

Client Memorandum

August 28, 2002

RE: SEC Adopts New Section 16 Reporting Rules

The recently enacted Sarbanes-Oxley Act (the "S-O Act") amended and restated Section 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act") to require executive officers, directors and greater than ten percent stockholders ("insiders") to file Section 16 transaction reports "before the end of the second business day following the day on which the subject transaction has been executed." The S-O Act authorized the Securities and Exchange Commission ("SEC") to exempt transactions from the two business day reporting requirement if it determines that reporting within that time is not "feasible." In addition, the SEC's general exemptive and rulemaking authority under Section 16(a) was not affected by the S-O Act.

The amendment to Section 16(a) became effective on August 29, 2002. On August 27, 2002, the SEC adopted final rules to address the amendments to Section 16(a). The final rules appear at <http://www.sec.gov/rules/final/34-46421.htm>. Under these rules, the new reporting requirements apply to transactions occurring on or after August 29, 2002.

Section 16(a) Reporting Changes

Under the SEC's final rules, the Section 16 reporting rules have been amended as follows:

- **Form 4 Reporting of Transactions between the Company and the Insider.** Transactions between an insider and the company (or an employee benefit plan) that are exempt from Section 16(b) liability but that previously were required to be reported on Form 5 are now reportable on Form 4. **As a result, the following transactions are subject to two business day reporting:**
 - o Grants, awards and other acquisitions from the issuer that satisfy the requirements of Rule 16b-3(d). This category includes stock option grants, restricted stock grants and acquisitions of stock units under non-tax qualified deferred compensation plans.
 - o Dispositions to the issuer that satisfy the requirements of Rule 16b-3(e). This category includes shares delivered to the company to pay tax withholding amounts or an option exercise price, options surrendered to the company in an option repricing, and sales of shares to a company.
 - o Discretionary transactions that satisfy the requirements of Rule 16b-3(f). A "discretionary transaction" is a participant-directed movement of a portion of his or her account balance into or out of a company stock fund under a deferred compensation plan. The term does not include transactions made in connection with the plan participant's death, disability, retirement or termination of employment, or that are required to be provided under IRS regulations. Discretionary transactions may occur in a tax-qualified plan, such as a 401(k) plan, or in a non-tax qualified plan, such as a SERP or a directors' fee deferral arrangement. As discussed below, the SEC provided a limited extension of time for Form 4 reporting of discretionary transactions.
- **Accelerated Reporting of Transactions on Form 4.** All Forms 4 are due on the second business day after the transaction is executed, subject to two narrow exceptions. **As a result, in addition to the transactions described above, the following transactions are subject to two business day reporting:**
 - o stock option exercises; and
 - o open market purchases and sales.

The SEC has provided a limited extension of time for Form 4 reporting for "discretionary transactions" (described above), and for transactions pursuant to Rule 10b5-1(c) trading plans, provided in both cases that the insider does not select the date the transaction is to occur. Under the limited extension, the two business day deadline is counted from a "deemed" transaction date, which is the earlier of (i) the date the insider receives notice that the transaction was executed, or (ii) the third business day after the date the transaction is executed. Consequently, the latest a Form 4 can be timely filed for these transactions is on the fifth business day after the transaction. Insiders should note, however, that the extended time period for these transactions is not available if the insider has selected the date for transaction execution. For example, if an insider establishes a Rule 10b5-1(c) trading plan that provides for a sale on the first business day of each month, the insider has selected the date of the transaction and the limited extension is not available. If a employee benefit plan operates such that a discretionary transaction occurs on a date determined by the day the insider provides instructions authorizing the transaction (as opposed to being executed on a date selected in the discretion of the plan administrator), the insider arguably has selected the date for execution of the transaction, and consequently the limited filing extension would not be available. In these circumstances, the insider will need to receive information from the plan administrator to complete and file a Form 4 reporting the transaction within the normal two business day deadline.

- **Other Reporting Exemptions Will Continue.** All pre-existing exemptions from Section 16 transaction reporting continue to be available. Consequently, as before, insiders are not required to report the following transactions:
 - o Acquisitions under tax-conditioned plans that satisfy the requirements of Rule 16b-3(c). This includes purchases that occur pursuant to stock allocations under ERISA profit-sharing plans and employee stock ownership plans ("ESOPs") and purchases that occur pursuant to payroll deductions under 401(k) plans, excess benefit plans that provide only for benefits or contributions in excess of certain limits imposed on tax-qualified plans, employee stock purchase plans that satisfy Section 423 of the Internal Revenue Code and similar plans that are not tax qualified but satisfy certain coverage and participation requirements.
 - o Forfeiture or expiration of stock options or restricted stock.
 - o Acquisitions pursuant to dividend reinvestment plans, other than purchases that result from a discretionary contribution to such plans.
 - o Stock splits, stock dividends and distributions of stock purchase rights.
 - o Transfers pursuant to divorce decrees and domestic relations orders.
 - o Changes in the form of ownership that do not affect the insider's pecuniary interest in the shares (such as changes from indirect to direct ownership).
 - o Transactions following termination of insider status, if the insider has not effected a matchable transaction during the previous six months while still an insider.
 - o Transactions effected in a fiduciary capacity as a guardian, executor or receiver, during the twelve months following the insider's appointment to such position.
- **Form 5 Reporting of Other Transactions.** A few categories of transactions remain eligible for reporting annually on Form 5. **Consequently, as before, insiders can use Form 5 to report the following transactions:**
 - o Acquisitions or dispositions of shares through gifts or inheritance.

- o "Small" acquisitions, meaning purchases aggregating less than \$10,000, provided that the transactions are not transaction with the company or an employee benefit plan that are described in Rule 16b-3(d) or (f), which as addressed above are now subject to two business day reporting. A common example of small transactions that remain eligible for Form 5 reporting are acquisitions under dividend reinvestment arrangements sponsored by brokerage firms when a company itself does not offer a reinvestment plan. Note, however, that if the \$10,000 threshold is exceeded, a Form 4 to report the transactions must be filed within the new two business day deadline.

In addition, Form 5 continues to be available for year-end disclosure of late transaction reports.

- **Form 3 and Form 5 Reporting.** The S-O Act did not change the filing deadlines for Form 3. For persons who become insiders after a company's initial public offering, a Form 3 is due within 10 days (not business days) after the person becomes a Section 16 insider. When companies first go public, Forms 3 are due on the effective date of a company's registration under Section 12. The S-O Act also does not address the timing of Form 5 filings, and the SEC has retained the deadline it originally developed for that form; i.e., 45 days after the end of the company's fiscal year.
- **Reporting Holdings.** Forms 4 continues to require "end of period" holdings to be reported, but the SEC has clarified that each Form 4 must report the person's holdings after giving effect to the transaction reported on the form. As in the past, a Form 4 is not required to reflect the effect on an insider's holdings of a transaction that is not reported on the Form 4 and that has not previously been reported (such as the effect of a gift or a discretionary transaction that has not yet been reported) and need only reflect the effect of non-reportable transactions (such as purchases under 401(k) payroll contributions and dividend reinvestment plans) as of the most recently available statement.
- **Transition Considerations.** The new reporting rules apply to all transactions effected on or after August 29, 2002. Transactions that currently are reportable on Form 4 but that occur before August 29, 2002 must be reported on a Form 4 filed on or before September 10, 2002. In addition, Rule 16b-3 transactions that occurred before August 29, 2002 remain eligible for reporting on Form 5.
- **Form 8-K Reporting.** In the release adopting the new rules, the SEC indicated that it will not pursue its rule proposal to require that companies disclose insiders' stock transactions on a Form 8-K. However, the SEC continues to consider its other Form 8-K company disclosure requirements (including its proposal that companies disclose the existence and any amendment of an insider's Rule 10b5-1(c) trading plan on a Form 8-K filing).

Section 16(a) Reporting Changes

Neither the S-O Act nor the SEC rules changed any of the pre-existing exemptions from liability under Section 16(b). Thus, any transaction that is exempt from reporting and any transaction that is exempt under a 16(b) rule (such as Rule 16b-3) is not subject to potential matching for purposes of determining short-swing liability.

Planning for Accelerated Section 16 Reporting

In light of the August 29, 2002 effective date for two business day reporting, companies should prepare now for the new rules. It is important to reiterate that the legal obligation to timely file reports is imposed on the insiders themselves, not on companies. If a Form 4 is filed late, the insiders will be identified in the company's proxy statement and/or Form 10-K as late filers, and it is the insiders who are subject to potential SEC enforcement actions for late filings. Insiders should understand that a company's undertaking to assist them does not shift this responsibility.

Nevertheless, recognizing that companies typically take an active role in promoting Section 16 reporting compliance, many companies will also undertake the procedures described below. Not all of these suggestions will be appropriate for each company, and companies may consider other actions to promote Section 16 reporting compliance and to address the increased public transparency of insider transactions.

- Inform Insiders of the New Reporting Deadlines. Companies should inform insiders of the new deadlines for Form 4 reporting. To the extent that a company is undertaking various steps to assist insiders in Section 16 compliance, the company should describe those steps to their insiders. Insiders should inform family members and others whose holdings or transactions are attributed to them of the new reporting deadlines. A sample memorandum for this purpose (which contemplates company assistance in a number of areas described below) is attached to this client memorandum.
- Designate Several Compliance Officers. The new deadlines mean that the timing of transaction reports will be less predictable. Therefore, it will be helpful for designated individuals to be available at all times to assist insiders with their Section 16 reports. Each company should designate at least two people for this responsibility, to accommodate times when one is on vacation or otherwise is absent. Files should be established with respect to each insider so that the compliance officers may keep track of past Section 16(a) filings and other vital reporting information.
- Coordinate with Plan Administrators. Contact plan administrators inside and outside of the company to ensure that they are aware of the new reporting deadlines, especially the fact that administrators need to report execution of trades on an expedited basis. While the three business day extension may be available in some instances, as noted above, if the insider knows when the plan administrator executes orders (for instance, by the business day after the order is placed), the three business day extension may not be available, and the administrator would need to provide information on the trade within one business day to enable the insider to meet the two business day deadline. Ask insiders to request that a copy of their plan account statements be sent to the company, after talking with the administrators to be sure that they can accommodate such requests. Find out how discretionary transactions are processed and how quickly they can be reported. Companies may wish to impose a temporary "black out" on insiders' discretionary transactions until the reporting requirements and procedures for those trades are established.
- Tighten Preclearance Procedures. More than ever, it will be important for companies that assist their insiders with Section 16 filings to know of proposed transactions in advance. We have always recommended a preclearance process to reduce the likelihood of insider trading or Section 16(b) violations. Now, those procedures should be revised to gather more information. Specifically, preclearance procedures should capture information on the size and terms of the proposed transaction (for example, whether it involves a limit order), the exact date the order is to be placed and contact information for the broker who is responsible for the order. Companies and insiders should begin to prepare the Form 4 at the same time an order is placed. The insider should instruct the broker to promptly report execution of the trade (whether executed in whole or in part) to the company's compliance officers.
- Obtain Powers of Attorney. Given the short reporting deadlines, a company may need to file reports on behalf of an insider without time for obtaining the insider's review of or signature on a Form 4. In order to establish their authority to make those filings, companies should obtain a power of attorney from their insiders. As with the compliance officers, several individuals should be authorized to act under an insider's power of attorney. A company may wish to ensure that the authorized individuals (as well as any compliance officers) are included or added to the company's D&O insurance policy as covered persons or, alternatively, may wish to include an indemnification provision in the power of attorney.
- Catalog Insiders' Holdings. In order to track transactions and accurately report holdings, insiders (and companies assisting them) should catalog all of their holdings (including holdings of family members) and their on-going stock purchase arrangements (401(k) plans, dividend reinvestment plans, employee stock purchase plans, stock fund accruals under non-qualified deferred compensation plans) and should understand who has authority over the shares. Obtain copies of any trading plans established under Rule 10b5-1(c). (Insiders should discuss with counsel whether to suspend trading plans with respect to transactions that may occur on or soon after August 29, until the reporting rules and procedures are established.) Contact information (telephone numbers, fax numbers and email addresses) should be obtained for brokers and any others whose assistance is necessary to prepare insiders' reports.

- Consider a "Catch-Up" Form 4 Filing. Insiders and companies should consider filing a Form 4 disclosing all of the insiders' Form 5 reportable transactions occurring prior to August 29, 2002. Regardless of the fact that exempt employee benefit plan transactions occurring before August 29, 2002 remain reportable on the current year's Form 5, as a matter of good practice it would be helpful to report those transactions early in September. This will avoid confusion in reporting holdings that may have been affected by those transactions, once two business day reporting applies to all reportable employee benefit plan transactions. That same Form 4 can be used to list all of the insiders' holdings and thereby establish a "baseline" report for all future transaction reports.
- Consider Establishing Shortened Trading Windows. In the past, companies typically restricted insider transactions to a limited open window trading period (such as the traditional "ten business days following the second business day after an earnings announcement"). In recent years, however, the trend has been to lengthen trading windows or to eliminate trading windows completely and instead apply only a strict preclearance policy. In light of the demands on coordinated reporting that the two business day requirement will produce and the fact that investors are more focused on tracking insiders' transaction reports, companies may wish to establish a short open trading window as well as a preclearance procedure. Some companies will find this approach preferable to prevent information on transactions from dribbling into the marketplace over extended periods.
- Prepare for EDGAR Filing of Forms 4. Because it will be necessary for Forms 4 to be received by the SEC during its filing desk business hours (currently, before 5:30 p.m. Eastern time) on the second business day after a transaction is executed, companies should consider training in-house staff on filing Forms 4 by EDGAR. The SEC has stated that, to facilitate EDGAR filing of Section 16 reports, it will accept EDGAR submissions that are not presented in the standard Form 4 box format and that omit the horizontal and vertical lines separating information items, so long as all required information is presented in the proper order. However, each insider will need to obtain individual EDGAR access codes. Therefore, companies may wish to prepare and obtain insiders' signatures on Form ID applications to obtain EDGAR access codes for insiders who have not already obtained individual access codes. If a company's insiders already have individual EDGAR access codes (for example, because a director is an insider at another company that files Section 16 reports electronically), the company should request the insider to provide the company his or her access codes. Note that companies should check with insiders before requesting EDGAR access codes for them, because filing to obtain a new EDGAR access code will automatically cancel an insider's current access codes. Companies can also check for current EDGAR access codes on the SEC's website at <http://www.sec.gov/edgar/searchedgar/cik.htm>. Companies that have not purchased a software program for tracking and generating insider transaction reports may wish to do so now. It should be noted that although more than 90% of Section 16 reports are currently filed in paper format through the SEC's filing desk, the S-O Act requires the SEC to establish rules by July 30, 2003 mandating that all Forms 4 be filed electronically and posted on the issuer's website, and the SEC has stated that it is proceeding "expeditiously" with rulemaking in this area. Even before that deadline, the SEC is likely to adopt rules that mandate two business day filings by companies for certain material corporate developments that are reportable on Form 8-K. Therefore, establishing in-house EDGAR filing capacity will prepare a company for each of these developments.
- Consider the Reporting Implications of Compensation Practices. Companies will need to review and consider the implications on their compensation practices of accelerated reporting. For example, two business day reporting of employee stock option and restricted stock grants may affect the timing or frequency of such events. Companies may need to revise the manner in which such grants are announced internally in light of the prompt public disclosure obligations. Transactions pursuant to Rule 10b5-1(c) trading plans may become more commonplace because of the view that sophisticated investors will not seek to read meaning into individual transactions once the existence of the trading program has been publicly disclosed.

Other provisions of the S-O Act are addressed in our memorandum to clients dated July 30, 2002, available at http://www.gibsondunn.com/fstore/documents/pubs/sarbanes_oxley.pdf.

For more information on Section 16 reporting, please contact the Gibson Dunn attorney with whom you work, or Ronald O. Mueller (202-955-8671), Brian J. Lane (202-887-3646), Amy Goodman (202-955-8653) or Stanton P. Eigenbrodt (214-698-3174). To contact any of these attorneys by email, use the first letter of the attorney's first name, followed by the attorney's last name, followed by "@gibsondunn.com".

