Guide to Short-Swing Transactions and Regulation

This guide is intended to summarize the complex regulatory framework surrounding short-swing transactions, as outlined in the Securities and Exchange Act of 1934. It should not in any way be substituted for legal advice or interpretation of SEC regulation. Further information about the Securities and Exchange Act can be found at http://www.sec.gov/about/laws.shtml.

A **short-swing transaction** is defined as the purchase and sale (or sale and purchase) of a company stock within a 6-month period or less. This type of transaction is particularly important in monitoring insider trading activity as it concerns the potential use of non-public information by company insiders to achieve short-term gains on equity trades.

Short-Swing FAQ

1) What is the SEC's Short-Swing Rule?

As stated in **Section 16b** of the **Securities and Exchange Act of 1934**, the Short-Swing Rule requires that certain company "insiders" who engage in any short-swing transactions involving a security, or security-based swap agreement, surrender any profits gained from the transactions.

2) To whom does the Rule apply?

The Rule applies to **Directors, Officers**, and **Beneficial Owners of more than 10 percent** of any class of equity security of the company whose stock is involved in the transaction.

3) Why was the Short-Swing Rule created?

The Rule was implemented to prevent the unfair use of non-public information by directors, officers, and other "insiders" to produce personal returns on equity transactions. In 2005, the SEC amended Section 16b to include **several exceptions to the Rule** (see "Detailed Explanation of Exceptions" section below).

4) How is the Rule Enforced?

Enforcement of the Rule relies on **Sections 16a** and **16b** of the **Securities and Exchange Act of 1934**. Section 16a requires designated insiders to disclose any purchases or sales of stock to the SEC. Section 16b allows the issuer of the security transacted to file a lawsuit against the insider in order to appropriate the gains from the transaction.

Note: **The insider does not have to be in possession of non-public information to be held in violation of the Rule. Violation is dependent on the nature of the transaction, regardless of whether or not the insider holds information pertinent to stock movement.**

Examples of Short-Swing Transactions

Transactions in Violation:

- A director of Company A buys 100,000 shares of the company on the open market. Four months later, the director decides to sell the shares while Company A is at a one-year high. The director stands in violation of the Short-Swing Rule, and Company A is legally entitled to file a lawsuit against the director to recover the profits gained from the director's purchase and sale of stock.

- A CEO decides to dispose of all of his holdings before he retires from Company Q in two months. Three months after his retirement, he buys 50,000 shares of the company. Though the former CEO is no longer part of Company Q, his purchase can be matched to the sale he made less than six months prior when he was still a reporting person. Therefore, the former CEO is in violation of the Rule. **Note:** If the first transaction had been deferred until the CEO's insider status had been officially terminated, the former CEO would not be held liable for short-swing gains.

- The wife of a CFO at Company R buys 2,000 shares of stock through her own account. Within the next six months, the CFO himself sells 250,000 shares of Company R. Since the CFO is recognized as the beneficial owner of family members' stock, he is held liable for any short-swing profits gained from the transaction, despite his wife buying through her own account.

Transactions Exempt:

- A CEO decides to purchase and sell 25,000 shares within a 6 month period, pursuant to a tax-conditioned employee stock purchase plan qualified under Section 423 of the Internal Revenue Code. Since the ESPP meets certain tax provisions of the IRC, the purchase and sale of shares under the plan do not violate the Short-Swing Rule.

Detailed Explanation of Exceptions to the Short-Swing Rule

As the legislation is primarily concerned with the misuse of insider information to realize short-term gains from trading activity, short-swing transactions which produce losses over any designated 6-month period ARE NOT subject to penalization under SEC regulation. Other exemptions from the Short-Swing Rule include the following types of transactions:

- **Exercise of In-the-money Stock Options**[1]
  - This includes the option to purchase shares, but does not include the sale of shares post-exercise.
- **Discretionary Transactions**
  - These include transactions involving an intra-plan transfer to or from a company stock fund, or cash distributions made to the participating employee funded by the disposition of a security.

[1] These are options where the market value of an equity is greater than the option exercise price on the date of exercise.

- These DO NOT include the following:
  - Transactions linked with death, disability, retirement, or termination of employment.
  - Transactions required under the Internal Revenue Code.

- **Grants, Awards and Other Acquisitions**
  - These include transactions that involve a grant, award or acquisition to an executive officer or director.
  - Also includes transactions pursuant to mergers or consolidations where the security purchased/sold is of a company that owns 85% of the equities or assets of all companies involved in the merger.
  - Exemptions occur when any of the following conditions are met:
    1. The transaction is approved by either the Board of Directors of a committee comprised of at least two non-employee directors.
    2. The transaction is approved/ratified by the majority of the company's shareholders no later than the next shareholder meeting.
    3. The acquired securities are held for a minimum of 6 months following the acquisition date.

- **Dispositions to the Company**
  - Include the following types of transactions:
    - Surrender of shares to meet tax obligations or the exercise price of options.
    - Cancellations, replacements, and surrenders of outstanding awards.
    - Company buybacks of outstanding awards.
    - Exercises of Stock Appreciation Rights[2] for cash.

- **Tax-Conditioned Plans**
  - These include qualified retirement plans, nonqualified excess benefit plans intended to compensate for limits of qualified plans, and certain stock purchase plans.
  - Specific exemptions under these terms include routine acquisitions of stock under a 401K, thrift, or stock purchase plan.

Sources:

The information used in this guide was taken from the following sources:

McDermott, Will & Emery –
http://www.mwe.com/info/pubs/SIEC2010.pdf

Meridian Compensation Partners, LLC – http://www.meridiancp.com/images/uploads/6_Section_16b-Insider_Trading_Rules.pdf

Simpson, Thatcher & Bartlett, LLP –
http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=81&focusID=610

[2] A right given to an employee which allows them to receive a bonus equal to the appreciation of a company's stock over a certain period of time.