

“insiders”) of the issuer of such security. Generally:

- Exchange Act Section 16(a) requires an insider to file an initial report with the Commission disclosing his or her beneficial ownership of all equity securities of the issuer upon becoming an insider. To keep this information current, Exchange Act Section 16(a) also requires insiders to report changes in such holdings, in most cases within two business days following the transaction.<sup>172</sup>

- Exchange Act Section 16(b) provides the issuer (or security holders suing on behalf of the issuer) a private right of action to recover from an insider any profit realized by the insider from any purchase and sale (or sale and purchase) of any equity security of the issuer within any period of less than six months.<sup>173</sup>

- Exchange Act Section 16(c) makes it unlawful for an insider to sell any equity security of the issuer if the insider: (1) does not own the security sold; or (2) owns the security, but does not deliver it against the sale within specified time periods.<sup>174</sup>

We do not believe that a group formed solely for the purpose of nominating a director pursuant to proposed Exchange Act Rule 14a–11, soliciting in connection with the election of that nominee, or having that nominee elected as a director, would be the type of group that should be viewed as being aggregated together for purposes of Exchange Act Section 16. Their actions are fully disclosed and are not for a “control” purpose, and they clearly do not have presumed “insider” status. Moreover, we believe it would be a disincentive to using the proposed security holder nomination procedure if security holders forming a group to nominate a director could become subject to Exchange Act Section 16 once the group owned over 10% of the company’s equity securities.

Accordingly, we are proposing an amendment to Exchange Act Rule 16a–1(a)(1), the rule that defines who is a 10% owner for Exchange Act Section 16 purposes, to exclude an Exchange Act Rule 14a–11 nominating security holder group from the definition.<sup>175</sup> These groups would remain subject to the general condition of the rule that they not have the purpose or effect of changing or influencing control of the issuer, but a note to Exchange Act Rule

16a–1(a)(1) would provide that members of nominating security holder groups would not be deemed to have a control purpose or effect solely by virtue of group membership.<sup>176</sup> We are not proposing to exclude from the definition of beneficial ownership for purposes of Exchange Act Section 16 security holders whose individual ownership exceeds 10% and are not otherwise excluded under the current rule.

Some security holders, particularly institutions and other entities, may be concerned that successful use of the proposed nomination procedure to elect a director may result in the nominating person also being deemed a director under the “deputization” theory developed by courts in Exchange Act Section 16(b) short-swing profit recovery cases.<sup>177</sup> Under this theory it is possible for a person to be deemed a director subject to Exchange Act Section 16, even though the issuer has not formally elected or otherwise named that person a director. The judicial decisions in which this theory was applied do not establish precise standards for determining when “deputization” may exist. However, the express purpose of Exchange Act Section 16(b) is to prevent the unfair use of information by insiders through their relationships to the issuer.<sup>178</sup>

Accordingly, one factor that courts may consider in determining if Exchange Act Section 16(b) liability applies is whether, by virtue of the “deputization” relationship, the “deputizing” entity’s transactions in issuer securities may benefit from the deputized director’s access to inside information.<sup>179</sup>

Proposed Exchange Act Rule 14a–11 includes standards for establishing the independence of the nominee from the nominating security holder, or members of the nominating security holder group, as applicable. We believe that, given these independence standards the “deputization” theory, whereby the

beneficial ownership of a security holder or group is imputed to a “deputized” director (and director status imputed to the security holder or group), should not apply. In considering the proposed independence standards, discussed in Section II.A.8, above, commenters also should consider the director by “deputization” theory, and whether the proposed standards should be modified in any way to make it less likely that in Exchange Act Section 16(b) cases courts would find nominating security holders to be “deputized” directors in circumstances where liability should not apply.

#### b. Questions

N.1. Would the proposed Exchange Act Rule 16a–1(a)(1) amendments address nominating security holders and nominating security holder groups appropriately? Should the proposed exclusion be based on any additional or different conditions?

N.2. If the Commission adopts a security holder nomination rule with an eligibility threshold of 10% or greater, would Exchange Act Section 16 reporting and short swing profit liability deter the formation of nominating security holder groups?

#### C. General Request for Comment

We request and encourage any interested person to submit comments regarding:

- The proposed amendments that are the subject of this release;
- Additional or different changes; or
- Other matters that may have an effect on the proposals contained in this release.

We request comment from the point of view of companies, investors and other market participants. With regard to any comments, we note that such comments are of great assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

### III. Paperwork Reduction Act

#### A. Background

The proposed amendments contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995.<sup>180</sup> We are submitting the proposal to the Office of Management and Budget for review in accordance with the PRA.<sup>181</sup> The titles for the collections of information are:

- (1) “Proxy Statements—Regulation 14A (Commission Rules 14a–1 through

<sup>176</sup> Exchange Act Rule 16a–1(a)(1) [17 CFR 240.16a–1(a)(1)] also contains a general condition that the securities be held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business, but this condition would not be applicable to nominating security holder groups. We believe that the requirement that they qualify for Exchange Act Schedule 13G rather than Exchange Act Schedule 13D provides adequate protection in this area.

<sup>177</sup> See *Feder v. Martin Marietta*, 406 F.2d 260 (2d Cir.), cert. denied, 396 U.S. 1036 (1970); *Blau v. Lehman*, 368 U.S. 403 (1962); and *Rattner v. Lehman*, 193 F.2d 564 (2d Cir. 1952).

<sup>178</sup> Exchange Act Section 16(b) begins: “For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer. . . .”

<sup>179</sup> See, e.g., *Feder v. Martin Marietta*, at note 177, above.

<sup>180</sup> 44 U.S.C. 3501 *et seq.*

<sup>181</sup> 44 U.S.C. 3507(d) and 5 CFR 1320.11.

<sup>172</sup> Exchange Act Section 16(a) [15 U.S.C. 78p(a)].

<sup>173</sup> Exchange Act Section 16(b) [15 U.S.C. 78p(b)].

<sup>174</sup> Exchange Act Section 16(c) [15 U.S.C. 78p(c)].

<sup>175</sup> Proposed Exchange Act Rule 16a–1(a)(1)(i).

Exchange Act Rule 16a–1(a)(1) also would be reorganized for clarity.