Public Chatter

Section 16 Gems for Your Mantelpiece

By Kelly Reinholdtsen | Counsel

CONTENTS

PERKINSCOIE

Section 16 Gems for Your Mantelpiece

- *by Kelly Reinholdtsen*

This guidebook about "Section 16 Gems for Your Mantelpiece" is meant to be practical. I'm hoping its quasi-conversational nature helps you more easily consume the lessons imparted. Enjoy – and please share your own practice tips or your own anecdotes, for the next edition of this Guidebook!

1. Yeah, I've Got a Footnote Philosophy for Form 4s

I'm into footnotes for Section 16 reports. They help provide clarity and eliminate confusion. They help companies look like they're not hiding the ball. And allow shareholders to understand details of a transaction that might not be evident just from the disclosures in the tables.

A good example is using footnotes liberally to denote that an insider's transaction occurred pursuant to a Rule 10b5-1 plan. An insider's reputation can take a big hit if a reporter "unearths" a trade that makes it seem like the insider exercised discretion at a time they knew something nonpublic.

Hopefully, the reporter would dig deep enough to read the footnote noting that the insider didn't exercise discretion in that case. Even better is if the SEC adopts the Council of Institutional Investor's suggestion to require insiders to check a box on Forms 4 and 5 if a transaction occurs under a Rule 10b5-1 plan. That would make it very clear whether a trade was pre-planned or not.

Of course, in a footnote, you'll want to include all details necessary for a full understanding of the transaction, particularly the extent to which the transaction increased – or decreased – the insider's beneficial ownership or affected their economic interest in the securities.

Most footnotes are fairly short, two or three lines. But on rare occasion, you'll see a footnote so long that it'll bleed into a second footnote – because there's a character limit for a single footnote set by the SEC's Edgar database.

Often a Section 16 filing doesn't require a footnote. But when it does, go for it!

2. The Tragic Story of the Form 4 Error That Required an Amendment

Okay, so it's not so tragic if you need to amend a Section 16 filing. On the whole, you want to avoid an amendment if you can. But it's not typically that big a deal if you need to. And if you need to, you need to.

Sometimes there's a judgment call here. Some circumstances clearly require an amendment. Missed transaction? Gulp. Yes, amendment.

But other types of errors might fall into more of a grey area. And might be "corrected" by a clarifying footnote in a future Form 4 rather than an amendment.

The key is to act fast to make that determination about what you need to do. And if you do file an amendment, you are going to want to throw in a footnote to place the amendment in context. Clarify what's being amended, particularly if there's a need to repeat a line on a form to gain access to the SEC's Edgar reporting system.

A few reminders here. Use the original filing date in the box on the form. You don't need to update content from the original filing for subsequent events – amendments speak as of date of the original filing.

How freaked out do insiders get about errors? It depends. Who found the error? The insider or someone else? What type of person is the insider? What kind of day are they having? What sort of delinquent filing implications are there for Item 405 proxy statement disclosure? Highlighting the error in the proxy statement is not necessarily a good look. But mistakes do happen.

3. Multiple Classes of Stock: Form 4 Reporting & Short Swing Matching

As companies continue to go public with dual classes of stock - SEC and proxy advisory firm scrutiny aside - questions arise around Form 4 reporting and short-swing profit recovery rules. For example, do you need to include all classes of stock on a Form 4 if you're only reporting a transaction in one class? Are transactions in one class of securities matchable under the short-swing profit rules with transactions in another class of securities?

Form 4 Reporting: Form 4 requires reporting only for securities of the same class - or classes - as the securities involved in the transaction. So if you're reporting an option exercise for Class A common stock in Table I, you're not also required to report your holdings of Class B common stock in Table I. You can, though companies typically do not. An initial Form 3, though, must include all holdings of common stock and derivative securities, including those of multiple classes of common stock.

Things get a bit more complicated where one class of stock is convertible into another class of securities, say upon a sale of shares into the market. In that case, you will still need to include two classes on the Form 4, one to report the conversion of the convertible securities - and the other to report the sale of those converted securities.

Short-Swing Matching: And what about short-swing matching for the two classes of securities? The SEC and the courts generally treat two classes of common stock that only have different voting rights independently of each other for determining 10% owner status under Section 16 of the Securities Exchange Act.

But things are a bit murkier in the area of short-swing matching - the SEC did not extend this position to the short swing profit recovery rules. But the Second Circuit in *Gibbons v. Malone*, 703 F. 3d 595 (2d Cir. 2013), held that transactions in different series of common stock were not matchable where the securities were separately traded, nonconvertible and have different voting rights.

This case is helpful for the position that transactions in typical dual-class securities should not be matchable with one another. But companies should nonetheless carefully track transactions involving the different classes of securities.

Insiders should be aware of the potential risk, including that the company may receive a demand letter from a plaintiff's lawyer seeking disgorgement of profits, notwithstanding the court case. The Section 16 plaintiff's bar continues to be inventive and resourceful.

4. Yes, You Can Disclaim Beneficial Ownership in a Form 4 in Appropriate Circumstances

Unless you're a diehard Section 16 fan, you might not realize that reporting securities as "indirectly owned through others" is not a binding admission of beneficial ownership. That can be a tough concept to grasp. It doesn't seem real sometimes.

Although not common, there certainly are situations where the extent of an insider's beneficial ownership isn't clear. In those cases of "genuine doubt," it may be appropriate to use a disclaimer of beneficial ownership in a Form 4.

This type of thing pops up sometimes for entity affiliations. For example, an insider who is a general partner of a partnership that holds company securities. Then you have the spousal (and legal partner) and family trust situations. An insider typically must report securities held by members of the insider's immediate family sharing the insider's household, even though the insider in appropriate circumstances may be able to rebut the presumption of beneficial ownership for those holdings.

For example, a gift of securities to an adult child living in the reporting person's household but who solely controls transactions in the shares. There also could be a situation where an insider reports securities indirectly held through an entity or trust in the aggregate - but only has a pecuniary interest in a portion of those securities. In that case, the insider can disclaim beneficial ownership for the amount in excess of the insider's pecuniary interest in the securities.

It remains dubious how valuable a disclaimer is, but if you're "Section 16 savvy" enough to spot the issue, you might as well include one under the appropriate circumstances. Disclosure also may be useful in warding off any claims of short-swing matching liability under Section 16(b) from the plaintiff's bar.

5. The Tricky World of Reporting Stock-Settled RSUs on Form 4s

Not too many choices exist in the technical world of Form 4 reporting. But there is a choice to be made for reporting grants of stock-settled, time-based restricted stock units (RSUs). For Section 16 nerds like me, this is as thrilling as it gets.

These grants can be reported on a Form 4 in either Table I as an acquisition of common stock (even though still subject to vesting) or in Table II where derivative securities are reported. Practices vary by companies. From time to time, in-house counsel may be asked by their Section 16 insiders about why the company reports its RSUs in the manner selected. Let's dig into the nerdy stuff:

To report RSUs in Table II of Form 4:

- Report the grant in Table II and footnote the vesting schedule.
- On each later vest date, report in Table II the conversion of the RSUs into underlying shares.
- On each later vest date, also report in Table I the acquisition of the underlying shares.

To report RSUs in Table I of Form 4:

- Report the grant in Table I. Footnote about vesting is not required but can be included.
- No later reporting on each vest date is required.

But in either case, shares withheld for taxes or sold to cover taxes need to be reported as a separate line-item in Table I. The insider can't report the net shares received if reporting vesting in Table I. For this

reason, some companies will decide to report RSU grants in Table II if they know they've got a tax transaction coming up later to report at vesting at any rate.

For RSU grants reported in Table I, the entire number of shares shows up as beneficially owned by the insider. Whoa! Here's where you can really help out your insider so they don't suffer a heart attack. Explain to them so they understand that shares are not being over-reported for them on their Form 4s.

Incidentally, this also means the number of shares reported as beneficially owned in the company's proxy statement may not match the Form 4, Table I report - which could also be the case for other reasons.

There really is no right answer when faced with this choice. You - and your insider - may have a preference for doing it one way over another as part of your internal Section 16 compliance program. You can even switch methods of reporting after reporting it one way at any time. You're not locked in just because your insider initially reported it a particular way.

It's important to note that these alternatives don't apply to RSUs that can be settled in cash instead of stock - which is a minority practice - or to performance RSUs where performance is based on metrics besides the company's stock price. Those are subject to different reporting rules. And a tale for another day.