

August 8, 2005

**SEC Clarifies Exemptions from Section 16 Liability**

The SEC has adopted clarifying amendments to two important exemptions from short-swing-profit liability under Section 16(b) of the Securities Exchange Act: (1) Rule 16b-3, which exempts certain transactions between an issuer and its officers or directors; and (2) Rule 16b-7, which exempts certain mergers, reclassifications, and consolidations. *See* Release No. 33-8600 (August 3, 2005) (available at <http://www.sec.gov/rules/final/33-8600.pdf>). The amendments are a direct response to the Third Circuit's decision in *Levy v. Sterling*, 314 F.3d 106 (2002), which imposed novel restrictions on the applicability of the exemptions.

In *Levy*, the Third Circuit held that grants, awards, and other issuances to officers or directors must be *compensation-related* to be eligible for exemption under Rule 16b-3(d). The Third Circuit also suggested that Rule 16b-7 would not exempt reclassifications that involve classes of securities with different risk-return characteristics (such as an exchange of non-convertible preferred stock for common stock) or that increase shareholders' percentage of common-stock ownership. (See our memo dated March 10, 2003.)

The SEC's clarifying amendments reaffirm its interpretation of Rules 16b-3 and 16b-7 and reject the Third Circuit's restrictions. As a result, officers and directors may once again rely on Rule 16b-3(d) to exempt certain board- or shareholder-approved acquisitions from or dispositions to the issuer, regardless of whether a compensation-related purpose can be demonstrated.

The amendments to Rule 16b-7 clarify that the only conditions for exempting a reclassification are those applicable to mergers and consolidations — that the company whose securities are acquired or disposed of owns 85% or more of the equity or assets of all companies that are parties to the transaction. Where a single issuer reclassifies one class of its securities into another, there is effectively 100% "cross-ownership" and the exemption is available. The SEC declined to define the term "reclassification," but provided examples of generally exempt reclassifications, including transactions in which an entire class of securities is replaced with securities of a different class and all holders of the reclassified securities are entitled to receive the same form and amount of consideration. The adopting release also clarifies that a transaction that has the same characteristics and effects as a merger or consolidation, such as an amalgamation or scheme of arrangement, also would be exempt without regard to the formal name of the transaction.

The clarifying amendments will be retroactive to the dates on which the SEC adopted the rules in their current forms — August 15, 1996 for Rule 16b-3, and May 1, 1991 for Rule 16b-7 — and are available to exempt any transaction occurring on or after those dates that satisfies the applicable conditions.

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