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# HRO Alert

## The Sarbanes-Oxley Act of 2002

### NEW SECTION 16 REPORTING RULES

The Sarbanes-Oxley Act (the "SO Act"), enacted into law on July 30, 2002, made sweeping changes to the beneficial ownership reporting requirements under Section 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act"). Effective Thursday, August 29, 2002, directors, officers and 10% stockholders of U.S. public companies are required to file a Form 4 within two business days of execution of most transactions in the company's stock pursuant to rules issued by the SEC on Tuesday, August 27, pursuant to the SO Act. Forms 4 are used to report acquisitions or dispositions of the company's stock. Under the new rules, more transactions will be reportable on a Form 4 rather than on a year-end Form 5.

#### Accelerated Form 4 Filing Deadline

For transactions reportable on a Form 4, the new Section 16(a) rules require filing within two business days of the date the transaction in the company's stock is executed. The accelerated filing deadline applies to all Form 4 transactions occurring on or after August 29, 2002.<sup>1</sup> Transactions occurring before August 29 will continue to be reportable on Form 4 or Form 5 as required under the prior rules.

#### Transactions Between a Company and its Directors and Officers

In the Release adopting the new rules, the SEC emphasized that one of the purposes of the SO Act was to ensure immediate disclosure of stock transactions by directors and officers, especially transactions with the company. Accordingly, the SEC has eliminated deferred reporting on Form 5 for most Rule 16b-3 transactions between a company and its directors and officers. The following transactions will now need to be reported on a Form 4:

- Stock option grants and other securities awards from the company,
- Dispositions of shares to the company, and
- Discretionary transactions under an employee benefit plan that occur within six months of an opposite-way discretionary transaction under the same plan (e.g., a sale followed by a purchase).

Other transactions previously exempted from current reporting on Form 4 will continue to be eligible for deferred reporting on Form 5 within 45 days of year-end. These include gifts of shares to or from a reporting person, as well as changes in the form of ownership (such as a distribution of company shares to a director by a partnership she controls). Exercises of stock options and other derivative securities will continue to be reportable on Form 4 as before, but under the shorter filing deadline.

<sup>1</sup> The SEC noted that the accelerated filing deadline for Form 4 may mean that, in some instances, new directors or officers of a company may be required to file a Form 4 prior to the due date of their Form 3 (ten days after they become a director or officer). In these circumstances, the SEC recommends that the reporting person file the Form 3 at the same time as the Form 4, although early filing of the Form 3 is not mandatory.

Transactions that were previously exempt from Section 16 reporting will remain exempt under the new rules. These include:

- Transactions under qualified plans (such as 401(k) plans),<sup>2</sup>
- Transactions under excess benefit plans,
- Transactions under stock purchase plans qualified under Section 423 of the Internal Revenue Code, and
- Reinvestment of dividends or interest under broad-based dividend or reinvestment plans.

Non-qualified deferred compensation plan transactions and other dividend or interest reinvestment plan transactions will be reportable on Form 4 within two business days.

The current de minimis exception for acquisitions of shares not exceeding \$10,000 in market value will continue to exist under the new rules. However, when the threshold is exceeded, the reporting person will need to file a Form 4 within two business days of the date the threshold is exceeded. In addition, acquisitions of shares directly from the company **no longer qualify** for deferred reporting; all such transactions will need to be reported currently on a Form 4 within two business days.

#### **Limited Exceptions to Two-Day Reporting**

The SO Act authorized the SEC to exempt categories of transactions from the two business day filing requirement if the SEC determined that the deadline was not feasible for those types of transactions. The SEC determined that the accelerated deadline for filing Form 4 would not be feasible in two instances. These are:

- Certain transactions under a Rule 10b5-1 plan (a prearranged agreement with a broker to buy or sell company shares on certain dates or when the company stock price reaches a certain level), and
- Certain discretionary transactions under an employee benefit plan.

In these cases, the reporting person does not control the timing of the transaction and may not know when the transaction actually occurs. Thus, the SEC determined that a deemed transaction date should trigger the Form 4 filing obligation. Under the new rules, these transactions are deemed to occur on the date the reporting person receives notice from the broker or plan administrator that the transaction has occurred, provided that the notice is given within three business days of the actual execution date. The reporting person then has two business days from the notice date to complete and file a Form 4 reporting the transaction. If no notice is given, then the third business day after execution is the deemed transaction date. Reporting persons should make arrangements with their broker and plan administrator for prompt notice of any transactions, so that the Form 4 filing deadline can be met.

The deemed execution date rule does not apply to transactions that are arranged to occur on a specific date, such as the first business day of each month. In such cases, the actual execution date will trigger the Form 4 filing obligation.

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<sup>2</sup> Certain transactions involving the movement of investments within a plan trust are excluded from this rule.

The SEC confirmed that it does not currently intend to exempt other categories of transactions from the two business day filing deadline.

#### **No Change to Short-Swing Profits Rules**

The recently adopted rule amendments do not affect the short-swing profits rules under Section 16(b). This means that transactions now subject to accelerated reporting on Form 4, such as option grants, will remain eligible for exemption from Section 16's transaction matching and profits disgorgement provisions. We recommend that all companies continue to have their compensation committee or board of directors approve all option grants and other stock awards to directors and officers, to ensure that these grants cannot be matched against other stock transactions.

#### **Changes to Form 4**

In the Release, the SEC announced plans to publish a new version of Form 4 as soon as possible, and the new form is now available on the SEC website. The new Form 4 requires reporting persons to indicate a month, day and year for the transaction (rather than only the month and year as before), and to report beneficial ownership following the transaction(s) reported on the Form 4 (rather than as of month-end). Although Edgar filing of Forms 4 is not yet mandatory (it will become mandatory no later than July 30, 2003), the SEC encourages all reporting persons to file their forms electronically. In an effort to encourage Edgar filing, the SEC has relaxed some of its formatting rules for Forms 4 filed electronically.

#### **Comment Period**

The rules described in this Alert are already in effect. However, the SEC has requested public comments on the new rules. All comments must be received on or before September 30, 2002.

#### **How HRO Can Help**

As directors and officers transition to filing more frequent Forms 4 and eventually to electronic filing on the Edgar system, we anticipate that they, and their companies, will have many questions regarding the new Section 16(a) rules. If you would like to discuss any of these rules and how they will impact your company and its practices, we encourage you to contact any of the persons listed in this Alert.