Section 16 Insider Reporting and Liability for Short-Swing Trading

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Section 16 Insider Reporting and Liability for Short-Swing Trading

A public company with a class of securities registered under Section 12 or which is subject to Section 15(d) of the Securities Exchange Act of 1934, as amended (“Exchange Act”) must file reports with the SEC (“Reporting Requirements”). The required reports include an annual Form 10-K, quarterly Form 10Q’s and current periodic Form 8-K as well as proxy reports and certain shareholder and affiliate reporting requirements.

Last week, I wrote about the “certain shareholder” filing requirements under Sections 13d and 13g of the Exchange Act, Regulation 13D-G beneficial ownership reporting and related Schedules 13D and 13G. This blog is a summary of the “certain shareholder and affiliate” reporting and related requirements under Section 16 of the Exchange Act. In particular, all directors, executive officers and 10% stockholders (“Insiders”) of reporting companies are subject to the reporting and insider trading provisions of Section 16 of the Exchange Act. At the end of the blog is a reference chart related to the Section 16 reporting obligations and short swing trading prohibitions as described herein.

A company becomes subject to the reporting requirements by filing an Exchange Act Section 12 registration statement on either Form 10 or Form 8-A (“Reporting Company”). A Section 12 registration statement may be filed voluntarily or per statutory requirement if the issuer's securities are held by either (i) 2,000 persons or (ii) 500 persons who are not accredited investors and where the issuer's total assets exceed $10 million. The Section 16 reporting and related obligations as to insiders is only applicable to the insiders of companies with a class of securities registered under Section 12 of the Exchange Act, commonly referred to as a ’34 Act filer. Although companies that file a Form S-1 registration statement under the Securities Act of 1933, as amended (“Securities Act”) become temporarily subject to reporting requirements under Section 15(d) of the Exchange Act (a ’33 Act filer), like Section 13, Section 16 is not applicable to the insiders of a ’33 Act filer.

Overview

Section 16 is intended to prevent unfair use of inside information and discourage speculative trading by insiders by requiring them to report holdings and transactions in a reporting company’s securities (under Section 16(a)). In addition, Section 16 also requires insiders to pay over to the reporting company any “profits” realized from any purchase and sale (or any sale and purchase) of the reporting company securities within a six-month period (under Section 16(b)). Under Section 16(c), insiders are precluded from making short sales (sales of shares they do not own at the time of the sale) of the reporting company’s securities.

In addition, the SEC requires that the reporting company disclose in its annual proxy statement the names of insiders who have failed to make required Section 16 filings on a timely basis, and also to note the existence of such disclosure on the cover of its annual report on Form 10-K.

The rules under Section 16 are complex and contain a number of “gray” areas and potential traps for the unwary. Insiders should consult with counsel before engaging in any transactions in the company’s securities, particularly transactions involving “derivative” securities (such as options or warrants).
Who is an Insider?

Section 16(a) requires directors and executive officers of a reporting company to report their beneficial ownership of and transactions in the company’s securities to the SEC and the public. A “director” refers to a person who is a member of the board of directors of the reporting company. Section 16 only covers certain named executive officers, including the (i) president and principal executive officer; (ii) any vice president in charge of a principal business unit, division or function; (iii) principal financial officer; (iv) principal accounting officer; and (v) any other person who performs similar policymaking functions for the company. The key determination is the level of control and ability to perform significant policy making functions for the reporting company. The SEC recognizes that reporting companies may give titles to individuals that include terms like “vice president of...” or “director of...” which individuals are not in a high-level control position. These individuals are not considered Section 16 filers.

In addition to directors and executive officers, persons, including entities, who beneficially own more than 10% of a class of the company’s registered securities are subject to Section 16(a) reporting requirements. As with other SEC rules and regulations, 10% ownership is based on beneficial ownership and not the legal title or record ownership. Beneficial ownership is determined by the person’s ability to control the voting power of the securities, investment decisions related to the securities (whether to buy or sell), and monetary interests in the securities. A monetary interest is the direct or indirect ability to profit from purchases or sales of securities.

An insider is considered to have a beneficial ownership interest of securities held by members of the insider’s immediate family sharing the same household. Immediate family household members include grandparents, grandchildren, siblings and in-laws, as well as the insider’s spouse, children and parents.

An insider is considered a beneficial owner of shares in a trust for Section 16 purposes if the insider has or shares investment control over the trust securities and the insider is a: (i) trustee and such trustee or trustee’s family members have a monetary interest in the securities; (ii) beneficiary; or (iii) settlor with powers to revoke the trust. An insider who has control or a controlling influence over a partnership or corporation will generally have beneficial ownership of the securities held by that partnership or corporation.

Disclaimer of Beneficial Ownership. When there is doubt as to the beneficial ownership of securities, an insider should report such securities as being beneficially owned. Such report will not amount to an admission of beneficial ownership if accompanied by a disclaimer of beneficial ownership. To disclaim beneficial ownership, the following statement can be included on a Form 3, 4 or 5:

The undersigned disclaims beneficial ownership of the securities indicated, and the reporting herein of such securities, shall not be construed as an admission that the undersigned is the beneficial owner thereof for purposes of Section 16 or for any other purpose.

Section 16 Reporting Obligations

Section 16 requires insiders to file an initial statement of beneficial ownership of the company’s securities on Form 3 at the time that such insider becomes subject to Section 16 (when they become an insider), as well as periodic statements reflecting changes in such beneficial ownership. Most changes in beneficial ownership (as defined below) must be reported electronically within two business days. In addition to common stock ownership, insiders must report derivative securities ownership. Derivative securities include options, stock appreciation rights, warrants, convertible securities or similar rights. Derivative securities also include third-party contracts: puts, calls, options or other rights to acquire the company’s securities.
The following are several relevant times and basic filing requirements:

(a) An initial statement of beneficial ownership of equity securities on Form 3 must be filed by the date that the registration statement for the company’s initial public offering becomes effective or, thereafter, within 10 days of the date a person becomes an insider. The initial Form 3 must include all of the insider’s holding of the reporting company’s securities. An insider must file a Form 3 even if they do not have any beneficial ownership in the company’s securities. For example, a newly elected director or newly appointed executive officer must file a Form 3 even if such director or officer does not have a beneficial interest in a single share of stock.

(b) Generally, any change in an insider’s beneficial ownership of the company’s securities is reported on a Form 4 by the second business day following the transaction date. The Form 4 must be filed for transactions, even if such transactions are exempt from the short swing profit rules discussed below.

(c) The remaining reportable transactions (such as gifts), including any (late) reports of transactions and holdings not previously reported, must be reported on Form 5 within 45 days of the company’s fiscal year end, unless the insider voluntarily reports the transaction or holding earlier on Form 4.

A few transactions (such as acquisitions under certain tax qualified plans) need not be separately reported (although their effect on an insider’s holdings will ultimately be reflected). In particular, exemptions from the two-day Form 4 filing requirement include (i) gifts; (ii) inheritances; and (iii) small acquisitions other than from the company that do not exceed in the aggregate $10,000 in market value within a six-month period, provided the insider makes no nonexempt dispositions during the six months thereafter.

Insiders are not required to report on Form 4 or 5 transactions that effect only a mere change in the form of the insider’s beneficial ownership. For example, a distribution to the insider of securities previously beneficially owned by the insider through an employee benefit plan merely changes the form of ownership (from indirect to direct) and is exempt from Forms 4 and 5 reporting requirements.

At the conclusion of this blog is a table of typical transactions an insider may encounter and when such insider must report them. Even though the reporting of a few transactions may be deferred, it is advisable to report all reportable transactions on a Form 4 at the time of the transaction because it is possible that the insider may not recall the transaction when it is time to file the Form 5. If Form 4 is filed for every reportable transaction, no Form 5 filing is required at the end of the company’s fiscal year.

Section 16 reports must now be filed using EDGAR, the SEC’s electronic filing system, so an insider must obtain a personal EDGAR access code before making a filing. Forms 4 and 5 contain an “exit” box, which may be checked when an insider ceases to be an insider. However, the insider would still be required to report a transaction after they cease to be an executive officer or director, if the transaction (such as a sale) “matches” with any transaction (such as a nonexempt purchase) while they were an executive officer or director.

Section 16 rules mandate that companies post on their corporate websites all Forms 3, 4 and 5 filed by their insiders and 10% beneficial owners by the end of the business day after the date of filing. Companies must keep the reports posted for at least 12 months. Most post by hyperlinking to third-party service providers or to the EDGAR database on the SEC’s website. The hyperlink must link directly to the forms or a list of the forms, and the link caption must clearly indicate access to insider Section 16 reports.
Filing Deadlines and Consequences for Late Filings

Form 3’s are due on the date the company goes public or, thereafter, within 10 days of the date a person becomes an insider. Forms 4 (other than voluntary filings) must be filed on or before the second business day after the reportable transaction occurred. A voluntary Form 4 may be filed at any time. Form 5 is due within 45 days after the end of the company’s fiscal year. If any transactions should have been reported earlier, the delinquent reports of those transactions must be included in the Form 5 and a special box must be checked indicating that reporting delinquencies have occurred. If all holdings and transactions have previously been reported, no Form 5 need be filed. If the due date falls on a weekend or a national holiday, the form is due on the next business day.

Failure to file a Form 3, 4 or 5 in a timely manner can result in substantial penalties to the insider. The SEC can seek fines in judicial enforcement actions of up to $7,500 for each violation by an individual and up to $75,000 for corporations and other entities. If the violation includes fraud or deceit or deliberate disregard of a regulatory requirement, the fine can be as much as $150,000 for an individual and $725,000 for a corporation. The SEC can also issue cease-and-desist orders in administrative proceedings against future violations. Failure to file reports also prevents the two-year statute of limitations from running on suits against insiders to recover any profits due to the company under Section 16(b).

In addition, a reporting company must disclose by name in its proxy statement or annual Form 10-K any insiders who reported transactions late or failed to file required reports during the fiscal year. The reporting company must also report on the cover of its Form 10-K that the report discloses late or delinquent Section 16 filing.

To ensure compliance, it is highly recommended that reporting companies implement policies requiring all Section 16 insiders to pre-clear their transactions with the company at least two business days before they initial any transaction. In addition, companies should obtain a representation from departing directors and officers that no Form 5 is due and that there have been no unreported Form 4 transactions.

Avoiding Short-Swing Liability

In addition to making complete and timely reports under Section 16(a), an insider must also be careful to plan transactions to avoid short-swing liability under Section 16(b). Section 16(b) is designed to discourage trading on inside information, and preserves that certain people inevitably benefit from their “insider” status. Under Section 16(b), any purchase and sale, or sale and purchase, of a reporting company’s securities by a company insider made during any given six-month period will be matched. Any “profit,” whether inadvertent or intentional, realized by matching a purchase and sale within a six-month period is recoverable by the company. If the company fails to recover such profit, any shareholder of the company may sue to recover it on behalf of the company. Forms 3, 4 and 5 filed with the SEC are publicly available and are routinely monitored by attorneys who make their living by threatening to file Section 16(b) suits on behalf of shareholders. In the event of a violation of Section 16(b) by an insider, these attorneys are generally able to compel the company and/or the offending insider to pay their fees and expenses if the company had not acted to obtain restitution of the deemed “profit” from the insider prior to receiving a communication from the attorney.

Unlike other provisions in the federal securities laws, intent to take unfair advantage of non-public information is not required for recovery under Section 16(b). In other words, transactions in the company’s securities within six months of one another can lead to recovery of profits irrespective of the reasons for or purposes of the transaction.

Except in the case of options and other derivative securities (for which there is a special rule for calculating profits), transactions are paired with mechanical rigidity so as to match the lowest purchase price with the highest sale price, thus squeezing out the maximum amount of “profit.” Thus, although an insider may have realized an economic loss, they may be treated for Section 16(b) purposes as having realized a “profit.”
The table at the end of this blog includes typical transactions and how they would be treated. It does not matter for Section 16(b) purposes whether the purchase or sale comes first. It makes no difference that the particular shares sold happen to be shares held more than six months, since it is not necessary for the same shares to be involved in each of the “matched” transactions. The rules apply not only to individual transactions but also to transactions engaged in by others if the insider is deemed to have a pecuniary interest in those shares. Thus, a purchase by an insider could be matched with a sale of shares by the insider’s spouse. Public and private transactions also can be matched. In the case of officers and directors, transactions occurring while an insider may be matched with transactions after the person ceases to be an insider. A 10% beneficial owner must, however, be a 10% beneficial owner at both the time of purchase and the time of sale to trigger Section 16(b) matching liability.

The purchase and sale of securities that are convertible into or exercisable for the purchase of shares of common stock may be matched either against the sale and purchase of other securities which are so convertible or the sale and purchase of shares of common stock. For example, a sale of common stock might be matched either against a purchase of convertible securities or a purchase of common stock within six months before or after such sale. The acquisition of options, warrants or convertible securities will also generally be treated as an acquisition of the underlying equity security, but the exercise of such option or warrant or conversion of such convertible securities will not be treated as a matchable purchase.

Any acquisition by an officer or director (but not a 10% holder) from the company, or any disposition by an officer or director to the company, is exempt from matching if approved in advance by the board of directors or a properly constituted committee of the board. Thus, neither the grant nor the exercise of an option issued under the company’s stock option plans will generally be treated as a matchable “purchase” for purposes of Section 16(b). Acquisitions of common stock under the company’s employee stock purchase plans will not generally be treated as matchable purchases for purposes of Section 16(b). If the officer or director elects to pay the exercise price (and/or any tax withholding obligations) by withholding option shares or tendering previously held shares to the company, the disposition of such shares will likewise be exempt from matching if properly approved in advance. However, the sale of shares by a broker to pay the exercise price and/or tax withholding would be treated as a matchable “sale” for purposes of Section 16(b).

**Short Sales**

In general, Section 16(c) of the Exchange Act makes it unlawful for an insider to make “short sales” or “sales against the box” when the securities sold are not delivered within the time periods set forth in Section 16(c). A “short sale” is any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller. A “sale against the box” is the type of short sale in which the seller actually owns sufficient shares to make delivery but chooses to borrow shares to cover the sale. The seller subsequently can either buy securities or use his own securities to repay the lender to complete the transaction.

**Avoiding Liability under Other Insider Trading Rules**

Section 16 is based on a presumption that certain people inevitably benefit from their access to inside information. Insiders should not forget that the Securities Exchange Act also prohibits the actual use of inside information, whether or not this involves six-month matching of purchase and sale transactions. Although this topic will be covered in depth in a future blog, in addition to the direct liability of insiders for insider trading violations, companies and their directors and officers may also be legally liable for failing to prevent such violations by company personnel. In light of this potential indirect liability, and the severity of possible sanctions both to you and to the company for insider trading violations, the company’s policies and procedures set forth in its insider trading policy statement should be observed at all times.
### MATCHING AND REPORTING UNDER SECTION 16 RULES

<table>
<thead>
<tr>
<th>Event</th>
<th>Report on Form 4 (due within 2nd business day after event)</th>
<th>Report on Form 5 (due within 45 days of end of fiscal year)</th>
<th>Not Required to be Reported (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grant to officer or director under company’s stock option plan</td>
<td>Exempt (1)</td>
<td></td>
<td>Code A</td>
</tr>
<tr>
<td>Exercise of option</td>
<td>Exempt acquisition of common stock and exempt disposition of option Code A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cashless option exercise by officer or director through issuer (by withholding shares or delivering previously held shares)</td>
<td>Exempt acquisition (of gross shares) Code M Matchable sale (of shares sold) Code S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cashless option exercise through broker</td>
<td>Exempt acquisition (of gross shares) Code M Matchable sale (of shares sold) Code S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expiration of option for no value</td>
<td>Exempt disposition</td>
<td></td>
<td></td>
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<tr>
<td>Acquisition under company’s employee stock purchase plan</td>
<td></td>
<td>Exempt acquisition</td>
<td></td>
</tr>
<tr>
<td>Conversion of preferred stock</td>
<td>Exempt acquisition of common stock and exempt disposition of preferred Code C</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock dividend</td>
<td>Exempt acquisition</td>
<td></td>
<td></td>
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<tr>
<td>Transfer pursuant to domestic relations order</td>
<td></td>
<td>Exempt acquisition or disposition</td>
<td></td>
</tr>
<tr>
<td>Distribution from limited partnership to general partner</td>
<td></td>
<td>Exempt change in form of beneficial ownership</td>
<td></td>
</tr>
<tr>
<td>Distribution from limited partnership to limited partner</td>
<td></td>
<td></td>
<td>Matchable purchase Code J</td>
</tr>
<tr>
<td>Other acquisition from issuer, including receipt of securities in merger</td>
<td>Exempt acquisition, if by director or officer (1) Code A Matchable purchase if by 10% holder Code P</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition from someone other than issuer</td>
<td></td>
<td></td>
<td>Matchable purchase Code P</td>
</tr>
<tr>
<td>Sale to issuer or tender in connection with merger into another company</td>
<td>Exempt disposition, if by officer or director (1) Code D Matchable sale, if by 10% holder Code S</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale to someone other than issuer</td>
<td></td>
<td></td>
<td>Matchable sale Code S</td>
</tr>
<tr>
<td>Gift</td>
<td></td>
<td>Exempt</td>
<td>Code G</td>
</tr>
</tbody>
</table>

(1) Assuming that the specific approval of the transaction required by new Rule 16b-3 has been obtained or, in the case of an acquisition, the security is held at least six months.

(2) Transactions that are not required to be reported as separate line items must be reflected in end-of-period holdings. Insiders may choose to indicate, by a footnote, that the report reflects the results of transactions which are not required to be itemized.
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Corporate and Securities Attorney Laura Anthony’s legal expertise includes but is not limited to registration statements, including Forms S-1, S-4, S-8 and Form 10, PIPE transactions, debt and equity financing transactions, private placements, reverse mergers, forward mergers, asset acquisitions, joint ventures, crowdfunding, and compliance with the reporting requirements of the Securities Exchange Act of 1934 including Forms 10-Q, 10-K and 8-K, the proxy requirements of Section 14, Section 16 filings and Sarbanes-Oxley mandated policies. Moreover, Ms. Anthony represents both target and acquiring companies in reverse mergers and forward mergers, including preparation of deal documents such as Merger Agreements, Share Exchange Agreements, Stock Purchase Agreements, Asset Purchase Agreements and Reorganization Agreements. Ms. Anthony prepares the necessary documentation and assists in completing the requirements of federal and state securities laws and SROs such as FINRA and DTC for corporate changes such as name changes, reverse and forward splits and change of domicile.

Contact Legal & Compliance, LLC. Technical nature are always encouraged.

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