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CLIENT ADVISORY

## Accelerated Reporting of Transactions by Insiders of Public Companies

On July 30, 2002, the President signed into law the Sarbanes-Oxley Act of 2002. The law represents sweeping legislation designed to create reforms in corporate governance, investor protection and the accounting industry. One of the many changes the Sarbanes-Oxley Act imposes is an amendment to Section 16 of the Securities Exchange Act of 1934 (the "34 Act") to require most transactions by insiders of public companies to be reported to the Securities and Exchange Commission before the end of the second business day following the day of the relevant transaction. This amendment becomes effective for transactions occurring on or after August 29, 2002. Below is a summary of the changes and some suggestions to assist in compliance.<sup>1</sup>

*Covered Persons, Transactions and Sanctions.* The changes to the filing requirements apply to all current Section 16 reporting persons of a public company, i.e., all beneficial owners of more than 10% of any class of any equity security, any directors, and executive and certain other officers (including their family members) (referred to as "insiders").<sup>2</sup> Currently, insiders are required to report on a Form 4, on a monthly basis, most, but not all, transactions by them involving company equity securities. Certain transactions such as gifts or option grants presently can be deferred until an annual report on Form 5. The new law requires almost all transactions to be reported on Form 4 and shortens the reporting deadline for Form 4 filings from 10 days after the end of the month in which the transaction occurred to only two business days following the transaction date.

In addition to purchases and sales, the two-day requirement will apply to any change in ownership, including stock and option grants and exercises and other transfers. It includes all transactions in a company's equity securities and derivative securities. The SEC has stated that it will adopt one or more new rules that will provide different Form 4 due dates for narrowly defined specified transactions as to which the SEC determines the two business day reporting period is not feasible. The exceptions will not be based on the type of issuer, type of insider or size of transaction. The limited transactions for which the SEC is currently considering calculating different Form 4 deadlines are (1) transactions pursuant to a single market order that is executed over more than one day, (2) transactions involving a pre-existing arrangement the timing of which is outside the knowledge of the insider before a confirmation or other notice of the transaction is sent to the insider, and (3) discretionary transactions involving an employee benefit plan, whether or not exempted by Rule 16b-3 under the 34 Act, where the delay would be tied to the notice of the transaction. It also appears that current deferrable reporting for acquisitions not exceeding \$10,000 and for gifts on an annual report on Form 5 will still be available. In addition, transactions currently exempt from reporting altogether, such as purchases under employee stock purchase plans and other qualified plans, will likely continue to be exempt. The SEC is expected to finalize and delineate these and any other exceptions to the two-day requirement by August 29, 2002. The SEC will also update the current format of Form 4 to reflect the changes imposed by the law.

The current Section 16 sanctions will continue to apply and any late or delinquent Form 4 filings are required to be reported in a company's annual proxy statement by naming the insiders who filed late or delinquent Forms 4. The SEC has been granted broad authority under the Sarbanes-Oxley Act to seek "any

<sup>1</sup> This client alert includes materials provided by *The Corporate Counsel*. For more information about the topics discussed herein and related model forms, go to [www.thecorporatecounsel.net](http://www.thecorporatecounsel.net).

<sup>2</sup> Presently and under the new law, the securities of foreign private issuers, as defined by the SEC, are not subject to Section 16 reports.

equitable relief that may be appropriate or necessary for the benefit of investors” for violations of any provisions of the securities laws. Additionally, the individual insider continues to face civil and criminal liability for false reports or for not reporting transactions that are required to be reported on Form 4 in a timely manner, and continues to have liability for any “short-swing” profits (the laws for which have not been amended).

*Suggestions for Compliance Procedures.* In light of the increased time pressure to file Forms 4, below are some suggestions that a company might want to implement to (1) ensure compliance with the new accelerated reporting requirements, (2) help prevent, in advance, any inadvertent violations of the federal securities laws and (3) avoid even the appearance of trading on inside information. Companies must make very clear to insiders that they are subject to increased time pressure and revised reporting obligations.

1. Mandatory Pre-clearance Procedure. Insiders should not engage in *any* transaction involving a company’s securities (including a stock plan transaction such as an option exercise, a gift, a loan or pledge or hedge, a contribution to a trust or any other transfer) without first obtaining pre-clearance of the transaction from a designated party, such as the General Counsel, CFO or other compliance officer of a company (referred to as the “pre-clearance officer”). A request for pre-clearance should be submitted to the pre-clearance officer at least two days in advance of the proposed transaction. The pre-clearance officer should be the one to determine if the transaction may proceed, and, if so, assist the insider in complying with the new reporting requirements to the extent necessary. While most companies already have pre-clearance procedures in place, often as part of anti-insider trading policies, such procedures should be reevaluated at this time to ensure that they are sufficiently broad to encompass *every* transaction that will now be reportable on an accelerated basis. The pre-clearance officer must always stay informed of material developments and be in direct communication with the person who will be preparing any Form 4.

If a company permits transactions in compliance with trading plans that are intended to meet the requirements of Rule 10b5-1 under the 34 Act, the company may want to require that insiders first pre-clear all trading plans with the company. It is important to remember that a person may enter into a trading plan only when that person is not in possession of material nonpublic information. In addition, generally a person may not enter into a trading plan during a company “blackout” period. Transactions effected pursuant to a pre-cleared trading plan would usually not require additional pre-clearance at the time of the actual transaction if the plan specifies the dates, prices and amounts of the contemplated trades, or establishes a formula for determining the dates, prices and amounts, such that a Form 4 could be easily prepared without additional information.

2. Broker Interface Procedures. The new accelerated reporting requirements will require a tight interface between a company and the brokers handling transactions for insiders. A good broker with knowledge and experience in recognizing and handling transactions subject to Rule 144 under the Securities Act of 1933, Section 16, Rule 10b-5 under the 34 Act and other securities laws can assist a company in complying with pre-clearance procedures and help to prevent inadvertent Section 16 and other violations. Companies may want to consider creating a coordinated procedure with a specific brokerage firm and encouraging or requiring insiders to enter all company stock transactions through a specified broker to reduce the chances for error.

Whether the insiders use the specified broker or their own broker, requiring that the insiders and the brokers sign a “Broker Instruction/Representation” should be considered. A Broker Instruction/Representation would impose two requirements on the broker handling transactions relating to company stock, namely (1) not to enter any order (except for orders under pre-cleared or pre-approved 10b5-1 plans) without (a) first verifying with the company that the transaction was pre-cleared and (b) complying with the brokerage firm’s compliance procedures (e.g., Rule 144) and (2) to report immediately to the company via telephone and in writing the details of every transaction involving company stock, including gifts, transfers, pledges and all 10b5-1 transactions. To further put brokers on notice and prevent errors, companies might consider placing legends on all insiders’ stock certificates regarding the need to pre-clear any transactions with the company.

3. Periodic Preventive Alerts and Reminders. Because the risk of inadvertent Form 4 filing violations is much higher as a result of the new accelerated requirements, a company should consider sending periodic preventive reminders and alerts to its insiders by e-mail or fax. Ideally, these reminders should be short and attention grabbing and should be provided on at least a monthly basis.

4. Memorandum to Directors, Executive Officers and Beneficial Owners. The CEO or another senior officer of a company should send a memorandum to its insiders outlining the information presented in this advisory. The memorandum should explain the new Section 16 accelerated reporting requirements imposed by the Sarbanes-Oxley Act and outline a company's new and old policies that will be in place to assist insiders in complying with the new requirements. All insiders who receive the memorandum should certify to their understanding of, and intent to comply with, the procedures set forth in the memorandum by completing a brief certification form.

5. Power of Attorney. Although Section 16 reports are the responsibility of the insiders and not the companies, as a practical matter, insiders often rely on companies to file their Forms 3, 4 and 5 on their behalf. In order to enable a company to prepare and file Forms 4 on a timely basis, a company may seek to have insiders sign and return to the company either a power of attorney or a confirming statement authorizing the company to take necessary action to file the Forms 3, 4 and 5. With the new accelerated filing requirements, this would avoid the need to track down insiders for their signatures. A company may, however, assume additional responsibility for the contents of any reports if signed pursuant to a power of attorney or confirming statement.

6. Electronic Filing. The Sarbanes-Oxley Act requires that by July 30, 2003, all insiders must file their Section 16 reports electronically with the SEC, and companies must post the reports on their websites. Insiders may voluntarily file electronically currently if they obtain requisite filing codes, a simple process. Electronic filing can save a day in the process by avoiding the need to physically get a document to the SEC's Washington office. The SEC has indicated that electronic reports that contain all of the required data in order will be accepted, even if not formatted with all of the boxes and lines of Form 4. Over time, the SEC will likely simplify the electronic filing process.

*Ideal Compliance Program.* In order for a company to maximize its compliance efforts and to demonstrate to regulators and the public that it is seriously committed to compliance, a company should consider implementing a compliance program. The ideal compliance program includes (1) sending a memorandum to all Section 16 reporting persons outlining the new legislation and related policies of the company; (2) requiring the Section 16 reporting person to sign a certification certifying that he or she received and understood the memorandum; (3) creating a comprehensive pre-clearance procedure for all Section 16 reporting persons covering all transactions and transfers; (4) creating a closely coordinated broker interface procedure and requiring all Section 16 reporting persons and their brokers to sign a Broker Instruction/Representation Form; and (5) sending periodic reminders and pointers to all Section 16 reporting persons. Following this compliance program will increase the likelihood of maintaining ongoing compliance and will allow a company to demonstrate, in the event of a regulatory inquiry, that the company has taken reasonable steps to prevent violations of the law by insiders.

*Conclusion.* The summary above covers the amendments to Section 16 as imposed by the Sarbanes-Oxley Act, to be further refined by the SEC, and provides some recommended practice procedures a company may want to consider in order to help its insiders comply with the new Section 16 accelerated reporting requirements under the Sarbanes-Oxley Act. For a more comprehensive discussion of the topics covered in this advisory or assistance in developing any of the procedures or documents described herein, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult, or the undersigned.

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*Because sound legal advice must necessarily take into account all relevant facts and developments in the law, the information you will find in this Advisory is not intended to constitute legal advice or a legal opinion as to any particular matter.*