

SEC Implements Two-Day Section 16 Reporting under Sarbanes-Oxley

At a meeting held on August 27, 2002, the Securities and Exchange Commission adopted rule changes under Section 16(a) of the Securities Exchange Act of 1934 to implement the two-day insider reporting requirements imposed by Section 403 of the Sarbanes-Oxley Act of 2002. As a result, effective August 29, 2002, market purchases and sales of company stock, as well as numerous types of employee benefit transactions, by public company directors and executive officers must be disclosed on a Form 4 filed with the SEC within two business days after the execution date of the transaction.

This memorandum (i) outlines the new reporting requirements, (ii) describes the impact of the new reporting requirements on some of the more common transactions in company stock, and (iii) in view of the tight filing schedule, offers some compliance suggestions.

Background

Before the Sarbanes-Oxley Act, Section 16(a) required each director and executive officer of a company with a class of equity security registered under Section 12 of the Securities Exchange Act of 1934 and any beneficial owner of more than 10% of any such registered class of equity security ("Section 16 Insiders") to report transactions in all equity securities of the company within ten days after the end of the month in which the transaction occurred. Under rules adopted by the SEC, however, the reporting of certain transactions, including various types of employee benefit transactions, could be deferred until after the end of the year in which the transaction occurred, and certain other transactions were exempt from reporting. The monthly transaction reports (now two business day reports) are filed on a Form 4. The annual transaction reports are filed on a Form 5, which is due within 45 days after the company's year-end.

Summary of the New Two-Business Day Reporting Requirements

In order to make information on trading by Section 16 Insiders available to the public earlier, the Sarbanes-Oxley Act amended Section 16(a) to require the reporting of changes in beneficial ownership "before the end of the second business day" following the day on which the transaction is executed, but subject to the authority of the SEC by rule to extend the filing deadline in any case in which it "determines that such 2-day period is not feasible." To implement the Sarbanes-Oxley amendments to Section 16(a), the SEC has

- Amended the Form 4 and its instructions to conform to the two-day filing requirement;
- Amended the reporting requirements in Rule 16a-3 to require the reporting within two business days on a Form 4 of all transactions between the company and a director or executive officer that are exempt under Rule 16b-3 from the short-profit recovery provisions of Section 16(b) and which previously were eligible for deferred reporting on a Form 5;

- ❑ Amended the reporting requirements in Rule 16a-3 to permit an extension of the two-business day reporting deadline for a period of up to three business days for two categories of transactions, as described below; and
- ❑ Left in place other existing rules permitting the deferred reporting on a Form 5 of certain transactions, as well as existing rules exempting certain other transactions from reporting.

Extension of the Two-Business Day Filing Requirement

The SEC has exercised its authority under the Sarbanes-Oxley Act to extend in two circumstances the two-business day deadline for filing Form 4s. The extension in each case is based on a finding by the SEC that the two-business day reporting deadline is not feasible because “objective criteria prevent the reporting person from controlling the trade date.” In each case, an extension of up to three additional business days is allowed to complete the filing. The SEC accomplishes this by establishing by rule that, regardless of the actual trade date, the execution date of the transaction is deemed to be the earlier of (i) date on which the executing broker, dealer, or plan administrator notifies the Section 16 Insider of the execution of the transaction and (ii) the third business day following the actual trade date. As a result, the Form 4 filing deadline is two business days after the deemed execution date. The two types of transactions qualifying for the reporting extension are:

Rule 10b5-1 Plan Transactions. Under Rule 16a-3(g)(2), a transaction is eligible for a reporting extension (the “Rule 10b5-1 Plan Extension”) if both of the following two conditions are satisfied:

- ❑ The transaction is pursuant to a contract, instruction, or written plan that satisfies the affirmative defense requirements of Rule 10b5-1¹; and
- ❑ The Section 16 Insider does not select the date of execution.

The theory underlying this extension is that the Section 16 Insider does not know the execution date of the transaction when the purchase or sale instructions are given, and therefore cannot anticipate with certainty the date on which the Form 4 filing is due.

It is important to note that not all transactions pursuant to a Rule 10b5-1 plan necessarily qualify for the reporting extension. For example, if the Rule 10b5-1 plan provides for the execution of transactions on specified dates (such as on the last trading day of each month), then the reporting extension will not be available because the execution dates will have been selected by the Section 16 Insider.

Discretionary Transactions. Under Rule 16a-3(g)(3), a transaction is eligible for a reporting extension (the “Discretionary Transaction Extension”) if both of the following two conditions are satisfied:

¹ Rule 10b5-1, which otherwise does not have any application to Section 16, provides an affirmative defense against a claim of insider trading for transactions by a person pursuant to a contract, instruction, or plan (i) entered into or given when the person is not aware of material nonpublic information, (ii) that specifies, or provides a formula for determining, the amount of securities to be purchased or sold and the prices(s) and the date(s) of the transaction(s), and (iii) that does not allow the person to exercise any subsequent influence over how, when, or whether the purchase or sale transaction(s) is completed.

- ❑ The transaction is a “discretionary transaction” as defined by Rule 16b-3(b)(1)²; and
- ❑ The Section 16 Insider does not select the date of execution.

Discretionary transactions generally are associated with funded plans that are qualified under the Internal Revenue Code, such as a 401(k) plan or an ESOP, or an excess benefits plan that operates in conjunction with a qualified plan that provides benefits supplemental to those permitted under the qualified plan (an “Excess Benefit Plan”). Typical discretionary transactions include intra-plan transfers, cash withdrawals, and loans that affect the balance of the employer stock fund.³ The theory underlying this extension again appears to be that, because of the manner in which the plan operates, the Section 16 Insider does not know the execution date of the transaction when the purchase or sale instructions are given.

No Effect on Section 16(b) Exemptions

Neither Sarbanes-Oxley nor the rule changes adopted by the SEC change in any way the existing exemptions from Section 16(b) as set forth in Rule 16b-3 and other SEC rules. Even though the reporting of many transactions exempted from the application of Section 16(b) has been accelerated by the amended rules, those transactions remain exempt from matching for short-swing profit recovery purposes.

Transitional Matters

The new two-day filing requirements apply to reportable transactions executed on or after August 29, 2002. All transactions executed before August 29 continue to be reportable, either on a Form 4 or Form 5, in accordance with the reporting requirements in effect at the time of the transaction. In other words, the new reporting requirements do not apply retroactively to transactions that occur prior to August 29. Of course, a Section 16 Insider voluntarily may elect to report any or all pre-August 29 transactions on an earlier date.

Amended Form 4s and Form 5s reflecting the new changes are yet not available. The SEC has stated that it plans to publish the new forms as soon as possible, but that, until the new forms are available, Section 16 Insiders should continue to use the existing forms, with the following modifications:

- ❑ Box 4 of the Form 4, which currently calls for the month and year of the transaction, should state the month, day, and year of the transaction; and
- ❑ When reporting a transaction pursuant to a Rule 10b5-1 Plan Extension or a Discretionary Transaction Extension, an asterisk should be placed next to the date in the Transaction Date column and accompanied by a footnote disclosing the deemed execution date.

² Rule 16b-3(b)(1) defines a “discretionary transaction” as a transaction pursuant to an employee benefit plan that (i) is made at the volition of the plan participant, (ii) is not made in connection with the participant’s death, disability, retirement, or termination of employment, (iii) is not required to be made available to the participant pursuant to a provision of the Internal Revenue Code, and (iv) results in an intra-plan transfer involving the company equity fund or a cash distribution funded by a volitional disposition of a company equity security.

³ As more fully discussed below, transactions other than discretionary transactions effected in connection with a funded plan or an Excess Benefit Plan continue to be exempt from transaction reporting under Section 16(a).

EDGAR Filing and Website Posting

The Sarbanes-Oxley Act requires that within one year after enactment, all Form 4s must be filed electronically and that each public company that maintains a corporate website must post all Form 4 filings not later than the end of the business day following the filing. The SEC has announced that it intends to commence rulemaking promptly to make the filing of Section 16(a) reports on EDGAR mandatory. In the meeting at which the new Section 16(a) rules were approved, the Division of Corporation Finance informed the Commission that it expects to present a proposal for consideration within “several months” with the goal of implementing mandatory EDGAR filing well in advance of the one-year deadline. In the interim, the SEC has encouraged voluntary EDGAR filing of all Section 16 forms. The SEC also has urged companies to begin posting Section 16(a) filings on their corporate website in advance of the July 30, 2003 Sarbanes-Oxley deadline.

Application of the Reporting Changes to Particular Transactions

As the result of the rule changes adopted by the SEC, transactions in the equity securities of a public company by Section 16 Insiders now fall into four different categories:

- Form 4 reporting within two business days;
- Form 4 reporting on a delayed basis of up to three additional business days;
- Form 4 reporting within 45 days after the end of the fiscal year; and
- Transactions that are not reportable.

The following is a brief outline of the application of the new reporting requirements to some of the more common transactions in company equity securities by directors and executive officers. A table categorizing the reporting treatment of the transactions described in this section is attached.

Third Party Transactions. An ordinary purchase or sale with a party other than the company, whether executed through a broker-dealer or privately negotiated, must be reported within two business days, unless the transaction qualifies for the Rule 10b5-1 Plan Extension.

Non-Plan Transactions with the Company. All purchases from or sales to the company by a director or executive officer, other than in connection with a dividend reinvestment plan or an employee benefit plan, must be reported within two business days, unless the transaction qualifies for the Rule 10b5-1 Plan Extension.

Stock Option Transactions. A stock option grant must be reported within two business days after receipt. The exercise of a stock option, including the delivery of shares to effect a cashless exercise or to satisfy a tax withholding obligation and the market sale of shares in connection with a broker-assisted cashless exercise, must be reported within two business days, unless the transaction qualifies for the Rule 10b5-1 Plan Extension. Also, the cancellation and regrant of a stock option, or the repricing of a stock option (which is deemed by the SEC to be a regrant), must be reported within two business days.

Stock Awards. A stock award under a company incentive or bonus plan must be reported within two business days after receipt. If the shares are subject to vesting either over time or based on the satisfaction of performance criteria, the vesting of the shares

continues to be a non-reportable transaction. When the shares are subsequently sold by the director or executive officer, the sale must be reported within two business days, unless it qualifies for the Rule 10b5-1 Plan Extension.

401(k)/ESOP Transactions. The initial investment of employee and employer contributions in a company stock fund continues to be exempt from the reporting requirements. However, as before, whenever a Form 4 or Form 5 otherwise is filed, the plan participant is required to list the number of shares constituting the participant's company stock fund account balance. A reduction in the company stock fund balance (due to a transfer to another plan fund, a cash withdrawal, or, to the extent permitted by Section 402 of the Sarbanes-Oxley Act, a plan loan) or an increase in the company stock fund balance (due to a transfer from another plan fund) is a transaction that must be reported within two business days, unless the transaction qualifies for the Discretionary Transaction Extension. Transactions involving an Excess Benefit Plan that operates in conjunction with a 401(k) plan are subject to the same reporting framework.

Section 423 Employee Stock Purchase Plans. Purchases of company stock under a plan that meets the coverage and participation requirements of Section 423 of the Internal Revenue Code continue to be exempt from reporting under Section 16(a); however, whenever a Form 4 or Form 5 otherwise is filed, the plan participant is required to include the shares acquired in the balance of shares shown as beneficially owned. When the shares are sold, the sale must be reported within two business days, unless the transaction qualifies for the Rule 10b5-1 Plan Extension.

Deferred Compensation Plan Transactions. Phantom company stock balances established in connection with a non-tax qualified deferred compensation plan are "derivative securities" that are reportable under Section 16(a). Generally, a transaction that either increases or decreases the phantom stock balance must be reported within two business days, unless the transaction qualifies for the Rule 10b5-1 Plan Extension.

Dividend Reinvestment Plan Transactions. Under Rule 16a-11, acquisitions of company stock through the reinvestment of dividends under a broad-based dividend reinvestment plan that does not discriminate in favor of employees of the company continue to be exempt from reporting. However, this exemption does not extend to supplemental cash purchases, which must be reported within two business days, unless they qualify for the Rule 10b5-1 Plan Extension.

Gifts. Both acquisitions and dispositions of company equity securities by gift continue to be eligible for deferred reporting on a Form 5 within 45 days after the end of the company's year-end.

Stock Dividends/Stock Splits. The acquisition of company stock pursuant to a stock dividend or a stock split continues to be exempt from reporting; however, whenever a Form 4 or Form 5 otherwise is filed, the director or executive officer is required to include the shares acquired in the balance of shares shown as beneficially owned.

Domestic Relations Orders. The acquisition of company stock pursuant a "domestic relations order" (as defined by the Internal Revenue Code or ERISA) continues to be exempt from reporting; however, whenever a Form 4 or Form 5 otherwise is filed, the director or executive officer is required to reflect the acquisition or disposition in the balance of shares shown as beneficially owned.

Small Acquisitions. Under Rule 16a-6, the reporting of acquisitions aggregating not more than \$10,000 in market value that otherwise would be reportable on a Form 4 continues to be eligible for deferred reporting on Form 5.

Compliance Suggestions

The two-day filing requirement will present logistical challenges for public company directors and executive officers who individually are responsible for the timely filing of Section 16(a) reports, as well as for those companies that elect to assist their directors and executive officers by preparing and submitting the filings on their behalf. A transaction that is subject to the two-day filing requirement must be reported on a Form 4 that is received by the SEC before the close of business (5:30 p.m. Eastern time) on the second business day following the date of the transaction (“Filing Deadline”). Section 16 forms may be filed with the SEC either electronically on EDGAR or by physical delivery (hand delivery, over-night courier, or the U.S. mail). Transmission by facsimile is not permitted.

To facilitate meeting the two-day filing deadline, companies may want to consider implementing one or more of the following measures:

Powers of Attorney or Other Written Authorizations. The instructions to the Section 16 forms permit signature of the forms either by the director or executive officer or “on behalf of the individual by a person authorized to sign for the individual.” This authorization can take the form of a formal power of attorney. Alternatively, according to the Section 16 form instructions, the authorization can be merely a confirming statement indicating “that the reporting person authorizes and designates the named person or persons to file [Section 16(a) forms] on the reporting person’s behalf” and stating “the duration of the authorization.”

The first time that a power of attorney or confirming statement is used, it must be filed as an attachment to the Section 16 form to which it applies (or as soon as practicable after the filing in an amendment to the Section 16 form filed by the director or executive officer). Thereafter, a filing made on behalf of the director or executive officer merely needs to refer to an effective power of attorney or confirming statement on file with the SEC.

Even if a company as a general policy matter does not wish to take the responsibility to sign reports for its directors or executive officers, in our view it would make good practical sense to have all directors and executive officers provide a power of attorney or confirming statement that empowers at least two company officials to act for him or her with respect to Section 16 filings. This would permit a company official to sign and file a report on behalf of the director or executive officer if unusual or unforeseen circumstances arise that otherwise would prevent a timely filing, and thus avoid the need for the disclosure of a late filing in the company’s proxy statement. Also, a director or executive officer may want to consider providing a power of attorney or confirming statement to his or her lawyer, accountant, or financial advisor to enable such person to make a filing if the director or executive officer is unavailable to sign the Section 16 form.

Broker Instructions on Transaction Notifications. If the company’s practice is to prepare and file Section 16 forms for its directors and executive officers (whether or not it also intends to sign the forms), it may wish to consider requesting that its directors and executive officers issue instructions to their brokers or financial advisors directing them to communicate the necessary transaction information directly to the company official

responsible for the preparation of the form immediately upon the occurrence of the transaction. This will avoid the delay caused by including the director or executive officer in the chain of communication.

Mandatory Company Preclearance of Trades. Increasingly, public companies are implementing mandatory preclearance procedures as a prerequisite to trading by its directors, executive officers, and other employees (or, in the case of a Rule 10b5-1 plan, the preclearance of the plan). In part, these procedures are designed to protect against trading while there is undisclosed material information. In view of the accelerated reporting of transactions, preclearance has the added benefit of putting the company on notice of a planned transaction, and thereby enhances the ability of the company to assist its directors and executive officers in the timely preparation and filing of the necessary Section 16(a) report.

File Section 16 Forms on EDGAR. Filing the Section 16 forms on EDGAR eliminates the need to otherwise arrange for the delivery of the forms to the SEC prior to the Filing Deadline. As discussed above, Sarbanes-Oxley provides for the mandatory filing of Form 4s by all Section 16 Insiders not later than the first anniversary of the legislation, with earlier implementation by the SEC expected. Currently, directors and executive officers are permitted, and are encouraged by the SEC, to file Section 16 forms electronically on a voluntary basis. In order for a director or executive officer to file on EDGAR, or to enable the company to file on his or her behalf, the director or executive officer must have an individual EDGAR access code number, which is obtained by filing a Form ID with the SEC.

The Section 16(a) reporting changes adopted by the SEC in response to the Sarbanes-Oxley Act of 2002 are set forth in Release No. 34-46421, which is available at <http://www.sec.gov/rules/final/34-46421.htm>.

If you have questions concerning the new Section 16(a) reporting requirements, please contact any Covington & Burling attorney that works with your company or D. Michael Lefever, of our Washington, D.C. office, at 202.662.5276.

If you would like to learn more about the Securities Practice Group at Covington & Burling, please call any of the following:

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Summary of New Section 16(a) Reporting Obligations

The following table categorizes the reporting requirements for some of the more common transactions in company equity securities by directors and executive officers under the Section 16(a) rules as amended in response to the Sarbanes-Oxley Act of 2002. Reports on Form 4 must be filed within two business days after the execution of the transaction being reported, unless the transaction is eligible for the Rule 10b5-1 Plan Extension or the Discretionary Transaction Extension, either of which can extend the filing deadline for up to three additional business days. Reports on Form 5 must be filed within 45 days after the end of the year.

Type of Transaction	Form 4	Form 5	Not Reportable
Third Party Transactions	X		
Non-Plan Transactions with the Company	X		
Stock Options:			
Grant	X		
Exercise (including Cashless Exercise)	X		
Delivery of Shares to Pay Exercise Price	X		
Delivery of Shares to Satisfy Tax Withholding	X		
Sale of Purchased Shares to the Company or a Third Party	X		
Regrant or Repricing of Stock Options	X		
Stock Awards:			
Grant	X		
Vesting			X
Sale of Shares to the Company or a Third Party	X		
Forfeiture	X		
401(k) Plans/ESOPs:			
Employee Contribution to the Company Stock Fund			X
Employer Contribution to the Company Stock Fund			X
Intra-Plan Transfer from the Company Stock Fund	X		
Intra-Plan Transfer to the Company Stock Fund	X		
Cash Withdrawal from the Company Stock Fund	X		
Loan from the Company Stock Fund	X		
Section 423 Employee Stock Purchase Plans:			
Purchase of Shares			X
Sale of Shares to the Company or a Third Party	X		
Deferred Compensation Plans:			
Acquisition of Phantom Stock	X		
Disposition of Phantom Stock	X		
Dividend Reinvestment Plans:			
Reinvestment of Dividends			X
Optional Cash Purchase	X		
Gifts		X	
Stock Dividends/Stock Splits			X
Domestic Relations Order Transfers			X
Small Acquisitions		X	