

SEC Proposes to Overturn Section 16 Levy Decision

On June 21, 2004, the Securities and Exchange Commission (SEC) proposed to amend two of its rules under Section 16 of the Securities Exchange Act of 1934 (Exchange Act) to remedy the Third Circuit's surprising and unfortunate decision in *Levy v. Sterling Holding Company, LLC*.¹ The SEC also proposed to modify Item 405 of SEC Regulations S-K and S-B, which requires disclosure of delinquent Section 16 filings, to reflect the current filing deadline. Comments on the proposals must be made by August 9, 2004.

The Levy Decision

Section 16 of the Exchange Act applies to holders of 10 percent of any class of equity security registered under Section 12 of the Exchange Act and officers and directors of issuers of such securities. Under Section 16(b), such insiders must pay to the company any profits they may realize from purchases and sales (or the reverse) within a six-month period – so-called “short swing” profits.

The SEC has adopted rules exempting various transactions from Section 16(b). Two of the exemptions insiders most commonly rely on are Rule 16b-3, which exempts certain transactions between an officer or director and the company, and Rule 16b-7, which exempts certain mergers, reclassifications and consolidations.

In the *Levy* case, the company, prior to an initial public offering, effected a reclassification, in which certain preferred stock was converted into common stock. The plaintiffs (shareholders of the company) argued that two 10 percent stockholders (who the district found were also directors) had, in that conversion, “purchased” the common stock, and that the purchases should be matched against subsequent sales, resulting in profits of \$72 million.

The court first held that the reclassification was not exempt under Rule 16b-7. The court noted that, although the title of Rule 16b-7 includes the word “reclassifications,” the text of the rule does not; instead, the text refers only to a “merger or consolidation.” The court also noted that the SEC staff has stated that Rule 16b-7 “can” apply to reclassifications, but construed the SEC’s statement to mean that the rule might – or might not – apply, depending on the circumstances. The court then determined that the reclassification would not be exempt, because 1) the reclassification resulted in the insiders owning equity securities with different risk characteristics than the securities surrendered; 2) the surrendered securities had not previously been convertible into the acquired securities; and 3) the result was an increase in the ownership percentage by the insiders.

The court then turned to Rule 16b-3. Rule 16b-3 exempts a “grant, award or other acquisition” from the company by an officer or director (with certain exceptions not relevant) if the transaction is approved by the board of directors, a committee composed solely of two or more non-employee directors, or a majority of the company’s shareholders. The transactions at issue were in fact approved by the company’s board of directors and shareholders. The court, however, held that Rule 16b-3 is “primarily” concerned with employee benefit plans. The court reasoned that the “grants” and “awards” are compensation events, and thus an “other transaction” must also be a compensation-related event. Despite statements by the SEC (in its 1996 release adopting amendments to broaden Rule 16b-3) that “a transaction need not . . . have a compensatory element” to be exempt, as well as SEC interpretations exempting a variety of transactions without regard to a compensatory element, the court held that a transaction must have “some

connection to a compensation-related function” to be exempt under Rule 16b-3. Finding that the transactions at issue had no such function, the court concluded that the transactions were not exempt under Rule 16b-3.

In connection with defendants’ petition for a rehearing or rehearing *en banc*, the SEC filed an amicus brief, arguing strenuously that the court had misconstrued both rules. Nevertheless, the court denied the petition, and the Supreme Court subsequently declined to consider the case.

The *Levy* decision surprised most lawyers familiar with Section 16 precedent. Moreover, it created significant difficulties and uncertainties in planning. Both rules, Rule 16b-3 in particular, have been heavily relied on for a wide range of transactions that do not raise the potential for speculative abuse that Section 16 was intended to address. In light of *Levy*, however, insiders could no longer determine, with any clarity, whether such transactions would be exempt.

Section 16 Proposals

Fortunately, the SEC has now proposed to “clarify” its rules to contravene the *Levy* decision. In Rule 16b-3, the SEC has proposed to replace “grant, award or other acquisition from the issuer” with “an acquisition from the issuer . . . including without limitation a grant or award,” thus eliminating the implication (as perceived by the Third Circuit, at least) that an “other acquisition” must be similar to a “grant” or “award.” In addition, the SEC would add a note to Rule 16b-3 stating that the exemption is not conditioned on the transaction “being intended for a compensatory or other particular purpose.”

The SEC has proposed to amend Rule 16b-7 by replacing “merger or consolidation,” each time those words appear in the rule, with “merger, reclassification or consolidation.” The SEC also proposes to add a paragraph stating that the exemption is not subject to the transaction satisfying any conditions other than those set forth in Rule 16b-7.

The proposals will be a welcome relief from the uncertainty created by a decision that contradicted a previously consistent and clear history of precedents and SEC statements.

Item 405

Item 405 allows an issuer to presume that a filing was made timely if the issuer receives a copy of the filing within three business days of the required filing date. This regulation was adopted when Section 16(a) filings were generally required to be made only monthly, within 10 days of the end of each month, and were filed on paper. Under the Sarbanes-Oxley Act and rules subsequently adopted by the SEC, Section 16(a) filings are now filed within two business days of most transactions, are filed electronically, and are generally transmitted to the issuer electronically. In light of these requirements, the SEC believes the three-business-day presumption is no longer appropriate. Moreover, given the electronic filing, the SEC believes that no presumption is appropriate. Accordingly, the SEC has proposed to eliminate this presumption, without substituting anything in its place.

¹ 314 F.3d 106 (3d Cir. 2002), cert. den. *Sterling Holding Co. v. Levy*, 124 S. Ct. 389 (2003).

For Further Information

If you have any questions regarding these proposals, including how they may affect your company, or if you are interested in submitting comments to the SEC, please contact one of the members of the Securities Practice Group or the lawyer in the firm with whom you are regularly in contact.

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