WILMER, CUTLER & PICKERING

Corporate and Securities Developments NEWSLETTER

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SEC PROPOSES SPEEDY DISCLOSURE OF CERTAIN INSIDER TRANSACTIONS

The Securities and Exchange Commission (the "SEC" or the "Commission") has proposed significant changes to the regime for disclosure of transactions by insiders in an issuer's securities. On February 13, 2002, the Commission announced that it planned to propose an array of changes to the disclosure system. The April 12, 2002 proposal on disclosure of certain management transactions[1] is one of the Commission's first proposed rule changes following that announcement.[2]

I. Background

Under Section 16 of the Securities Exchange Act of 1934 (the "Exchange Act"), officers and directors of an issuer are generally required to disclose their transactions in the issuer's equity securities by the tenth day of the month after the trade was made. Reporting of some transactions may be deferred until 45 days after the end of the reporting company's fiscal year. Thus, there might be a significant time lag between the transaction itself and its disclosure to the market. Issuers generally are not required to report insider's transactions in their securities under current rules, though they are required to report insider's holdings in their proxy statements.

Recently, demand for more prompt and more complete disclosure of insiders' transactions has grown. The proposals in the Insider Trading Release represent the SEC's response to this demand by requiring that issuers disclose transactions involving company executive officers and directors.

II. Description of Proposal

As described in detail below, the proposal would require a reporting company to electronically file significant information concerning transactions in an issuer's securities by executive officers and directors, and loans by an issuer to executive officers and directors, within as little as two days after the transaction.

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[1] *Form 8-K Disclosure of Certain Management Transactions*, Exchange Act Release No. 33-8090 (April 12, 2002), *available at* http//:www.sec.gov/rules/proposed/33-8090.htm (hereinafter *Insider Trading Release*).

[2] The Commission issued a companion release on the same day relating to filing deadlines for Forms 10-Q and 10-K. *See Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports*, Exchange Act Release No. 8089 (April 12, 2002), *available at* http://www.sec.gov/rules/proposed/33-8089.htm (hereinafter *Accelerated Filings Release*). We discuss the Accelerated Filings Release in a separate newsletter.

In addition to the proposals to improve periodic reporting requirements, the SEC on April 30, 2002 proposed enhanced disclosure in management's discussion and analysis regarding the effect of critical accounting judgments on an issuer's reported results, and the staff of the SEC has indicated that it expects to issue a proposal in the next month to require disclosure of additional events on Form 8-K. We will update you as new proposals are released and rules are modified.

A. Included Disclosures

The Insider Trading Release proposes to add a new Item 10 to Form 8-K. This item would require an issuer subject to Form 8-K reporting requirements[3] to report:

- Directors' and executive officers' transactions in the issuer's equity securities (including derivative securities transactions and transactions, including the grant of stock options, with the issuer);
- The adoption, modification or termination of so-called Rule 10b5-1 plans[4]; and
- Loans and forgiveness of loans to a director or executive officer made or guaranteed by the issuer.

The transactions subject to disclosure by proposed Item 10 are more extensive than those subject to reporting under Section 16 in two respects. First, two of the categories covered by the proposal are not covered by Section 16 at all: Rule 10b5-1 plans and loans and guarantees by the issuer.[5] Second, rules governing Section 16 explicitly exempt (or delay reporting of) a number of transactions that are not exempted from Item 10. Most significantly, transactions between an issuer and its directors and executive officers (which are exempt under Rule 16b-3(d) and (e) if certain requirements are met) are not exempt. In contrast, proposed Item 10 is specifically designed to require prompt reporting of transactions between an issuer and its directors and executive officers.[6]

Proposed Item 10 describes the information that must be reported for each type of transaction. The information required for acquisition or disposition of an issuer's securities would include:

- The name and title of the director or executive officer;
- The date of the transaction;
- The nature of the transaction (gift, loan, sale to or purchase from the issuer, exercise or conversion of derivative securities, etc.);
- The title and number of securities acquired or disposed of;
- The per share acquisition or disposition price;
- The exercise or conversion price of options and other derivative securities and the dates derivative securities become exercisable and the dates they expire;
- The aggregate value of the transaction; and
- Any other material information regarding the transaction.

The information required with respect to Rule 10b5-1 plans would include:

- The name and title of the director or executive officer;
- The date on which the individual entered into the contract or written plan;
- A description of the contract or written plan, including the duration, aggregate number of securities to be purchased or sold, and the name of the counterparty or agent; and

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[3] The reporting obligation would apply to all issuers who have a class of equity securities registered under the Exchange Act, but would not apply to companies that have only debt securities registered under the act.

[4] Rule 10b5-1 plans are plans that provide for the purchase or sale of securities pursuant to a pre-established plan. If the plan complies with the requirements of Rule 10b5-1, the rule establishes an affirmative defense to certain elements of an insider trading claim. The proposal expressly states that the availability of the Rule 10b5-1 defense is not conditioned on an issuer's filing of a Form 8-K. *See Insider Trading Release*, p. 16.

[5] Loans may be reportable by the issuer in the issuer's annual report on Form 10-K or Proxy Statement pursuant to Regulation S-K, Item 404(c).

[6] Other transactions exempt under Section 16 that are not exempt from Item 10 reporting are: gifts (exempt under Rule 16b-5), transactions approved by regulatory authorities (exempt under Rule 16b-1), exercise of derivative securities (exempt from liability, but not reporting, under Rule 16b-6), certain merger transactions exempt under Rule 16b-7, and certain transactions in voting trust interests exempt under Rule 16b-8. *See Insider Trading Release*, p. 12.

- If the report relates to the modification or termination of a plan, the date of any modification or termination of a plan and a description of the modification.

The information required with respect to loans would include:

- The name and title of the director or executive officer;
- The date of the agreement and the date of any loans or guarantees under the agreement;
- The dollar amount and other material terms of the agreement or loan, including interest rate, terms of repayment, and provisions with respect to forgiveness;
- The number and class of any securities of the issuer pledged as collateral and the material terms of the pledge, including whether it was made with or without recourse; and
- If the report relates to the forgiveness, foreclosure or payment on a guarantee, the date and dollar amount of the forgiveness or foreclosure, and the number and class of any securities foreclosed upon.

The proposal does not dictate the format the information must take, and generally permits "any narrative or tabular format that provides a clear, accurate description of the transactions."[7] However, section V of the release includes a sample disclosure in tabular format, and the SEC generally favors tabular formats.

B. Timing of Disclosure

The proposal requires issuers to file reports on transactions and loans involving more than $100,000 within two business days of the transaction. Reports on other transactions or loans would be due by the close of business on the second business day of the week following the transaction. However, if a transaction involves an aggregate value less than $10,000, the issuer may defer reporting until the aggregate cumulative value of unreported events for the same director or executive officer exceeds $10,000.

The date of the reportable event would be the date on which relevant parties enter into an agreement. For example, the date of an open-market purchase or sale of securities would be the trade date, not the settlement date. Loan arrangements must be reported when a loan agreement is signed (whether or not money is lent at that time) and again whenever funds are actually disbursed.

The proposal includes relief from the most onerous consequences of late filing with respect to reporting of these transactions. Normally a late filing of a Form 8-K would render an issuer ineligible to use the short-form registration statements under the Securities Act of 1933 (including Form S-3), and would (until the late filing is made) prohibit the issuer from issuing securities under employee benefit plans on Form S-8. In addition, while any filings are delinquent, affiliates and any holder of the issuer's restricted securities would be prevented from relying on Rule 144 to sell securities without registration. But the proposal specifically provides that a delinquency in filing an Item 10 Form 8-K would not disqualify an issuer from eligibility for short form registration statements or the availability of Rule 144.[8]

III. Potential Implications for Reporting Companies

If adopted in its current form, Item 10 to Form 8-K would significantly increase the reporting obligations of many issuers. The SEC itself estimates that issuers will make approximately 21 additional disclosures per year, or nearly two a month.[9] In addition, the reports would require detailed information about transactions by directors and executive officers, to which issuers generally do not have direct access. Notably, an issuer must report market transactions by directors and executive officers, and transactions with other independent third parties. In order to prepare the reports, issuers will need to learn of the transactions and then obtain reliable information regarding the terms of the transactions.

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[7] *See Insider Trading Release*, p. 13.

[8] *See* proposed amended General Instruction I.C to Form S-2, General Instruction I.A.3 to Form S-3, General Instruction A.1 to Form S-8 and Securities Act of 1933 Rule 144(c).

[9] This estimate is based on the SEC's review of Section 16(a) reports filed by officers and directors between February and December 2000, consultations with several law firms and a review of related-party transactions disclosed in 2001. *See Insider Trading Release*, p. 23 and note 76.

All of this will have to occur in a very short time frame — as little as two business days. Thus, a director who is not an executive officer of the issuer could sell shares late on Monday, and the issuer would be delinquent in its filing responsibilities if it had not learned of the transaction and obtained and verified all the required information in time to complete a filing by 5:30 on Wednesday.

The SEC has proposed giving some relief to issuers who make a good faith effort to obtain and report the required information. Proposed new instructions to Form 8-K would specifically state that "it is not in the public interest to impose any sanction on a [registrant], notwithstanding a violation, that demonstrates that:

(1) at the time of the violation, it had designed procedures and a system for applying such procedures sufficient to provide reasonable assurances that Item 10 events are timely reported,

(2) at the time of the violation, the [registrant] followed those procedures, and

(3) as promptly as reasonably practicable, the [registrant] made a filing to correct any violation."[10]

Notwithstanding this relief, issuers would still need to invest in creating reasonable procedures and monitoring the implementation of the procedures. This alone could be a burden to many issuers.

Because of the burden imposed by the proposed new reporting, we expect that the proposal will generate substantial comment. Nonetheless, in the current environment, it seems likely that the proposal will be adopted in some form or another in the not too distant future.

The comment period for the Insider Trading Release expires on June 24, 2002. If you would like a copy of the SEC's Insider Trading Release of if you have any questions, please do not hesitate to contact:

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