act, Rule 144(f).

69. 1933 Act, Rule 144(h).

2.5.4 Sales Under Regulation S

Regulation S is technically not an exemption from registration under the 1933 Act, but rather a clarification of the territorial approach to the registration requirements of Section 5 of the 1933 Act. The SEC adopted Regulation S in 1990 to clarify when offers and sales will be deemed to take place outside the United States and, therefore, not be subject to the registration requirements of the 1933 Act.

Rule 904 provides a safe harbor for determining when resales by any person other than the issuer, a distributor, or any of their respective affiliates (except any officer or director who is an affiliate solely by virtue of holding such position) will be deemed to occur outside the United States. To fall within the Rule 904 safe harbor, the offer or sale must take place in an “offshore transaction,” and “no directed selling efforts” may be made in the United States. Special additional conditions apply to resales by dealers, persons receiving selling commissions, and certain affiliates (any officer or director of the issuer who is an affiliate of the issuer solely by virtue of holding such position). Each one of these terms is defined in Rule 902. An accurate summary of them would be almost as long as the regulation itself.

This exemption is useful for U.S. issuers with employees outside the United States and for foreign private issuers with employees in the United States. If the foreign private issuer is registered under the 1934 Act, then Form S-8 is available, and there is no need to look to Regulation S; however, if the foreign private issuer is not registered under the 1934 Act, then it will need to use Rule 701 or Regulation D to make offers and sales to its U.S. employees. Those exemptions will result in the purchase of restricted securities that cannot be sold in the United States without further exemptions. In addition, there is probably no trading market in the United States for such securities. To cover that situation, Rule 904 of Regulation S will allow for sales outside the United States without having to comply with any other U.S. exemptions. For further discussion of Regulation S, see SEC Release No. 33-7505.

2.6 2007 Executive Compensation Disclosure Rules

While the scope of this chapter does not allow for a detailed analysis of the new executive compensation disclosure rules, it is necessary to mention them briefly. They are set forth in a 436-page SEC Release (No.

33-8732A) (August 29, 2006). The rules became effective on November 7, 2006, and require significantly greater quantitative and qualitative disclosure of executive compensation by U.S. public companies. Companies generally must comply with the rule changes in annual reports on Form 10-K for fiscal years ending on or after December 15, 2006; registration statements and proxy and information statements for filings made after December 15, 2006; and Form 8-Ks where the trigger event occurs on or after November 7, 2006.

The gathering of the data, assembly, and presentation of the information and the legal and financial analyses needed will require substantial legal, finance, tax, human resources, benefits, actuarial, and accounting input. Companies should start to prepare for the upcoming proxy statement immediately. Commencing preparation of the proxy statement information early will ensure disclosure and timing issues are identified, and circulation of draft disclosures will timely inform management and board members as to the sweeping nature of the rules changes and possibly avoid, in the words of a senior SEC official, “unpleasant surprises.”

With respect to equity compensation plans, the rule provides for expanded disclosure regarding stock option grants and grant policies, including any arrangement to time the grant of options in relation to the release of material non-public information. It also requires the Summary Compensation Table to include the grant date FAS 123(R) fair value of equity awards, year-to-year changes in accumulated pension benefits, above-market annual earnings on nonqualified deferred compensation, and every other element of annual compensation (except the value of a minor amount of perquisites and other personal benefits permitted to be excluded).

The new rules also require additional tables and narrative disclosure regarding pension and other retirement benefits, deferred compensation, severance, and change of control payments, all of which could involve equity compensation plans.

The current executive compensation rules also include a number of changes to the Section 16 rules. They eliminated the need to disclose Section 16(b) indebtedness under S-K Item 404(c) and made some changes with respect to the definition of “non-employee director” in Rule 16b-3. These changes were necessary because of the changes that were made in the related party disclosure items in Regulation S-K. Rule 16b-3 also contains a new note (no. 4) to this definition clarifying the determination of non-employee director status and providing for a good-faith analysis of the director’s status without a retroactive application if the analysis proves incorrect.

Finally, the new rules require a new table specifying and totaling directors' compensation, including equity compensation awards.

A more detailed analysis of this rule may be found in a memorandum dated September 25, 2006, prepared by McDermott Will & Emery LLP, at <http://www.mwe.com/info/news/SECexecomprules.pdf>.

2.6.1 Form 8-K Reporting Requirements and Corporate Governance Shareholder Approval Rules

On April 11, 2002, the SEC proposed rules regarding insider transactions that, if adopted, would have required public companies to file current reports on Form 8-K that describe directors' and executive officers' transactions in company equity securities, directors' and executive officers' Rule 10b5-1 arrangements for the purchase and sale of company equity securities, and loans of money to a director or an executive officer made or guaranteed by the company or an affiliate of the company.⁷⁰ On August 23, 2004, the SEC adopted its final changes to Form 8-K (Release No. 33-8400), and none of the foregoing matters were expressly included in the new reporting requirements under Form 8-K. If, however, a material amendment is made to a stock incentive plan or an award document, or if a new benefit plan is adopted by the board of directors (with or without shareholder approval), it must be reported on Form 8-K within four business days under Item 1.01 as a material definitive agreement.

Item 1.01 of Form 8-K has been broadly interpreted to require disclosure of grants of options or awards of stock or other stock benefits to executive officers and directors unless the forms of these award documents are already on file with the SEC (usually in the exhibits section of the Form 10-K or Form 10-Q).

Effective November 7, 2006, Form 8-K has been amended as part of a comprehensive amendment to the executive compensation disclosure rules discussed above (see SEC Release No. 33-8732A). This release amended Form 8-K to move the reporting requirements with respect to executive compensation matters from Item 1.01 to Items 5.02(e) and (f). It also clarified the persons for whom information should be reported—namely, the principal executive officers (CEO and CFO) and the named executive officers from the company's last filed proxy statement. The remainder of current executive officers are no longer covered by this disclosure requirement. Also, compensation for existing directors need not be disclosed, but information about compensation to newly appointed

70. SEC Release No. 33-8090 (April 12, 2002).

directors is required to be disclosed. The new item also establishes a materiality test for grants or awards and for material amendments or modifications to those awards. This is a substantial departure from the earlier positions taken with respect to this disclosure.

It should also be noted that effective June 30, 2003, the New York Stock Exchange, American Stock Exchange, and NASDAQ all adopted very broad rules requiring shareholder approval of all stock-based employee benefit plans and material amendments thereto, with very limited exceptions. Further discussion is beyond the scope of this chapter. Finally, the SEC now requires that an elaborate “Equity Compensation Plan Information” table be included in the corporation’s proxy statement or Form 10-K (see S-K Item 201(d)).

2.7 Conclusion

As reflected by the above discussion, the federal securities laws issues attributable to an equity compensation plan are numerous and complex. Many times, compliance problems are attributable to a failure by the issuing corporation to either (1) adequately communicate the various securities law reporting and trading restrictions governing the purchase and sale of employer securities by its directors and officers or (2) provide sufficient support to enable such persons to comply with these rules. Companies offering stock options and other equity compensation, particularly public companies, are well advised to provide directors and officers with a summary description of the relevant securities laws and to establish a program for assisting directors and officers in complying with these laws. Along these lines, many companies establish (1) a “code of business conduct” prohibiting insider trading by their employees and establishing “blackout” periods during which company stock may not be traded by officers, directors, and other reporting persons possessing material information about the company and (2) a preclearance policy.

To avoid noncompliance problems, broad assistance should be provided to directors and officers to make sure they understand and comply with trading and reporting restrictions.

APPENDIX A

The Sarbanes-Oxley Act of 2002: Impact on Executive Compensation Plans

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the “2002 Act”), which makes far-reaching changes in federal regulation applicable to corporate America and its executives, auditors and advisers. In addition to corporate governance and accounting reforms, the 2002 Act makes several changes that immediately affect many executive compensation arrangements (including stock benefit plans) and their administration. Directors, executives, Section 16 compliance officers and human resources administrators will want to consider closely the following provisions under the 2002 Act:

- Prohibition on personal loans to directors and executive officers
- Accelerated Section 16 filing deadlines
- Restrictions on stock transactions during retirement plan blackout periods
- Forfeiture of executive pay due to accounting restatements
- Freeze on extraordinary payments to directors and officers

Prohibition on Personal Loans to Directors and Executive Officers

Section 402 of the 2002 Act amends Section 13 of the 1934 Act to prohibit publicly held U.S. and non-U.S. companies from making or extending personal loans to directors and executive officers. Section 402 became effective on July 30, 2002, subject to grandfathering provisions and certain limited exceptions.

General Loan Prohibition Under Section 402. Section 402 states that “[i]t shall be unlawful for any issuer (as defined in Section 2 of the Sarbanes-Oxley Act of 2002), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer.” Unless grandfathering treatment or an exception applies, effective July 30, 2002, issuers are prohibited from extending a personal loan in any manner to a director or executive officer.

Directors and Executive Officers. The term “director” is defined in Section 3(a)(7) of the 1934 Act as “any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.” There are real questions about advisory, emeritus, or honorary directors, and the SEC interpretations under Section 16 of the 1934 Act may be relevant to this issue. The SEC has indicated in various releases that it believes that advisory and emeritus directors generally should be treated as directors for Section 16 purposes, but that honorary directors should not be so treated.

As noted above, the provisions of Section 402 of the 2002 Act are implemented as an amendment to the 1934 Act. Accordingly, unless and until the SEC adopts a different definition, the term “executive officer” under Section 402 should be interpreted in a manner consistent with existing SEC rules. 1934 Act Rule 3b-7 defines an “executive officer” (for purposes of, among others, proxy, 10-K, and other 1934 Act disclosures) as the “president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant.” Executive officers of subsidiaries may be deemed executive officers of a publicly held company if they perform policy-making functions for the publicly held company.

Grandfather Protection. A limited grandfather provision provides some relief but raises many questions. Section 402 exempts loans maintained before July 30, 2002, “provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit” on or after July 30, 2002. A material modification of any term results in loss of grandfather treatment. Any action that might be considered to be a change to the terms of a loan should be carefully considered, given that Section 402 may be violated even if the change is minor and does not affect the overall financing arrangement.

Identifying Transactions Potentially Subject to Section 402. The ambiguity as to what is a “personal loan” and the breadth of what may be considered an arrangement for “extension of credit” suggest that publicly held companies should immediately identify all transactions potentially subject to Section 402. Common arrangements that may be viewed to involve an extension of credit are split-dollar life insurance and cashless stock option exercises. The following is a partial list of other transactions

with directors and executives officers that may be treated as an extension of credit:

- Loans to purchase stock, a personal residence, or other property
- Loans to meet margin calls upon a decline in the price of the company's stock
- Loans for relocation to a different geographic area
- Routine advances for business purposes (such as reimbursement accounts and travel expense allowances), particularly if repaid over long period of time
- Personal use of company credit cards
- Indemnification payments made under company bylaws or an employment agreement before a determination of entitlement to such payment
- Use of company funds to meet an executive's payroll tax obligations for nonqualified deferred compensation benefits
- Signing bonuses subject to repayment on early termination of employment

Cashless Stock Option Exercises Under Section 402. A common executive compensation practice that has been affected by Section 402 is the cashless exercise of stock options facilitated through a broker. In a cashless exercise, the option holder instructs a brokerage firm to sell a sufficient number of the shares being acquired by the option exercise to satisfy the option price and any applicable withholding taxes. The broker sells the shares and remits the exercise price and any taxes required to be withheld to the company, with any balance remitted to the option holder. The company delivers the requisite number of shares to the broker and the balance to the option holder.

There are two common methods to execute a cashless exercise of a stock option. A broker may sell the shares on the date of receipt of exercise instructions and remit the exercise price and withholding taxes to the company a few days later, on the date of the settlement of the sale of those shares. Alternatively, a broker may sell the shares on the date of receipt of the instructions and remit the exercise price and withholding taxes immediately to the company, treating the amount as a margin loan to the option holder. Other variations on this practice also exist.

Any of these cashless exercise methods may be viewed as resulting in an “extension of credit” under Section 402. A broker-assisted direct sale involves the company making stock or cash available to the option holder for the exercise, albeit only for a very short period of time. While a margin loan from a broker does not involve the use of the company funds, it may also be subject to Section 402 to the extent that the company is viewed as having “arranged” this financing by establishing the cashless exercise program with the brokerage firm. None of these methods would seem to be the type of loan targeted by the Congress under the 2002 Act. It was hoped that the SEC would issue guidance to clarify the impact of Section 402 on cashless exercise programs, but the SEC has not done so to date. The margin loan method discussed above has become an acceptable practice to avoid Section 402 problems.

Accelerated Section 16 Filing Deadlines

Section 403 of the 2002 Act amended Section 16(a) of the 1934 Act to require Section 16 reporting persons (directors, 10% or more shareholders, and certain executive officers) to report changes in beneficial ownership of issuer securities within two business days. The two-day filing requirement became effective August 29, 2002, under amended Section 16 rules adopted by the SEC on August 27, 2002 (SEC Release No. 34-46421).

The 2002 Act also requires the SEC to adopt rules requiring that Section 16(a) reports be filed electronically (rather than in paper form) no later than July 30, 2003. These rules went into effect on June 30, 2003. To file electronically, SEC rules require each Section 16 reporting person to apply for and obtain his or her own access codes to the SEC’s Electronic Data Gathering, Analysis and Retrieval System (EDGAR).

Foreign Private Issuers

Currently, foreign private issuers with securities registered under the Exchange Act are not subject to any aspect of Section 16. The SEC has indicated that it does not intend to change the exemption for foreign private issuers.

SEC Rulemaking

Highlights of the revised Section 16 reporting rules are follows:

- All transactions occurring on or after August 29, 2002, must be reported on a Form 4 received by the SEC no later than 10 p.m. Eastern time on the second business day following the transaction date. These include:
 - Option grants and exercises
 - Stock awards, performance share awards, and SARs
 - Option repricings, cancellations, regrants, and amendments
 - Dispositions to the issuer, including stock swaps and share withholding to pay taxes
 - Open market purchases and sales
- All of the previously permitted reporting deferrals for transactions between the issuer and Section 16 reporting persons set forth in Rule 16b-3 are subject to two-business day reporting on Form 4 except for the following:
 - Routine purchases under the payroll deduction provisions of a 401(k) plan (including an excess benefit plan), employee stock purchase plan, or employee stock ownership plan (ESOP), which transactions remain exempt from reporting (but must be included in the “shares beneficially owned” column) with a footnote explanation.
 - “Discretionary transactions” under 401(k) and other employee benefit plans and certain transactions made pursuant to so-called Rule 10b5-1 plans, which transactions must be reported on a Form 4 under a special “deemed execution” rule discussed below, which can allow up to five-business day reporting.
- All of the exemptions contained in the Section 16(a) rules remain in effect and may either be voluntarily reported on a Form 4 at any time up to the due date of the Form 5 or reported on a Form 5 within 45 days of the end of the issuer’s fiscal year. These include:
 - Gifts
 - Small acquisitions, but not from the issuer or an employee benefit plan sponsored by the issuer
 - Stock splits and stock dividends
 - Pro-rata distributions
 - Transfers under domestic relations orders

- Changes in form of beneficial ownership
- Regular dividend reinvestment plan contributions
- Expiration of options without consideration

Note that the first two situations above require transaction reporting, but the last six situations need not be reported as transactions but should only be identified in the “shares beneficially owned” column with a footnote explanation.

- The SEC has adopted special limited deferred reporting rules (up to five business days depending upon circumstances) for the following transactions:
 - Transactions pursuant to a contract, instruction, or written plan for the purchase or sale of issuer equity securities that satisfies the affirmative defense conditions of Rule 10b5-1(c) where the Section 16 reporting person does not select the date(s) of execution (such as the first date of each month).
 - Discretionary transactions where the Section 16 reporting person does not select the date(s) of execution.
 - Deferred compensation plan investments in a company stock fund, but only if they fall within the scope of a Rule 10b5-1 plan.
 - Transactions that occur over more than one day, but only if they fall within the scope of a Rule 10b5-1 plan.

These transactions are subject to reporting on Form 4 within two business days of the “deemed execution” date of the transaction. The deemed execution date of the transaction will be the earlier of (1) the date on which the executing broker, dealer, or plan administrator notifies the Section 16 reporting person of the execution of the transaction, and (2) the third business day following the trade date. (The SEC noted in its release adopting the new rules that a trade confirmation sent through the mail could take several days to arrive and the SEC would, therefore, usually expect brokers, dealers and plan administrators to provide the information needed for Section 16(a) reporting purposes to the Section 16 reporting person either electronically or by telephone.)

- The rules with respect to the timing of the filing of Form 3 (initial statement of beneficial ownership) have not changed. For a company that is already public, the Form 3 must be filed within 10 days of the

person becoming a Section 16 reporting person. For companies going public, the Form 3 must be filed before the company goes public. The SEC noted that a transaction might be required to be filed on Form 4 before the due date of Form 3. In this situation, the SEC encouraged the filing of both the Form 3 and the Form 4 by the due date of the Form 4.

Recommendations

The following recommendations should be considered in order to comply with the revised Section 16 rules:

- Have a mandatory pre-clearance policy for all transactions as to which the timing is within the control of the Section 16 reporting person. Appendix B provides a suggested form of such pre-clearance policy.
- For transactions as to which timing is outside the control of the Section 16 reporting person, require brokerage firms conducting transactions for the Section 16 reporting person to provide promptly upon trade execution, and certainly by the third business day, the information needed for Section 16(a) reporting purposes to the Section 16 reporting person either electronically or by telephone.
- Review and update the procedures for discretionary transactions under benefit plans to ensure that the Section 16 reporting person receives timely notification (no later than three business days) of execution of the transaction from the plan administrator.
- Educate all Section 16 reporting persons by a memorandum that they should read, sign, and return.
- Establish a cashless exercise policy for Section 16 reporting persons in which the Section 16 reporting person obtains any credit extension from the broker or other third party of his or her choice and (not the issuer) and results in the issuer being paid the exercise price on the day of exercise.
- Obtain powers of attorney with multiple attorneys-in-fact from all Section 16 reporting persons.
- Apply for EDGAR access codes for all Section 16 reporting persons. Section 16 reporting persons can obtain a Form ID for obtaining EDGAR access codes from the SEC at <http://www.sec.gov/about/forms/formid.pdf>.

Forfeiture of Compensation and Stock Sale Profits by CEOs and CFOs upon Restatements Due to Misconduct

Section 304 of the 2002 Act requires forfeiture of certain bonuses and profits realized by the CEO and CFO of a company that is required to prepare an accounting restatement due to the company's "material noncompliance, as a result of misconduct, with any financial reporting requirement under the securities laws." Specifically, the CEO and CFO must reimburse to the company any bonus or other incentive- or equity-based compensation received, and any profit realized from the sale of the company's stock sold, during a specified recapture period. Reimbursement is required whether or not the CEO or CFO engaged in or knew of the misconduct. The "recapture period" is the 12-month period following "the first public issuance or filing with the SEC (whichever first occurs) of the financial document embodying such financial reporting requirement."

It is unclear how one determines when targeted compensation is "received" for purposes of Section 304. The application of Section 304 of the 2002 Act to common executive compensation arrangements will be difficult to apply in practice. For example, is equity-based compensation "received" upon the grant or exercise of a stock option, or both? Is restricted stock "received" upon grant or vesting? Are performance-based nonqualified deferred compensation benefits "received" in the year earned or in the year of actual receipt? Do constructive principles similar to those under the tax laws apply? These and other types of interpretative questions will require regulatory guidance or legislative clarification.

This provision applies to both U.S. and non-U.S. companies. The SEC may exercise its authority to exempt non-U.S. companies.

Insider Trades During Pension Fund Blackout Periods

Section 306(a) of the 2002 Act makes it unlawful for any director or executive officer of an issuer of any equity security (other than an exempted security), directly or indirectly, to purchase, sell, or otherwise acquire or transfer any equity security of the issuer (other than an exempted security) during any pension plan blackout period with respect to such equity security, if the director or executive officer acquires the equity security in connection with his or her service or employment as a director or executive officer. This provision equalizes the treatment of corporate executives and rank-and-file employees with respect to their ability to

engage in transactions involving issuer equity securities during a pension plan blackout period if the securities were acquired in connection with their service to, or employment with, the issuer.

Regulation BTR, originally adopted to clarify the scope and operation of Section 306(a) of the 2002 Act and to prevent evasion of the statutory trading restriction, defines terms used in Section 306(a), including the term “acquired in connection with service or employment as a director or executive officer.” Under this definition as originally adopted, one of the specified methods by which a director or executive officer directly or indirectly acquires equity securities in connection with such service is an acquisition “at a time when he or she was a director or executive officer, as a result of any transaction or business relationship described in paragraph (a) or (b) of Item 404 of Regulation S-K.” To conform this provision of Regulation BTR to the Item 404 amendments in the current executive compensation rules, the SEC has amended Rule 100(a)(2) of Regulation BTR so that it references only transactions described in paragraph (a) of Item 404.

Freeze on Extraordinary Payments to Directors and Officers

Section 1103 of the 2002 Act allows the SEC, during an investigation of an issuer or its directors, officers, partners, controlling persons, or other employees, to seek a temporary order in federal court requiring the issuer to escrow “extraordinary payments” to such person for 45 to three months (or, if such person is charged with a violation of the securities laws, until conclusion of the proceedings). There is no definition of “extraordinary payments” other than to indicate that it includes compensation. “Extraordinary payments” might include bonuses, stock option exercises, payments under a nonqualified deferred compensation plan, and severance pay.

This provision applies to both U.S. and non-U.S. companies. The SEC may exercise its authority to exempt non-U.S. companies.

APPENDIX B

Section 16 Mandatory Pre-clearance Policy

(As Authorized by the Board of Directors of the Company)

To: Section 16 Insiders (all directors and executive officers)

The Sarbanes-Oxley Act of 2002 amended Section 16(a) of the Securities Exchange Act of 1934 to accelerate the reporting by Section 16 Insiders of all transactions involving the Company's stock. Effective August 29, 2002, Section 16 Insiders are required to report changes in beneficial ownership involving the Company's stock within two business days of the transaction. Failure to file on a timely basis will result in the person being named as a delinquent filer in the Company's proxy statement. Repeated failure to file on a timely basis can result in civil actions against the individual by the SEC, which has the power to seek fines for delinquent filings and bring injunctive actions against delinquent filers. Under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, the SEC is also empowered to seek removal of an officer or director from office and to ban such persons from future service as an officer or director of a public company. The SEC has used these remedies in extreme situations.

The Board of Directors believes that the only way to assure timely compliance is to impose a mandatory pre-clearance policy for all transactions by Section 16 Insiders and members of their immediate family involving the Company's stock. Transactions covered by this policy include, without limitation, stock option grants and option exercises, stock awards and stock equivalent awards, purchases and sales publicly or privately, gifts, and transfers in or out of trusts or limited partnerships or any other estate planning devices.

Accordingly, all Section 16 Insiders and members of their immediate family may not engage in any transactions involving the Company's stock without first notifying the Vice President-Chief Financial Officer *and* the [Vice President-General Counsel and Secretary]. This notice must be given in writing to the designated persons at least three business days before the proposed transaction. Failure to comply with this Policy will result at a minimum in embarrassment to the Company and the Section 16 Insider. It also can expose the Section 16 Insider to the civil actions and penalties discussed above.

If you have any questions about the pre-clearance policy, please contact the [Vice President-General Counsel and Secretary].

APPENDIX C

Excerpts from *Current Issues and Rulemaking Projects Outline Dated March 31, 2001*

Section 12 Registration Relief Involving Employee Stock Option Plans

Companies have granted stock options to broad based groups of employees under stock option plans in anticipation of going public within a short time after the stock option grants. These stock options are granted under stock option plans established for compensatory purposes. Many companies are now finding that they have granted stock options to 500 or more employees and their plans to go public have been delayed.

Under Section 12(g) of the Exchange Act, an issuer with 500 holders of record of a class of equity security and assets in excess of \$10 million at the end of its most recently ended fiscal year must register the class of equity security, unless it has an exemption from registration. Stock options are a separate equity security under the Exchange Act. Accordingly, an issuer with 500 or more option holders and more than \$10 million in assets is required to register that class under the Exchange Act, absent an exemption. The exemption from registration under Section 12(g) contained in Rule 12h-1(a) for “[a]ny interest or participation in an employee stock bonus, stock purchase, profit sharing, pension, retirement, incentive, thrift, savings or similar plan which is not transferable by the holder except in the event of death or mental incompetency, or any security issued solely to fund such plans” does not apply to stock options.

Beginning in 1991, the Commission by order, and subsequently the staff by no action letter, exempted or relieved issuers with 500 or more stock option holders from having to register their stock options under the Exchange Act when specified conditions were present. For the conditions necessary to receive relief under these letters and orders see, for example, the no action letter to Mitchell International Holdings, Inc. (available December 27, 2000).

Due to current market conditions, which are delaying the plans of many companies to go public, we are revising the conditions necessary to receive relief from registering their employee stock options under Section 12(g). As in the past, any relief granted by the staff would apply only to the stock options. Once a company has 500 holders of record of any other class of equity securities (*e.g.*, common stock outstanding as a

result of stock issuances, including option exercises), it would be required to register that class. The modified conditions would need to be present only when the company is relying on the relief.

We will consider granting relief in situations where the conditions of our prior no action letters noted above are met with the following modifications:

- The options may be immediately exercisable.
- Former employees may retain their vested options.
- As with the current conditions, the options must remain non-transferable in most cases. However, we will permit the options to transfer on death or disability of the option holder. The stock received on exercise of the options may not be transferable, except back to the company or in the event of death or disability.
- Consultants may participate in the option plan if they would be able to participate under Rule 701. We encourage you to review the adopting releases effecting the recent changes to Rule 701 and Form S-8 to understand the categories of consulting services that fall within this group. Releases 33-7645 and 33-7646.

We will premise any changes in our current position on option holders receiving essentially the same Exchange Act registration statement, annual report and quarterly report information they would have received had the company registered the class of securities under Section 12, including audited annual financial statements and unaudited quarterly financial information, each prepared in accordance with GAAP.

April 30, 2001 is the filing date for registration statements of issuers that met the Section 12(g) registration requirement as of December 31, 2000. We will consider extending that filing date to July 30, 2001 for any issuer that has submitted a no-action request to us by April 30, 2001. Any questions may be directed to Amy Starr in the Office of the Chief Counsel, (202) 942-2900.

APPENDIX D-1

Memorandum to Company Regarding Continuing Reporting Obligations with Respect to a Departing Officer or Director of the Company

MEMORANDUM

Confidential

Attorney-Client Privilege

Date:

To:

cc:

From:

Re: Continuing Reporting Obligations Applicable to a Departing Executive Officer or Director of the Company

This Memorandum discusses the continuing reporting obligations and transaction restrictions after an executive officer or director of the company (“Section 16 Reporting Person”) ceases to be a Section 16 Reporting Person by resigning as an executive officer or director of the company.

Attached is a sample memorandum for departing Section 16 Reporting Persons [appendix D-2]. This memorandum can be used to cover Section 16 reporting obligations as well as insider trading restrictions under Rule 10b-5.

Section 16 Reporting Obligations

A Section 16 Reporting Person has an obligation to file Section 16 reports (Form 4s) for six months after that person’s status as a Section 16 Reporting Person is terminated, but only with respect to non-exempt transactions that are matchable with non-exempt transactions that occurred while the person was a Section 16 Reporting Person. For example, if a Section 16 Reporting Person had an open market purchase three months prior to his or her termination of Section 16 reporting status, that person would have to report all open market sales for the three months following his or her termination, and the purchases and sales would be matchable for Section 16(b) purposes.

Option exercises, vesting of restricted stock, and gifts are all examples of exempt transactions that would not have to be reported. To

carry this example further, if the option exercise was done by the delivery to the company of previously owned company shares, that transaction would likewise be exempt and not reportable. The same would be true if shares were delivered to the company to pay taxes. If, however, the departing Section 16 Reporting Person uses a cashless exercise method (sale of stock by a broker to pay the exercise price), the sale is not exempt and must be reported and potentially matched if there were opposite-way purchases within the same six-month period while the person was a Section 16 Reporting Person. Finally, we understand that the company's 401(k) plan has a company stock fund. The transfer out of that fund after termination of Section 16 reporting status is reportable only if there has been a transfer into the stock fund within six months while the person had Section 16 reporting obligations. This is considered a "discretionary transaction" and involves very arcane concepts. As a general rule, a departed Section 16 Reporting Person should pre-clear all discretionary transactions with your office before they are entered into.

In addition, if the Section 16 Reporting Person has had a transaction while he or she was a Section 16 Reporting Person that was deferred until the Form 5 was due (such as a gift), that transaction should be reported either on a voluntary Form 4 or a mandatory Form 5 within 45 days of the end of the company's fiscal year. We recommend reporting it on a voluntary Form 4 to get it out of the way. We understand that is the company's present policy.

Rule 10b-5 Insider Trading Restrictions

In addition to Section 16, the departing Section 16 Reporting Person has to be guided by the company's insider trading policy for some period of time after cessation of Section 16 reporting status to allow his or her knowledge about the company with respect to non-public material information to go stale. As a guideline, we recommend that the former Section 16 Reporting Person follow the company's insider trading policies for at least three months after termination of Section 16 reporting status. After that, it is highly likely that the Section 16 Reporting Person's knowledge would be stale. Note that the departing Section 16 Reporting Person can remain employed beyond the date of his or her termination of Section 16 reporting status. As long as the former Section 16 Reporting Person is not performing activities that would cause him or her to continue to be a Section 16 Reporting Person, the three-month period should run from his or her termination of Section 16 reporting status.

Rule 144

It is our understanding that no person at the company has restricted securities within the meaning of SEC Rule 144. By “restricted” we mean securities that have been obtained from the issuer not in a registered public offering. If you wish more information on restricted securities and control securities, involving Rule 144, we will be glad to give you a more detailed analysis. Attached for your reference is a brief outline of Rule 144 requirements [appendix D-3].

Proxy Statement Disclosure

SK Item 405 would still apply to the departing Section 16 Reporting Person and would require disclosure in the proxy statement of any delinquencies in that person’s filings.

Any special compensation arrangements for a departing Section 16 Reporting Person may have to be disclosed in the company’s proxy statement for the ensuing year, depending on whether that person fits the definition of “named executive officer” in SK Item 402. Usually, there is no disclosure with respect to a departing director who is not named in the proxy statement.

APPENDIX D-2

Exit Memorandum

MEMORANDUM

[DATE]

TO: Name of Departing Section 16 Reporting Person]

FROM: [Name of Section 16 Compliance Person]

RE: Continuing Reporting Obligations and Transaction Restrictions
Applicable to a Departing Executive Officer or Director of the
Company

With respect to your recent resignation as a[n] [executive officer/director], I am writing to remind you that any person who ceases to be an executive officer or director of the company continues to have certain obligations under the federal securities laws as follows:

Rule 10b-5 Trading Restrictions. Rule 10b-5 states that you may not buy or sell securities of the company on the basis of material non-public information obtained from the company or any party associated with the company. In addition, you may not furnish material non-public information about the company to any person who might trade on the information. We suggest that you follow these rules and the company's insider trading policy for three months from the termination of your [executive officer/director status].

Short-Swing Profit Rule Applies up to Six Months After Termination. Section 16(b) provides for the loss of profits on any sale and purchase of company common stock within a six-month period. It continues to apply to open market purchases and sales that occur within less than six months of an opposite-way, open market purchase and sale that took place while you were subject to Section 16.

For example, if you bought stock in the open market three months before you terminated your status as a Section 16 Reporting Person, any open market sales you make for three months after you have terminated your status will be reportable on a Form 4 within two business days and potentially matchable with the purchase you made while you

were a Section 16 Reporting Person. Stock option exercises, however, are treated as exempt purchases and need not be reported regardless of the transactions that occurred while you were a Section 16 Reporting Person. This is equally true with respect to the delivery of previously owned shares to pay the exercise price or to pay taxes or the vesting of restricted stock. A cashless exercise in which you sell stock in the open market to pay the exercise price is reportable and matchable if you have had an open market purchase within six months while you were a Section 16 Reporting Person. With respect to any proposed transactions involving the company's common stock in the company's 401(k) plan, you should consult with me or an attorney in my office before changing your investments in the company stock fund. Any other transactions involving the 401(k) plan, need not be pre-cleared.

Form 4. You must file a Form 4 to report any open market purchases and sales in company stock after you cease to be a Section 16 Reporting Person that occurs within six months of any opposite-way, open market purchase and sale that took place while you were a Section 16 Reporting Person. Form 4 must be filed with the SEC by the second business day after the date of execution of the transaction. Please notify us so we may do the filing for you.

Form 5. You must file a Form 5 [within 45 days after the issuer's fiscal year-end] to report any pre-resignation transactions and any reportable post-resignation transactions not previously reported on Form 4. For example, a gift made while you were a Section 16 Reporting Person and not reported on a voluntary Form 4 needs to be filed on a voluntary Form 4 or mandatory Form 5. (It is the company's policy to report all gifts on a voluntary Form 4, so this should not be a problem unless we were not told of the gift.) If you have no transactions requiring a Form 5, we may ask you to so certify to the company in writing prior to the printing of the company's proxy statement to avoid being named in the company's proxy statement for failing to file a Form 5.

Exit Box. On each Form 4 or Form 5 you file after your resignation, the "exit" box in the upper left hand corner of the form should be checked.

SEC Enforcement. There may be significant civil and criminal penalties if you fail to comply with the above requirements.

Because the Section 16 reporting requirements are extremely complex, the company recommends that you consult with [Section 16 compliance person], when preparing any Form 4 or Form 5, or if you have any questions regarding the reporting requirements.

Rule 144. [Our records indicate that you do not have any restricted securities.] If you have “restricted” securities, they need to be sold under Rule 144 for at least three months after your cessation of Section 16 status, provided that you have held the restricted securities for at least one year. After three months (and the one-year holding period), you may sell the securities free of any Rule 144 restrictions.

APPENDIX D-3

Summary of Rule 144 Under the New Rules

Rule 144 is a safe harbor exemption for sales of restricted stock and control stock. Restricted stock means stock acquired from the issuer without registration of that stock. Control stock means stock held by an affiliate regardless of source, i.e., bought from the issuer or in the open market. The requirements for sale under Rule 144 are:

1. Current public information about the company must be available.
Affiliates: Always applies
Non-affiliates: Stock held for less than one year
2. If the stock is restricted stock, it must be held for six months before sale; unrestricted control stock does not have to be held for any period.
3. The amount to be sold during any three-month period is limited to the greater of (1) one percent of the total number of outstanding shares, or (2) the average weekly trading volume for the four calendar weeks preceding the filing of Form 144 (*applies only to affiliates*).
4. The stock must be sold in unsolicited brokers' transactions (any responsible broker will know how to do a 144 transaction) (*applies only to affiliates*).
5. Form 144 must be filed with the SEC before the sale occurs if greater than 5,000 shares or \$50,000 (*applies only to affiliates*).

Notes:

Rule 144(k) permits sales of restricted stock free from the requirements of Rule 144 by non-affiliates after a one-year holding period.

If the reporting person is an affiliate, sales must be reported on SEC Form 4 no later than the second business day following the sale and are matchable against any nonexempt purchases made by the reporting person six months before or after the sale.

APPENDIX D-4

Comparison of Old Rule 144 with New Rule 144

Topic	Old Rule 144	New Rule 144
Resales of Restricted Securities by Non-affiliates Under Rule 144	<ul style="list-style-type: none"> –Limited resales after holding restricted securities for one year. –Unlimited resales after holding restricted securities for two years if they have not been affiliates during the prior three months. –No tolling of holding period as a result of hedging transactions. 	<ul style="list-style-type: none"> –Unlimited resales after holding restricted securities of Exchange Act reporting companies for six months if they have not been affiliates during the prior three months, except that such resales would be subject to the current public information requirement between the end of the six-month holding period and one year after the acquisition date of the securities. –Unlimited resales after holding restricted securities of non-reporting companies for one year if they have not been affiliates during the prior three months. –Specific provision tolling the holding period when engaged in certain hedging transactions. Maximum one-year holding period.
Resales by Affiliates Under Rule 144	<ul style="list-style-type: none"> –Limited resales after holding restricted securities for one year. –No tolling of holding period as a result of hedging transactions. 	<ul style="list-style-type: none"> –Limited resales after holding restricted securities of Exchange Act reporting companies for six months. –Limited resales after holding restricted securities of non-reporting companies for one year. –Specific provision tolling the holding period when engaged in certain hedging transactions. Maximum one-year holding period.
Manner of Sale Restrictions	<ul style="list-style-type: none"> –Apply to resale of any type of security under Rule 144. 	<ul style="list-style-type: none"> –Would not apply to resale of debt securities by affiliates or to any resale by non-affiliates.
Form 144	<ul style="list-style-type: none"> –Filing threshold at 500 shares or \$10,000. 	<ul style="list-style-type: none"> –With respect to affiliates, filing threshold at 1,000 [5,000] shares or \$50,000. –No Form 144 filing required for non-affiliates.

APPENDIX D-5

SEC Summary of Rule 144 from Final Release

The final conditions applicable to the resale under Rule 144 of restricted securities held by affiliates and non-affiliates of the issuer have been summarized by the SEC in Release 33-8869 as follows:

	Affiliate or Person Selling on Behalf of an Affiliate	Non-affiliate (and Has Not Been an Affiliate During the Prior Three Months)
Restricted Securities of Reporting Issuers	<p><i>During six-month holding period</i>—no resales under Rule 144 permitted.</p> <p><i>After six-month holding period</i>—may resell in accordance with all Rule 144 requirements, including:</p> <ul style="list-style-type: none"> • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144. 	<p><i>During six-month holding period</i>—no resales under Rule 144 permitted.</p> <p><i>After six-month holding period but before one year</i>—unlimited public resales under Rule 144 except that the current public information requirement still applies.</p> <p><i>After one-year holding period</i>—unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.</p>
Restricted Securities of Non-reporting Issuers	<p><i>During one-year holding period</i>—no resales under Rule 144 permitted.</p> <p><i>After one-year holding period</i>—may resell in accordance with all Rule 144 requirements, including:</p> <ul style="list-style-type: none"> • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144. 	<p><i>During one-year holding period</i>—no resales under Rule 144 permitted.</p> <p><i>After one-year holding period</i>—unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.</p>