“Broken Window” Filings: How to Avoid SEC Section 16 Problems for Officers, Directors, Public Companies and Principal Stockholders

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Introduction: What's a "broken window" filing?

The Securities and Exchange Commission has announced a policy that “broken windows” will not be tolerated and will be punished.

• The “broken window” term takes its name from psychological and crime prevention theories in which “disorder and crime are . . . inextricably linked”. . . “The theory is that when a window is broken and someone fixes it – it is a sign that disorder will not be tolerated. But, when a broken window is not fixed, it “is a signal that no one cares, and so breaking more windows costs nothing.”

• “The strategy was simple. They wanted to avoid an environment of disorder that would encourage more serious crimes to flourish. They wanted to send a message of law and order.”


2. Id. referring to the policies of New York City Mayor Rudy Giuliani and Police Commissioner Bill Bratton.
Presentation Overview

1. Overview of Requirements and Recent SEC Mass Enforcement Action
   a. Section 16(a) in a nutshell
   b. The SEC's Enforcement Action
   c. Nature of Mass Enforcement as both compliance tool and showcase for new SEC statistical monitoring capabilities
   d. Overview: what can we learn from this action?

2. Getting Your Section 16 Compliance House in Order – Best Practices for Avoiding Section 16 Problems
   a. Thoroughly understand the requirements - what persons, securities and trades are covered?
   b. Advising officers and directors of their reporting obligations
   c. How can the company help officers and directors meet their obligations
   d. Procedures to ensure that filings are made on time: for example, preclearance policies and powers of attorney
   e. The interplay of insider trading policies and Section 16 reporting
   f. The special issues created by Rule 10b5-1 programs
Presentation Overview (continued)

g. The special issues created by stock plans

h. Educating your compliance team and communicating with 3rd party vendors

3. What Happens When the Filings Are Late and the SEC Comes Calling?

a. Can Officers and Directors request advancement of legal expenses for defense costs?

b. Are fines or penalties reimbursable under statutory indemnification laws? What about the SEC’s policy?

c. Under what circumstances might director and officer coverage apply to fines and penalties? Are there different standards for officers/employees than for directors?

d. How will the SEC approach negotiations with companies and/or individuals after this mass enforcement action?

4. Special Issues for Financial Institutions
1. Recent SEC Mass Enforcement Action
Section 16(a) in a Nutshell

• Section 16 of the Securities Exchange Act of 1934 (the “Exchange Act”) governs the regulatory filing responsibilities that must be met by directors, officers, and principal stockholders.

• Section 16(a) specifically applies to:
  – Public companies only
  – Applies to “Insiders” (officers, directors and 10% equity holders).
    • “Officer” is defined as president, CFO, principal accounting officer, VP of principal business unit, division or function (e.g. sales, administration, and any other person with a “policy-making” function).
    • Boards of directors often specify who is (and is not).

• Section 16(a) requires:
  – Form 3s must be filed within 10 business days of becoming an Insider.
  – Form 4s must be filed within 2 business days of change in beneficial ownership.
  – Form 5s must be filed annually to report any insider transactions that were not previously reported on Form 4.
Section 16(a) in a Nutshell (continued)

• Filings promote enforcement of Section 16(b) "short swing" profit disgorgement
• Also can provide basis for Rule 10b-5 violations
• Individual has the obligation to file . . .
• . . . regardless of assistance from Company
Consequences of Not Complying

• Failure to file timely must be reported in proxy statement.
  – Item 405 requires issuers to report in proxy statements any late filings by officers and directors.
  – Must include insider's name and the number of any late filings and failures to file.

• Fines
• Reputational
• Grist for other charges, including Rule 10b-5 and Section 17.
Section 16(a) Enforcement: Observations on Recent Mass Enforcement Action

- On September 10, the SEC announced enforcement actions against 34 companies and Insiders for failing to:
  - file timely Section 16(a) reports and Schedules 13D and 13G or
  - disclose insiders’ violations in the Proxy Statement per Item 405.

- All but one settled, with cease-and-desist orders and monetary penalties ranging from $25,000 to $150,000.

- SEC enforcement staff used quantitative data sources and ranking algorithms to identify these insiders as repeatedly filing late. Some filings were delayed by weeks, months, or even years.

- The enforcement actions came without warning after more than a decade of relatively low profile SEC enforcement in this area with scarce few individuals named during that time.

- In the past, enforcement actions in this area were usually limited to being part of proceedings that alleged other, “more serious” violations.
Who Was Named?

- 13 individuals – current or former officers and directors
- 10 institutional investors
- 5 individual investors
- 6 public companies
Why Were Public Companies Named?

• May be first time for the SEC
• Five companies cited had failed to report late filings in their annual proxy statements as required by item 405 of Regulation S-K
  – Accurate Proxy disclosure is the company’s responsibility.
  – Independent duty to verify.
  – Generic disclosure will not comply: "Certain officers and directors filed late."
  – One company said it based its conclusions on written certifications when in fact it never received them.
Why Were Public Companies Named? (continued)

• Four "caused" violations by officers and directors by agreeing to help them make timely filings, but then failing to do so
  – Over half of named officers and directors said they relied on their companies to make their filings on time
    • On your personal filings: “Trust but verify”
  – "Causing" a violation is a separate offense (section 32(a))
  – Company agreement to make filings is not a valid defense to individual director and officer liability
    • One accounting officer had been named even though the company had not advised him that a filing was required

• Number of late filings ranged from 35 over 3 years to 75 in a single year.
• Company fines ranged from $75,000 to $150,000
• Not just a courtesy for officers and directors; now a compliance risk for the company.
Inadvertence and Excuses Don’t Work; More Cases to Come?

• Andrew J. Ceresney, Director of the SEC's Division of Enforcement, stated: "Officers, directors, major shareholders and issuers should all take note: inadvertence is no defense to filing violations, and we will vigorously police these sorts of violations through streamlined actions."

• Reliance on others no excuse
  – Insiders offered wide range of defenses; none worked
  – Insiders blamed companies for not making filings on time
  – Companies blamed insiders for not giving them information on time
  – Shareholders blamed counsel
  – No “state of mind” requirement; effectively, absolute liability
Kinds of Violations

- Multiple and flagrant; not "foot faults"
- Individuals cited averaged 30 late filings per person
  - Ranged between 9-70 late filings per individual
- Additionally, insiders had missed the filing deadlines not by hours or even days, but usually by weeks if not months
  - Typical filing was 6 months late, but some were filed up to 4 years late
  - Late reported transactions had market values of between $1 million - 182 million
- Average penalty for individuals was $72,000. Fines increased with number of filings missed and days late
- In a separate case, SEC brought antifraud charges against company and CEO because proxy statement failed to disclose that CEO failed to file 27 Form 4s over a two year period; would have been "material" to reasonable persons voting and investment decisions.
Section 16(a) Enforcement: Observations on Recent Mass Enforcement Action

• Our sense is that the SEC is both:
  – sending a strong enforcement message regarding the need for timely filings, and
  – showcasing new statistical monitoring capabilities.

• Lessons
  – Insiders should trust and verify.
  – Companies should treat Section 405 disclosure with the same care as the rest of the proxy statement.
Section 16(a) Enforcement: Now What?

• All public companies should review compliance procedures and filing history.
  – Observations on public company disclosures on Late Filings AFTER the SEC enforcement actions
2. Getting Your Section 16 Compliance House in Order: Steps to Consider Now
Understand the Requirements

• Who must file?
• What holdings are covered?
• What transactions are covered?
Who Must File?

- "Officer": an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer 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 issuer.

- Officers of the issuer's parent(s) or subsidiaries shall be deemed officers of the issuer if they perform such policy-making functions for the issuer.

- In addition, when the issuer is a limited partnership, officers or employees of the general partner(s) who perform policy-making functions for the limited partnership are deemed officers of the limited partnership.

- When the issuer is a trust, officers or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust.
Who Must File? (Continued)

• Not just those still in office;

• All individuals serving as the registrant's principal executive officer ("PEO") or individuals acting in a similar capacity, during the last completed fiscal year regardless of compensation level;

• All individuals serving as the registrant's principal financial officer ("PFO"), or individuals acting in a similar capacity, during the last completed fiscal year ("PFO"), regardless of compensation level;

• The registrant's three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year; and

• Up to two additional individuals for whom disclosure would have been provided pursuant to Item 402(a)(3)(iii) but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.
What Holdings Are Covered?

• “Beneficial ownership” is key concept.

• Under Section 16, a person is deemed to beneficially own securities held by members of their “immediate family” who share their residence (including children, stepchildren, grandchildren, parents, step-parents, grandparents, spouses, siblings and in-laws, and all adoptive relationships).

• However, a member of a group is required to report only the stock in which the person has a “pecuniary interest,” or the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the equity securities.
Getting Your Section 16 Compliance House in Order: Form 4 – What Kinds of Transactions?

• Not just garden variety purchases and sales, also includes:
  – Grant of Stock Options
  – Cashless Exercise of Stock Options (and sale of shares)
  – Grant of Restricted Stock Units (“RSUs”)
  – Vesting (Settlement) of RSUs
  – Open Market Purchase of Stock
  – Open Market Sale of Stock
  – Transfer of Shares from Insider’s Grantor Retained Annuity Trust (“GRAT”) to Spouse’s GRAT
How Can the Company Help?

In summary, companies:

• Currently often make filings for individuals
• May continue to make such filings
• Should consider requiring pre-clearance of trades for Insiders
• May consider obtaining powers of attorney in advance so filings made be made quickly
• Should make sure officers and directors know about the requirements
• May conduct “freshman orientation” for Insiders to inform them of the obligations
• Can send periodic reminders to Insiders of their filing obligations
• MUST remember: Ignorance is no defense
Pre-clearance

• Compliance and Pre-clearance: most public companies maintain a compliance and pre-clearance program. Public companies' compliance programs typically require all reporting persons to pre-clear transactions in company stock (including the exercise of stock options and certain benefit plan transactions) with the office of the corporate secretary or general counsel.

• Companies' pre-clearance programs also generally apply to (1) transactions conducted by members of a reporting person's immediate family who share the same household, (2) shares of company stock held in “street name,” (3) shares of company stock held in other accounts (e.g., individual retirement accounts and trust accounts), and (4) company stock owned by companies and partnerships over which the reporting person exercises control.
Preparation of Forms

• The company will prepare SEC Form 3 upon an individual's assumption of reporting person status.

• Additionally, the company will automatically prepare the appropriate SEC Form 4 on behalf of all reporting persons upon being informed of transactions in company stock (including certain benefit plan transactions) pursuant to the pre-clearance requirement.

• The company will require each reporting person to execute a power of attorney authorizing the corporate secretary and/or outside counsel to sign SEC Forms 3 and 4 on his or her behalf.

• The company should adopt procedures to ensure that the appropriate parties are informed in advance of pending equity grants or other activity so that the Form 4s can be filed in a timely manner.
Compliance Programs

• Prior to clearing a reporting person's transaction in company stock, the corporate secretary or general counsel's office would review with the individual any Section 16(b) matchable transactions that may have occurred within the preceding six months as well as any transactions that may occur within the coming months.

• Matchable transactions conducted by members of the reporting person's immediate family who share his or her household also would be reviewed.
Interplay with Insider Trading Policies

• Customarily require pre-clearance of trades by officers and directors and family members
  – Even during "open windows"

• Provides notice of imminent Form 4 filing
Rule 10b5-1 Plans Raise Special Issues

• Rule 10b5-1 plans essentially allow officers, directors and 10% shareholders to trade even when in possession of material nonpublic information.

• Subject to detailed and strict requirements, including no material non-public information at time plan established.

• But plan trades are subject to Section 16 reporting (and Section 16(b) liability).

• Make sure plan broker understands obligation to report trades to Company so Form 4 filings can be made on time.
3. What Happens When Filings Are Late and the SEC Comes Calling?
Outline of Section 3: Advancement, Indemnification, Insurance Coverage and Settlement Negotiations

• Advancement and Indemnification are separate concepts and the ability to collect one is not necessarily determined by the director or officer’s right to the other.

• Indemnification may depend on a finding of fault and on whether the violation was viewed as being intentional or reckless.

• Insurance coverage will depend on factors such as nature of claim, extent of coverage, and jurisdictional restrictions.
Advancement of Legal Fees

• The company, rather than the individual director or officer, will usually bear the defense costs incurred by the individual in SEC enforcement actions pursuant to the company’s obligation to advance directors & officers legal expenses
  
  – Most state corporations laws permit a company to advance expenses, including attorneys’ fees, to directors & officers upon execution of an undertaking to repay any amounts advanced if it is ultimately determined that the officer or director is not entitled to indemnification

  – Most companies also make such statutorily “permissive” advancement contractually “mandatory” via their corporate charter and/or individual indemnification agreements
Advancement (continued)

• Importantly, advancement and indemnification are distinct rights

• The obligation to advance defense costs pursuant to a mandatory advancement provision does not depend on whether the individual will ultimately be entitled to indemnification

  – Accordingly, mere *allegations* of knowing, intentional or bad faith conduct will not deprive directors & officers of the right to have their legal costs covered by the corporation in real time
Indemnification Issues, Generally

• The SEC has for decades taken the position that indemnification of directors & officers for violations of the federal securities laws is unenforceable as against public policy

• The courts, however, have supported that position only with respect to the anti-fraud provisions of the federal securities laws
  – Thus, under settled federal case law, a corporation cannot indemnify its directors & officers pursuant to state indemnification statues for intentional, reckless, or knowing securities law violations
Indemnification, Generally (continued)

• With respect to other securities law violations for which state-of-mind is not an element -- including Section 16 -- the judicial prohibition on indemnification does not apply

  NOTE: In at least one recent case in which the SEC prevailed after litigation, the court:

  • Observed that the SEC had provided no authority for an order prohibiting the defendant from seeking reimbursement for the fine imposed; **but**

  • Nevertheless ordered that the penalty be doubled if the defendant received reimbursement because “the remedial purpose of any such fine would be highly diluted if it were borne by any third party”
Indemnification for Settlement Amounts

• Under federal case law, indemnification for securities law violations, even where allegedly knowing or intentional, is prohibited only where an officer or director is found \textit{guilty of, or liable for}, such a violation

• That is, for indemnification to be prohibited, there must be a judicial \textit{finding} of an \textit{actual} securities law violation
  
  – If, however, the case settles without an admission of guilt or liability, the prohibition on indemnification doesn’t apply

    • This is, in fact, often a significant driver behind settlement
Indemnification for Settlements (continued)

• In addition to seeking admissions of liability in connection with settlements, the SEC has increasingly attempted to prevent indemnification of directors & officers for settlement amounts -- even where there is no finding or admission of a violation -- by including provisions in settlement agreements that expressly prohibit directors and officers from using indemnification to shift the costs of settlement to the corporation

  – In fact, the SEC’s unwritten policy requires, as a condition to settling claims against directors & officers, that the settling party agree not seek indemnification from any source (including D&O insurance) for any penalties or other amounts paid in settlement of the SEC action
Indemnification for Settlements (continued)

• Pursuant to this policy – aka the “Donaldson Doctrine” – the SEC may insist, as a condition to settling, that a director or officer agree to pay any settlement amount personally, notwithstanding that the corporation has agreed to indemnify him or her.

• Significantly, the SEC has not yet, to our knowledge, sought to similarly restrict the advancement or ultimate indemnification of attorneys’ fees and has indicated that it is unlikely to do so.

  – Indeed, any attempt to do so may well be rejected by the courts.
Directors and Officers Insurance Coverage May Cover Some/All of The Expense

• The company's Directors and Officers Insurance may cover these SEC claims/demands as well as attendant defense expense.

• Coverage governed by nature of claim, policy language, and applicable jurisdiction:
  – Policy language varies widely among insurers.
    • Claims that are expressly covered under some policies may be expressly excluded under others.
  – Insurance policy construction varies widely among states.
    • Claims that are covered in some jurisdictions are excluded in others.
    • For example, some exclude coverage for fines and penalties while others look behind the title to determine the basis for the claim.
Directors and Officers Insurance Coverage May Cover Some/All Of The Expense (continued)

• Policies also may have obligation to advance defense costs.
• Important to notify insurer in timely fashion.
  – Timeliness can be defined in policy in terms of number of days or more subjectively (e.g., "as soon as practicable").
  – Jurisdictions differ in construing these requirements and applying consequences to any failure to comply.
  – Best practice is to notify insurer immediately.
4. Special Issues for Financial Institutions
Filing Duties of "Beneficial Owners"

• Under Section 16, a financial institution that has or shares voting or investment power over more than 10% of a class of registered equity security must file:
  – Form 3,
  – Form 4, and
  – Form 5.

• It also likely will have to file timely Schedules 13D or 13G and amendments thereto.
  – Amendments due 45 days after end of calendar year
• Section 13(d) of the Securities Exchange Act of 1934 determines whether a firm is a greater than 10% “beneficial owner”.

• SEC Rule 13d-3 broadly defines the term “beneficial owner” to include:
  – “any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares voting or investment power with respect to a registered equity security.
  – More than one person may be a “beneficial owners” of the same securities.

• Because the definition includes the words “directly or indirectly,” “beneficial ownership” by a firm is also ordinarily attributable to persons that control such firm.
SEC Enforcement Initiative Included Financial Institutions as “Beneficial Owners”

• 10 of the 34 defendants were investment firms that were beneficial owners of more than 10% of a registered class of equity securities.

• These included banks:
  – Brown Brothers Harriman & Co. ($120,000 penalty)
  – The Royal Bank of Scotland Group plc ($120,000 penalty)
Brown Brothers Harriman & Co.

• BBH was general partner of a private pooled investment vehicle structured as a limited partnership.

• BBH designated certain of its partners to exercise voting and investment power over investments of the partnership, but took responsibility for making all beneficial ownership filings.

• BBH allegedly failed on multiple occasions to file timely Section 16(a) reports of transactions in securities (and amendments to Schedule 13G).
• Examples:
  – Deltek, Inc.
    • > 10% equity interest acquired November 18, 2010
      – Form 3 not filed until September 26, 2011
    • 6 open market purchases ($18 million) between 11/19/10 and 3/2/11
      – Form 4s not filed until September 26, 2011
    • No Form 5 filed
    • Amendment to Schedule 13G due February 14, 2011,
      – not filed until December 8, 2011
  – Tyler Technologies, Inc.
    • > 10% equity interest acquired October 26, 2009
      – Form 3 not filed until April 30, 2010
    • 11 open market sales ($3 million) between 6/28/11 and 7/20/11
      – Form 4s not filed until September 26, 2011
    • Amendment to Schedule 13G due February 14, 2011,
      – not filed until December 8, 2011
The Royal Bank of Scotland Group plc

- Allegedly failed to file timely reports of holdings and transactions in:
  - Lyondell Basell Industries N. V.
    - > 10% acquired October 13, 2010
      - Form 3 not filed until July 22, 2011
    - 4 open market sales ($180 million) between 11/30/10 to 12/3/10
      - Form 4s not filed until July 22, 2011
    - No Form 5 filed
  - YRC Worldwide Inc.
    - >10% acquired September 16, 2011
      - Form 3 not filed until January 4, 2012
    - 8 open market sales ($2 million) between 9/16/11 to 9/29/11
      - Form 4s not filed until January 4, 2012
Getting Your Section 16 Compliance House in Order: Special Focus for Financial Institutions

• Review process and procedures within private banking/wealth management/investment management/trust area for compliance.
  – Those holdings as to which the FI has exclusive or shared voting or investment power must be aggregated to compare against the Section 13 and Section 16 triggers which are 5% and 10% respectively.

• Transactions need to be monitored to ensure that any transaction that puts the FI in excess of the triggers will initiate compliance with the requisite reporting requirement immediately.
Indemnification of Directors and Officers of Financial Institutions

• Federal Reserve policy may limit indemnification of directors and officers of bank and thrift holding companies.
  – Section 18(k) of the Federal Deposit Insurance Act and FDIC regulations adopted thereunder generally prohibit the making of indemnification payments by banks or such holding companies to pay or reimburse an officer or director for any liability or legal expense with regard to an administrative proceeding or civil action instituted by a “federal banking agency.”
Indemnification of Directors and Officers of Financial Institutions (continued)

• However, in 2002, the Federal Reserve Board issued SR 02-17 – “Guidance Regarding Indemnification Agreements and Payments.”
  – That Guidance alerts banks and holding companies to Section 18(k)’s prohibition, but it also states that the law reinforces:
    • The “Federal Reserve’s longstanding policy that a [director or officer] who engages in misconduct should not be insulated from the consequences of his or her misconduct. From a safety and soundness perspective, a … holding company should not divert its assets to pay a fine or other final judgment issued against an [director or officer] for misconduct that presumably violates the institution’s policy of compliance with applicable law. …”
  – Thus, it appears that the making of an indemnification payment by a bank holding company or thrift holding company to a director or officer related to an SEC enforcement action based on Section 16 violations could violate the Federal Reserve’s longstanding policy.
Appendix: Common Issues and Questions

• M&A Transactions
  – Disposition of issuer securities in merger eligible for exemption under rule 16b-3(e) [best if last day resolution "approves all sales by executives."]
  – Approval resolutions should name each insider whose dispositions are to be exempted and the number of securities to be disposed of.
  – Where shareholder approval is basis for rule 16b-3(e) exemption, approval resolutions should state exemptive purpose.
  – Failure to list insiders and their holdings does not necessarily render rule 16b-3 unavailable.

• Late Filings or Amended Reports
  – File the delinquent report and/or correct the incorrect report as promptly as possible.
  – For amendments, it’s often ok just to amend one report and not every subsequent report in which the error carried forward (in total amounts reported) before detection of the error.
  – Remember to disclose the late filing in the proxy statement, if applicable (if only the Holdings column of the Form is incorrect or if the size of transaction was over-reported, it may not be a reportable failure to file).
Common Issues and Questions (continued)

- Compensation Committee Composition – options if a compensation committee member does not qualify as a “non-employee director”
  - Remove from Compensation Committee
  - Create a sub-committee of the Compensation Committee that will approve equity awards (need at least two)
  - Have the Board approve all equity grants (may cause issues with 162(m) compliance though)
  - NOTE: make sure the workaround is consistent with the Stock Plan and Compensation Committee Charter

- Estate Planning Transactions
  - Basic rule – transferring securities from one form of ownership (direct) to another form (direct) generally does not result in a reportable transaction
  - Exception – a change in the form of ownership is reportable if it affects the ownership interest of a third party whose ownership can be attributed to the insider (i.e. a family member or a spousal trust)
Common Issues and Questions (continued)

- Reportable Derivative Securities
  - Derivative securities are those that derive their value solely from the underlying security.
  - Grants of RSUs and stock options are reportable within 2 days of grant on a Form 4.
  - Grants of performance-based stock awards are reportable as derivative securities only if the performance condition relates solely to the stock price.
    - So a performance share award that vests upon the stock price hitting $25 is reportable.
    - A performance share award that vests based on earnings per share is not reportable.
    - The staff has stated that an instrument whose exercisability is subject to a material condition (other than the passage of time or continued employment) that is not tied to the market price of an equity security of the issuer is not a derivative security until the condition is satisfied. The Commission has affirmed the staff’s position, stating that a non-market price condition will be considered “material” if it has substance independent of the passage of time or continued employment. The position means, for example, that an option granted to an insider subject to shareholder approval is not acquired by the insider-grantee for purposes of Section 16 until shareholder approval is obtained.
Common Issues and Questions (continued)

• Grants of performance-based stock awards are reportable as derivative securities only if the performance condition relates solely to the stock price.

  – From a reporting standpoint, instruments such as performance rights and earn-out rights, which generally are subject to material conditions that are not based on the market price of the issuer’s securities (e.g., the reaching of performance goals or the attainment of earnings targets) will not be deemed beneficially owned until the number of shares that can be acquired under the rights is determined. From the standpoint of Section 16(b), the purchase date may be deferred until the contingency is removed and the derivative security comes into existence (or the underlying security is acquired).

  – An award that vests or becomes exercisable only if the issuer achieves a specified level of “total shareholder return” (defined as stock price appreciation plus dividends) may (or may not) be considered to be tied solely to the price of the issuer’s stock, depending on the significance of dividends as a component of the issuer’s total shareholder return. If, for example, the issuer pays no dividends or only a de minimis dividend, conditioning vesting of an award on total shareholder return would be equivalent to conditioning vesting on the issuer's stock price, and therefore the condition would not prevent the award from being reportable at the time of grant. The staff has not provided guidance regarding the circumstances under which a dividend should be considered de minimis.
• Grants of performance-based stock awards are reportable as derivative securities only if the performance condition relates solely to the stock price.

  – Accordingly, whether an award conditioned upon achievement of a specified level of total shareholder return should be deemed reportable at the time of grant requires that a judgment be made based on the circumstances of the individual issuer.

  – Release No. 34-37260, III. D. Value Derived from Market Price of an Equity Security. In the 1994 Release the Commission proposed an amendment to the definition of "derivative security" to codify the staff interpretive position that an instrument is not within the scope of Section 16 if it includes a material non-market price based condition (such as return on equity) to exercise or settlement. Although the Commission endorses the application of this analysis to date, the Commission also recognizes the advantage in retaining the interpretive role of the staff to modify or develop further this analysis as may be appropriate with respect to new instruments that may be developed in the future. Accordingly, the proposed amendment is not adopted, and questions regarding this analysis should continue to be addressed to the staff. For purposes of this interpretive analysis, a condition will be considered "material" only if it possesses substance independent of the passage of time or continued employment.

  – Most importantly, the Commission believes that under the new rule much of the incentive to characterize these instruments one way or the other will evaporate. In almost all cases, they will be exempt from Section 16(b) because they will be able to satisfy easily one of the simplified approval conditions. Consequently, the only effect of a particular characterization is on the need for and timing of any reporting under Section 16(a). The Commission does not believe that relief generally will be needed for this purpose.
Common Issues and Questions (continued)

- Footnotes

  - Release No. 34-37260, § III.D. (1996). In the same release, the Commission declined to adopt a proposed amendment to the definition of derivative securities that would have codified the staff’s position in Certilman, indicating that there is an advantage to allowing the staff to modify or develop the position further with respect to new instruments that may be developed in the future. The proposal that the Commission declined to adopt appears in Release No. 34-34514, § II.D. (1994).

  - For a discussion of the date of purchase of securities whose issuance is subject to a material condition, see Romeo & Dye § 11.02[2] infra.

  - See Report of the American Bar Association’s Joint Committee on Employee Benefits of questions addressed in its meeting with the staff of the SEC on May 6, 2008, Q. 19, reported in ROMEO & DYE, XVIII SECTION 16 UPDATES (September 2008) at 9.

  - Proposed Rule 16a-1(c)(9).

  - This is an interpretation of current Rule 16a-1(c), which requires a derivative security to have "an exercise or conversion privilege at a price related to an equity security, or . . . a value derived from the value of an equity security." See General Mills, Inc. (Jan. 31, 1992); and Certilman Balin Adler & Hyman (Apr. 20, 1992). See also Boston Edison Company (Mar. 19, 1992); Merrill Lynch & Co. (Aug. 28, 1992) Q. 4. (Registrant discretion to adjust the applicable performance measure, as to either duration or level of performance, excludes a performance unit from being a derivative security.
Questions?

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Thank You