Alan Dye on the Latest Section 16 Developments

Q&A and Practice Tips from the Expert

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Audio Archive

Alan: Thanks, Barbara. It's good to be doing the program with you again this year. Thank you for moderating the discussion.

Before we address the questions members submitted in advance, I want to cover a few recent developments, just to make sure that everyone is up to date on current issues affecting the Section 16 compliance community.

Year-end Compliance Checklist

First, the annual year-end compliance checklist has been posted on Section16.net. The checklist is intended to address all of the Section 16 compliance issues that should be considered at the end of the company's fiscal year. Section 16 veterans should already be familiar with the items on the checklist. If you're a Section 16 compliance rookie, you might take a look at the checklist to make sure that you are doing all of the things on the checklist. As a reminder for people working for calendar year companies, the deadline for filing any Forms 5 required this year is Thursday, February 14.

Stock Withholding Litigation

I also want to update the group on the status of the tax withholding cases that have been percolating through the courts for the last couple of years. As most members know, John Olagues is a former options trader who lives in New Orleans and who for at least ten years has filed Section 16(b) actions from time to time against insiders who traded in derivative securities. His theories of liability have been novel, to say the least, and to my knowledge he has lost every case he has initiated. Starting about two and a half years ago, John teamed up with two of his friends to mount a challenge to the application of Rule 16b-3(e) to the withholding of shares to pay taxes due upon the vesting of a stock award or the exercise of an option. As members know, the withholding of shares is a sale by the insider, and if the sale isn't exempt from Section 16(b), it can be matched with an open market purchase occurring within less than six months and result in recoverable short-swing profits. Withholding is exempt if approved in advance by the board or a committee of non-employee directors, and a note to Rule 16b-3 provides that approval of an equity award that provides for tax withholding also constitutes approval of the later withholding. A lot of companies rely on that note to allow insiders to elect tax withholding at the time of vesting or exercise in lieu of paying the taxes in cash.

John Olagues and his friends believe that the rule exempts withholding only if the award provides that withholding is automatic, and doesn't exempt withholding if the insider could elect to pay the taxes in cash instead, or if the *issuer* could elect to withhold taxes from some other component of the insider's compensation instead of withholding stock. If either the insider or the issuer has discretion whether to withhold, they say, the exercise of the right itself has to be approved by the

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dismissed the complaint. The plaintiff appealed both decisions, and in both cases, one of which was just decided last week, the appellate court affirmed the district court. In more recently filed cases, courts have dismissed the complaint on the ground that none of the three plaintiffs is a lawyer, so they are ineligible to assert a claim on behalf of the company and need to hire a lawyer to pursue the claim. They found a lawyer in New Orleans who was willing to refile a complaint they had filed in Louisiana, but they haven't refiled any of their other complaints.

All of these developments suggest that the challenge to Rule 16b-3(e) is winding down and is not likely to result in case law narrowing the application of the rule to automatic withholding. Companies that provide for automatic withholding, or whose insiders never buy stock in the open market and therefore would never have a potentially matchable transaction, really don't need to concern themselves with the status of the remaining cases. For companies that allow discretionary withholding, it's at least theoretically possible that one of the pending cases could result in a holding that discretionary withholding is nonexempt. The risk is very low, I think, but companies need to stay aware of what is happening with the pending litigation

Item 405 Disclosure

We received a couple of questions about Item 405 disclosure, and I receive a lot of Item 405 questions in the Q&A forum on Section16.net. Rather than address the questions individually during our Q&A session today, I'm going to talk generally, now, about the principles that I think govern the determination whether a reporting error requires disclosure in the company's proxy statement and Form 10-K under Item 405.

Item 405 is triggered by either of two things. The first is an insider's filing of a required report after its due date. The second is an insider's failure to file a required report. So, it's clear that Item 405 requires disclosure of late filings and failures to file. Where questions arise is when a timely filed report contains an error. In those cases, the question becomes whether the error means the report was effectively "not filed" for purposes of Item 405 (or, if the error is corrected by amendment, whether the correction is effectively a "late" report). This is a bit of a dark corner of Section 16 practice, and it is not a topic on which the SEC staff has published guidance. Some staff members did say during a panel discussion at a conference over 20 years ago that a failure to report a transaction involving a de minimis number of shares might not warrant disclosure under Item 405. Based on that statement, most practitioners believe there is some room for making a judgment whether an error in a report is a de minimis error and therefore doesn't require disclosure under Item 405.

In making this judgment, companies usually apply a facts and circumstances approach to determine whether the error was "material." The facts and circumstances relevant to the determination may differ from case to case, but usually companies consider the nature of the error, its materiality in the context of the insider's total holdings, and the importance of the information to the purposes of the Section 16 reporting requirements. Usually, only two types of error lead to a conclusion that Item 405 disclosure is required: omission of a transaction entirely from a filed report, or a material misstatement of the number of securities involved in a reported transaction. Other common errors, such as incorrect transaction codes, reporting acquisitions as dispositions (and vice versa), misstating vesting dates, and mistakes in the boxes at the top of page 1 of the report, generally aren't considered to be significant enough for the report to be deemed "not filed." Errors of these types may, though, warrant an amendment to the filed report.

SEC's Section 16(a) Enforcement Program

Let me also say a few words about the SEC's Section 16(a) enforcement program. We all dislike having to disclose our late or unfiled reports in the proxy statement under Item 405. An SEC enforcement action, though, is an ever scarier prospect. Any late report violates Section 16(a), of course, and therefore could result in an SEC enforcement action against the insider, or against the company if the company has undertaken for file its insiders' reports for them. The SEC uses its enforcement authority sparingly, though, and usually limits Section 16(a) claims to cases in

which an insider has committed other, more serious violations as part of an effort to conceal trading. The staff has initiated eight or ten enforcement actions of this type every year in recent years. The staff hasn't brought an enforcement action based solely on 16(a) violations since it announced 34 simultaneous Section 16(a) actions in September of 2014. No one knows, of course, when the SEC might bring more actions based solely on Section 16(a) violations, but if history is any guide, when the staff does initiate another sweep, the staff won't single out filers who have had only an occasional late report.

Ok, Barbara, shall we move on to the questions?

QUESTIONS AND ANSWERS

Deferral of Vesting Restricted Stock Units

Barbara: Is a Form 4 required when an insider defers receipt of shares issuable upon the vesting of restricted stock units that were reported in Table I at the time of grant and the terms of the deferred compensation plan provide that the deferred units will settle in stock, and can't be settled for cash? Please assume that no shares or units will be withheld on the vesting date to pay FICA or other taxes.

Alan: While I don't know of any SEC staff guidance addressing this issue specifically, my view is that no Form 4 is required when stock deliverable upon the vesting of RSUs becomes deliverable on a later date as a result of the insider's deferral of receipt under a non-qualified deferred compensation plan. The reason for that conclusion is that the staff has said that, even though restricted stock units are a derivative security, if they will settle by delivery of common stock, on a share-for-unit basis, and neither the insider nor the company can elect to settle the units for cash instead, then the RSUs are essentially common stock and therefore can be reported in Table I of Form 4 as common stock. When an insider elects to treat RSUs as common stock and report their grant in Table I, there is no need to disclose in the report, as would be required in Table II, the date of vesting or the date on which shares will actually be delivered to the insider. The staff takes the same position regarding deferred stock units under a deferred compensation plan. If the units will settle only in stock, on a one-for-one basis, they may be reported in Table I, as common stock. So, where RSUs reported in Table I are deferred into deferred units that also are reportable in Table I, the deferral does nothing to change the insider's reported ownership. Both before and after the deferral, the insider owns the same number of stock equivalents that may be reported in Table I. To me, that means there is no change in beneficial ownership to report.

FICA Withholding from Unvested RSUs

Barbara: Are there Form 4 or Form 5 reporting obligations associated with the achievement of criteria which make the holder of options and/or RSUs eligible for retirement (thus ending the risk of forfeiture of the awards)?

Alan: Yes, there are, but only if taxes due when those criteria are satisfied are paid through the withholding of shares from the award. First, let me say that I am not an expert on tax law by any stretch of anyone's imagination. To explain the Section 16 issues, though, I need to describe how those issues arise, which requires that I discuss the impact of the Tax Cuts and Jobs Act on certain equity awards. Please don't rely on my response to this question to make decisions about the tax consequences of your company's equity arrangements. In a nutshell, the value of RSUs becomes taxable income, giving rise to tax withholding obligations, when the RSUs are no longer subject to a substantial risk of forfeiture. Ordinarily, RSUs are subject to a substantial risk of forfeiture until they vest, because until then the RSUs would be forfeited if the grantee's employment were terminated. At some companies, once an employee has reached a certain age, or has achieved a certain score based on both age and years of service, the grantee will be entitled to the shares underlying RSUs even if the grantee retires before the vesting date. The shares won't actually be delivered, though, until the vesting date. Under recent tax law changes, if a grantee reaches the age and/or years of service where vesting will occur even if the grantee terminates service before the vesting date, the award will no longer be deemed subject to a

substantial risk of forfeiture, and the value of the award will be taxable on that date, but only as to FICA and FUTA taxes. Other withholding obligations continue to be deferred until the RSUs actually vest. The FICA and FUTA taxes can be paid with cash or by withholding a portion of the award. If shares are withheld, the withholding will need to be reported on Form 4. If the initial award was reported in Table I, then the withholding will be reportable in Table I. If the initial award was reported in Table II, the Form 4 will report the partial conversion of RSUs into common stock, and then, on a separate line of Table I, the withholding of shares to pay the tax. Bear in mind that the value of RSUs withheld to cover FICA and FUTA taxes is considered income which triggers further tax withholding obligations and therefore withholding of additional RSUs.

Additional Power of Attorney

Barbara: We are on-boarding a new director who is an executive officer of another public company, and he signed a power of attorney at that company authorizing certain people there to sign and file Section 16(a) reports on his behalf. We would like a power of attorney from the director, too, so that we can file Section 16(a) reports of his transactions in our securities. If we have the director sign a separate power of attorney, will filing it invalidate the power of attorney filed by the other company, or can there be two effective powers of attorney on file at the same time?

Alan: It is fine for an insider to sign more than one power of attorney, at the same company or at different companies. An insider's execution of a power of attorney does not revoke prior powers of attorney unless the new power expressly revokes the prior one. In the absence of an express revocation, each power of attorney will remain effective for the term specified in the power, and the designated attorneys in fact at both companies will be able to sign the director's reports. Having two or more powers of attorney on file is common practice where a person is an insider of more than one public company.

Contingent Convertible Bonds

Barbara: We represent an investment fund that owns approximately 9% of a company's common stock. The company is conducting a private placement of contingent convertible bonds which are payable in cash at maturity on June 30, 2025. If, however, the company's debt-to-equity ratio exceeds a certain amount at any time during the term of the bond, the issuer will have the right to convert the bonds into common stock at a specified price per share. In addition, beginning three months prior to maturity, a holder of the bonds may elect to convert them into common stock, subject to the company's right to pay the bond holder the cash value of the shares in lieu of issuing shares. For purposes of determining whether the fund is a ten percent owner, will the fund be deemed to own the shares underlying the bonds?

Alan: I think the answer is no. For purposes of determining whether a person is a ten percent owner, the person is deemed to own any securities that it has a "right to acquire" within 60 days. Here, the fund will not have a right to convert the bonds until some time in 2025, not within 60 days. Moreover, even if the fund elects to convert the bonds in 2025, the issuer can elect to pay the cash value of the shares issuable upon conversion, so the fund won't have a right to acquire shares even when they become convertible. It's true that the company may gain a right to force conversion if the debt contingency is triggered, but even then only the company will have a right to convert the bonds, not the fund. So, I don't think the bonds will ever represent beneficial ownership of the underlying common stock, unless they are actually converted into common stock.

Combined Direct and Indirect Holdings in Form 3

Barbara: We on-boarded a new Section 16 officer last year and accurately reported on her Form 3 the number of shares of company common stock she beneficially owned. We reported all of the shares as directly owned, however, and we now realize that five of the shares are owned indirectly through her minor son, who resides in the officer's household. Do we need to separate out those five shares, or can we leave them as is?

Alan: The way I look at issues like this, there are technical requirements in the SEC's rules, and there are practical considerations in complying with those rules, and sometimes practical considerations may justify treating a technical requirement as a "general rule" that is subject to exceptions based on practical considerations. Here, I think the instructions to Forms 3, 4 and 5 would lead to a conclusion that the five shares owned by the insider's son are "indirectly" owned by the officer and therefore should be reported on a separate line from the officer's directly owned shares. Nevertheless, the fact that the number of shares owned indirectly is unquestionably "de minimis," and no shares were left out of the Form 3, I think it would be reasonable not to amend the Form 3. I also think I would be comfortable continuing to aggregate the shares in future reports, for the same reason, although I would consider striving for "technical compliance in the future. If one were to do that, it could be done by just breaking out the five shares in the officer's next report, without or without an explanatory footnote.

Designation of Acting Officer

Barbara: Our CFO has announced her retirement, and a non-executive employee in her department will be appointed acting CFO while the company searches for a replacement. We expect to complete the search process and appoint a new CFO within two or three months. Do we need to file a Form 3 for the acting CFO in the interim?

Alan: I think the answer is yes. When the person designated as an acting officer is not already subject to Section 16, in most cases the person should be deemed a Section 16 officer as of the date of designation, at least where the person is designated the acting principal executive officer, principal financial officer, or principal accounting officer. The staff takes the view that, at all times, someone has to be performing the functions of the principal executive officer, the principal financial officer, and the principal accounting officer, and the person(s) performing those functions should be deemed to hold those positions whether they have been assigned the titles or not. In a Compliance and Disclosure Interpretation, the staff has said that where a CFO "temporarily turns his or her duties over to another person," the company is required to file a Form 8-K under Item 5.02(b) to report that the CFO has temporarily stepped down and under Item 5.02(c) to report that a replacement has been appointed. The staff also says that the CEO and CFO certifications required by Rules 13a-14(a) and 15d-14(a) have to be signed by someone. These staff positions are consistent with case law holding that whether a person is a Section 16 officer depends on the functions the person performs, regardless of the person's title. Accordingly, when an officer identified in Rule 16a-1(f) terminates employment, the issuer should identify the person who will perform that person's functions and get that person to file a Form 3.

It may not be necessary to file a Form 3 for someone who is acting for a former Section 16 officer who did not hold one of the titles specified in Rule 16a-1(f), but instead was a significant policy-maker. In that circumstance, the acting officer may not have the same degree of influence over significant policy that the former officer had, and therefore may conclude that the acting officer is not a Section 16 officer.

Forfeiture of Restricted Stock Upon Termination of Service

Barbara: Our executive officers receive annual grants of restricted stock which vest annually over a three-year period. Insiders have the right to vote their shares and to receive any dividends paid on the shares during the vesting period. The plan provides that, it a grantee resigns or otherwise voluntarily terminates employment with the company, unvested awards will be forfeited. If an executive resigns and, as a result, forfeits an award of restricted stock, is the forfeiture reportable on Form 4?

Alan: The answer to this question depends on whether the executive is an insider at the time forfeiture occurs, and the answer to that question probably depends on how the plan or the award agreement is worded. If forfeiture occurs *after* the insider terminates service, forfeiture is not reportable because Rule 16a-2 exempts from reporting any transaction that occurs after termination of insider statue if the transaction is exempt from Section 16(b), and presumably the

forfeiture is exempted by Rule 16b-3 because the award was approved by a committee of non-employee directors. The answer to the question isn't so clear if the plan or the award agreement provides that forfeiture occurs *simultaneously* with termination of service. The SEC has said that when a person becomes an insider and simultaneously receives an equity award, the grant occurs while the person is an insider, and therefore the award is reportable on Form 4, not on the insider's Form 3. It is unclear whether the SEC's position also means that a forfeiture that occurs simultaneously with termination of service occurs "while" the person is an insider. Logically, it seems that a forfeiture occurs after termination, because termination is what triggers forfeiture. For that reason, a lot of companies whose plans provide for simultaneous forfeiture treat forfeiture as a post-termination transaction and don't report it. Peter Romeo and I support that position in our publications. There's no reason, though, filers should have to live with any ambiguity. Companies can avoid any existing risk by making a simple drafting change to provide that forfeiture occurs "immediately after" termination of employment. Language of that type should assure that forfeiture is exempt from reporting under Rule 16a-2 as a "post-termination" transaction.

Late Forms 4

Barbara: I am responsible for Section 16 reporting at my company and was just informed that two of our executive officers received a grant of time-vesting restricted stock units last week. Should I just file the Forms 4 now, late, rather than report them on Form 5 after the end of this year (in February 2020). And if I file Forms 4, am I required to say something special in them to call attention to the fact that they are being filed late, or can I let the dates in Box 3 and Column 2 of Table I speak for themselves?

Alan: Since the transactions will be reported late no matter what you do, neither approach is necessarily preferable to the other. The staff has said that, in this circumstance, you can either wait and report the grants on Form 5 after the end of the year, or you can voluntarily report the grants earlier on Form 4. I have a slight preference for filing earlier Forms 4, only because the SEC has said in past enforcement actions under Section 16(a) that the number of days late a report is filed is a factor the staff takes into account in deciding whether to bring an enforcement action. Filing on Form 4 also gets the filing out of the way while it's on your mind, so that you don't have to revisit the issue a year from now or risk forgetting. If you do choose to file Forms 4, there is no need to make any special notation on the forms to indicate that they are late. Form 4 doesn't have the delinquency box that has to be checked when a transaction is reported late on Form 5, which is intended to alert the issuer that it may need to disclose a reporting delinquency in the proxy statement, but that doesn't mean that a late Form 4 needs to include a footnote indicating that the form is late. The transaction date reported in the Form 4 adequately informs the issuer that a disclosable delinquency has occurred.

Failure to Identify Chief Accounting Officer as Section 16 Filer

Barbara: We have always taken the position that our controller (who is the principal accounting officer) is not an "executive officer" for Rule 3b-7 purposes. We now realize that he is nevertheless a Section 16 officer. However, the company has not filed any Section 16(a) reports for him, and he has been our controller for over ten years. To fix the problem, we propose to file a Form 3, and also file a single Form 4 reporting only transactions that occurred within the last two years. He has never had a short-swing transaction, so we would not be concealing any Section 16(b) liability. Do you see a need to report all of the insider's transactions since the beginning?

How far back to go is a judgment call. No matter what you do, the insider has violated Section 16(a). If the insider reports all prior transactions, the reporting is late, and if he reports only some of the prior transactions, he is still late and for some transactions hasn't filed at all. I don't think the SEC staff or anyone else would say it is acceptable not to report old transactions, any more than they would say that it's acceptable to report them late. It is not uncommon for someone who discovers years of unreported transaction to decide to cut off the look-back at some point, on the theory that older transactions are no longer material, in that they don't indicate the insider's

current view regarding the direction of the issuer's stock price, and also can't lead to recovery of short-swing profits under Section 16(b), at least if the statute of limitations is a statute of repose. Whatever a person does in this circumstance, they just need to cross their fingers and hope the SEC staff doesn't show an interest.

Sale of 401(k) Plan Shares to Pay Administrative Fees

Barbara: How should we report an insider's monthly reduction in the number of shares owned through a 401(k) company stock fund resulting from participation fees charged against the fund?

Alan: Administrative fees charged to plan participants and paid by liquidating a pro rata portion of each investment alternative selected by the participant are mandatory charges and therefore result in mandatory, or non-volitional dispositions. When these charges result in a disposition of an insider's interest in a company stock fund, the non-volitional nature of the disposition means that the disposition is not a Discretionary Transaction as defined in Rule 16b-3. As a transaction in a qualified plan that is not a Discretionary Transaction, the disposition is exempt under Rule 16b-3(c). As transactions exempted by Rule 16b-3(c), the transactions also are exempt from reporting under Rule 16a-3. So, the monthly dispositions do not need to be reported, on Form 4 or Form 5. In future reports, though, the total number of shares owned through the plan, as reported in Column 5 of Table I, should be adjusted appropriately.

Same Day Grant and Vesting of Restricted Stock

Barbara: The compensation committee of our board of directors intends to grant to one of our insiders restricted stock that will vest on the date of grant and that will be subject to mandatory withholding of shares to pay withholding taxes. As a result, shares will be withheld on the same day the grant is made. Will the withholding of shares be reportable, and if so, will the use of transaction code "F" suffice, or will we need to explain the transaction in a footnote?

Alan: Yes, both the grant of the full number of shares awarded and the withholding of shares to pay taxes will be reportable. They should be reported on separate lines of the Form 4. The staff doesn't allow "net" reporting, by reporting only the acquisition of the shares remaining after tax withholding. The withholding should be reported using transaction code "F," just as with any other tax withholding. There is no need to explain why taxes were withheld on the date of grant, but the filer can choose to provide that information voluntarily, in a footnote, if there is a reason to think someone will ask the question. Some filers like to include a footnote any time transaction code "F" used, just to explain that the transaction is necessary to pay taxes, and isn't an open-market sale that might suggest the insider doesn't see much upside in the company's stock.

Compensation Committee Ratification of Existing Tax Withholding Right

Barbara: A vice president of the company holds a stock option which was granted to him by an executive officer of the company pursuant to authority delegated by the compensation committee (as permitted by state law). The option agreement allows the employee to elect, at the time of exercise, to have shares withheld to pay the exercise price of the option as well as any related tax obligations. The board of directors now intends to deem the vice president to be a Section 16 insider. Is it possible to exempt any future withholding of shares under Rule 16b-3(e) by having the board ratify the withholding rights, even though the rights have already been granted?

Alan: Yes, it is possible for committee ratification of the tax withholding right to exempt a subsequent exercise of the right. Rule 16b-3 exempts an officer's transaction with the issuer if the transaction is approved in advance by the issuer's board of directors or a committee composed solely of two or more nonemployee directors. The rule does not address (either way) whether approval is effective if the insider already has a contractual right to engage in the transaction. The staff and the SEC have both said, though, that the purpose of requiring board or committee approval is to allow the board to serve as gatekeeper for determining whether an insider's

transaction with the issuer should be exempt from Section 16(b). That gatekeeping function can be served whether or not the insider already has a contractual right to engage in the transaction, so ratification of an existing right should be sufficient to satisfy the requirements of Rule 16b-3.

Committee Approval of RSU Grant Effective on Future Date

Barbara: Our compensation committee is scheduled to hold a meeting for the purpose of approving grants of restricted stock units to executive officers. The committee will approve the grants before we issue our earnings release for 2018, and the committee does not want to size the awards until the market has absorbed the information in the release. To accomplish that, the committee will approve a dollar amount for each executive's award, and will provide in the approval resolutions that the number of RSUs will be determined by dividing that dollar amount by the price of the company's stock at the close of trading on the day following the date of the earnings release. What will be the deadline for filing Forms 4 to report the grants?

Alan: The Forms 4 will be due two business days after the number of RSUs each executive will receive can be determined. The number of RSUs each director will receive will be known on the trading day following the date of the earnings release, so Forms 4 will be due two business days after that trading day. Most of the time, the deadline for filing Form 4 is two business days after the compensation committee approves the awards. In those cases, though, the committee approves a specific number of shares or options for each grantee, so the terms of the award are known at the time of committee approval. When a committee approves awards based on a formula that depends on future contingencies, the award doesn't become reportable until the contingency occurs.

Gift to Insider's Grandchild under UTMA

Barbara: Our CEO wants to transfer shares to his minor grandchild under the Uniform Transfers to Minors Act. The grandchild does not live in the same household as the CEO. The CEO and his wife will be the custodians for the account. I understand the gift will be reportable in the insider's Form 5 or voluntarily on Form 4. Do we also need to report the shares as "indirect holdings"?

Alan: The answer to this question isn't entirely clear. Rule 16a-8 provides that, where an insider is trustee of a trust, the insider has a pecuniary interest in securities held by the trust if the insider or any member of the insider's immediate family is a beneficiary of the trust. In the trust context, it doesn't matter if the family member shares the insider's household or not—the trustee's control over the account is enough to result in attribution of beneficial ownership to the insider. A UTMA account isn't necessarily a trust. The powers of a custodian are substantially equivalent to those of a trustee, though, so I would apply Rule 16a-8 and treat the insider-custodian as indirect beneficial owner of shares held in the UTMA.

Amending Error in Box 5 of Form 4

Barbara: Our CFO filed her Form 3 two years ago, checking the "officer" line in Box 4 and noting on the line below that she is chief financial officer. Beginning with her first Form 4, however, we inadvertently checked the line indicating that she also is a ten percent owner, in addition to continuing to indicate that she is CFO. This mistake carried forward on each subsequent Form 4, for a total of four reports in all. We will stop checking the ten percent owner line going forward. Do we also need to amend any of the prior Forms 4, and if so, which ones?

Alan: Whether to amend a Form 4 to correct an error is usually a judgment call. The primary consideration, I think, is whether the error is material, and in this context I think materiality is based on whether the error has the potential to mislead readers regarding something that is important to the purposes of Section 16(a), which is intended to inform people about an insider's transactions in and holdings of issuer securities. Where a Form 4 has reported transactional information and beneficial ownership information correctly, and also has reported the insider's officer status, I think it is reasonable to assume that investors will not consider it material whether the CFO is or isn't a ten percent owner. In addition, here the error has been in the market for over

two years. So, under these circumstances, I would not consider it necessary to correct the error by rushing to amend any of the prior Forms 4. Instead, I would fix the mistake in the insider's next Form 4, and include in that Form 4 a footnote saying that prior Forms 4 inadvertently and mistakenly indicated that the filer was a 10% owner as well as an officer.

Grant of Performance-Based and Time-Based Restricted Stock Units

Barbara: Our compensation committee approved a grant of 40,000 restricted stock units to the CEO. 10,000 of the units will vest annually over the next three years if the CEO remains employed by the company on the vesting dates, and the remaining 30,000 units will vest at the end of the same three-year period if and to the extent that the company's revenues and return on equity reach certain levels. I understand that the 10,000 shares that vest based on the passage of time will be reportable of Form 4 within two business days of the committee's approval of the grant. Can the performance-based shares also be reported now?

Alan: This question raises an issue that has been discussed in a lot of forums but that doesn't have a clear answer. Restricted stock units are derivative securities. Generally, the grant of a derivative security is reportable on Form 4. The staff has expressed the view, though, that an award that vests only upon the occurrence of a material condition is not reportable at the time of grant, and instead becomes reportable if and when the condition is satisfied. The staff also has expressed the view that the passage of time and continued employment are not material conditions to vesting. For that reason, the 10,000-share time-based award referred to in this question will be reportable on Form 4, within two business days of the committee's approval of the award.

An award that is subject to performance conditions, in contrast, is not deemed beneficially owned until the condition is satisfied. So, the grant of the 30,000 performance shares is not reportable, and won't be reportable until some or all of the shares are earned at the end of the performance period. This question seems to be asking whether insiders can report the performance-based portion of the award anyway, at the time of grant. I see no problem with doing that, and I'm told that many companies do report performance shares at the time of grant. The potentially troublesome issue, though, is whether early reporting of the award excuses the insider from reporting the actual vesting of the award, which technically is a reportable event. I don't know of a staff position that allows insiders not to report a reportable event by reporting the event on an earlier date. For that reason, if I were going to report a *grant* of performance shares, I would also report the vesting of the shares. If some filers aren't reporting the vesting, I've never heard the staff raise the issue, so it's probably not going to be a problem for filers who report early.

Reporting Gifts of Stock

Barbara: If an insider makes multiple gifts of common stock on the same day, some to non-family members and others to family members (including family members who share the insider's household), can all of the gifts be aggregated on one line of the insider's Form 5? And is it necessary to identify the donees?

Alan: Multiple gifts that occur on the same day can be reported on a single line of Form 5, just as multiple sales in the open market on the same day can be aggregated on one line. And there is no requirement that the identities of the donees be disclosed in the report. When securities are gifted to a family member who resides in the insider's household, though, the securities remain beneficially owned by the insider under Rule 16a-1(a)(2)(ii)(A), and therefore the family's member's securities need to be listed on a separate line of the insider's report, as an indirect holding. Usually, to make clear why directly owned shares were disposed of and indirectly owned shares show up on the report, the filer footnotes both lines to explain that the securities were gifted to a family member. So, it's apparent from the report who some of the donees are.

Former Insider's Resumption of Insider Status

Barbara: One of our vice-presidents was considered a Section 16 officer until January 2018, when we re-evaluated our list and concluded that she should no longer be considered a significant policy maker. Now, that vice-president is being promoted to an executive officer position. The vice-president did not file an exit report last year or file any subsequent Forms 4 to indicate that she was no longer subject to Section 16. Do we need to file a new Form 3, or can we just resume filing Forms 4?

Alan: We get this question all the time. The staff has been clear that, in this circumstance, the insider needs to file a new Form 3. Basically, a Form 3 is effective only until the insider ceases to be an insider. If a former insider later becomes subject to Section 16 again, a new Form 3 has to be filed to show total holdings as of the date of the insider's resumption of insider status, whether or not the insider previously filed a report that checked the exit box.

Insider's Termination as Trustee of Family Trust

Barbara: One of our insiders was the trustee of an irrevocable trust that she established for the benefit of her children and grandchildren. We have always reported the trust's holdings of company stock on the insider's Section 16 reports as indirectly owned through the trust. Several months ago, without our knowledge, the insider resigned as trustee and was replaced by an institutional trustee. Since the insider's resignation as trustee resulted in her no longer being the beneficial owner of the trust's holdings, should we have reported the resignation on Form 4? Since we didn't, should we now report the resignation on Form 5?

Alan: I don't think a filing was necessary when the resignation occurred, and I don't think one is necessary now, on Form 5 or otherwise. It is true that Section 16(a) calls for reports of changes in beneficial ownership, and resigning as trustee resulted in a change in the insider's beneficial ownership. However, Section 16(a) also ties the reporting deadline to the execution of a transaction. When a change in beneficial ownership results from a change in the inside's relationship with the holder of securities rather than from a transaction in securities, I don't think reporting is required. Peter Romeo and I have said in our publications that a loss of investment control over a portfolio of securities should not be considered a reportable event, given that no person gains or loses an economic interest in securities and therefore no "transaction" occurs. The same issue comes up when a child who owns company stock moves out of an insider's house. I don't think events of that nature require reporting. Instead, the loss of beneficial ownership will be reflected in the insider's future reports, by dropping the indirect holding.

Transactions in Securities of Exchange Traded Fund

Barbara: An insider has asked if she can purchase shares in an exchange-traded fund that focuses on our industry and therefore may hold shares of our stock. Would her ownership of the ETF's shares represent a pecuniary interest in the company stock owned by the ETF, such that she would need to report on Form 4 her transactions in ETF shares, and possibly the ETF's transactions in our stock? And would a purchase of ETF shares constitute "hedging" under the Dodd-Frank Act?

Alan: In almost all cases, an insider's transactions in securities of an exchange-traded fund would not be reportable as transactions in issuer securities held in the ETF's portfolio. An ETF is essentially a mutual fund, and interests in the ETF represent an interest in a broad, diversified portfolio of companies. Rule 16a-1(a)(5)(iii) provides that Section 16 does not apply to an insider's transactions in "interests in securities comprising part of a broad-based, publicly traded market basket or index of stocks, approved for trading by the appropriate federal governmental authority." So, unless the ETF holds an unusually high percentage of its assets in issuer securities, an insider's transactions in ETF securities should not be reportable. And, for the same reasons, the ETF's transactions in issuer securities also would not be reportable by the insider. As for the hedging question, the Dodd-Frank Act defined hedging to include transactions involving an exchange fund. Exchange funds are different from exchange traded funds, and therefore transactions in ETF securities shouldn't be considered hedging within the meaning of Dodd-Frank.