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Senate defense bill's Section 16 expansion would be a significant change for foreign private issuers

September 21, 2023 | Client Update | 5-minute read

Buried in a defense spending bill that clocks in at over 2,000 pages is an amendment to Section 16 of the Exchange Act that would extend its application to foreign private issuers, adding a meaningful compliance burden on foreign companies listing on a U.S. stock exchange.

On July 27, 2023, the U.S. Senate passed its version of the National Defense Authorization Act for Fiscal Year 2024 with broad bipartisan support. The Senate and House of Representatives are now in the process of resolving differences between their respective versions of the bill. Buried in the Senate bill is Section 6081, which would extend the application of Section 16 of the Securities Exchange Act of 1934, or the Exchange Act, to foreign private issuers.

Why Section 16 matters

Section 16 of the Exchange Act applies to directors, officers and any person who beneficially owns more than 10 percent of any registered class of a company's equity securities (commonly referred to as "insiders"). It requires insiders to immediately report transactions in company securities and disgorge imputed profits from short-term trading in those securities.

Securities of foreign private issuer insiders are currently exempt from these reporting requirements, and such insiders are not subject to the short-swing disgorgement rules that apply to insiders of domestic public companies. In addition, compensation of foreign private issuer directors and officers is currently only disclosed on an aggregate basis unless individual disclosure is made in the home country, and share ownership of each director and officer is disclosed only if it is greater than 1% of a class of shares. Equity compensation can be a significant component of director and officer compensation, and the proposed change to Section 16 would require disclosure of equity compensation information that such insiders may never have previously publicly disclosed. This would represent a significant change from existing foreign private issuer insider disclosure obligations.

Insider reporting requirements

Directors, officers and 10 percent shareholders must report their initial holdings on Form 3 on the same day that a company goes public (which generally is the date the registration statement becomes effective), or within ten calendar days of when a person becomes a new director or officer of an already-public company. In addition, they must report most equity transactions (including purchases and sales, gifts, and compensation-related transactions (e.g., equity compensation grants, sales to cover exercise price payments and tax withholding obligations)) on Form 4 within two business days of the transaction. They must also report certain previously unreported transactions on Form 5 within 45 days after the end of the applicable fiscal year.

Disgorgement of short-swing profits

Section 16 also requires insiders to disgorge all profits derived from any purchase and sale, or sale and purchase, of a company's equity securities in which the insider has a direct or indirect pecuniary interest that occurs within any period of less than six months. It is a strict liability statute and does not require a showing of actual possession or misuse of insider information, or of unlawful intent, to require disgorgement. Even transactions within six months prior to listing by officers or directors may need to be reviewed to prevent inadvertent Section 16 issues – particularly if these individuals may sell or purchase shares in a secondary component of an initial public offering. Section 16(b) (which regulates short-swing trading) is not enforced by the SEC but instead by an active plaintiffs' bar. This means insiders must carefully consider any sale or purchase, including any transactions that may be deemed to be a sale or purchase, of company securities to avoid the application of such disgorgement rules.

Consequences of Section 16 violations

Violating Section 16 reporting rules can be embarrassing for insiders and companies alike, and can occasionally trigger SEC scrutiny. And it is a violation of the securities laws by the insider. Engaging in a transaction that causes a short-swing profit can be expensive for the individual and time-consuming for the company. The SEC also has broad authority to seek "any equitable relief that may be appropriate or necessary for the benefit of investors" for violations of any provisions of the securities laws. In addition, the statute of limitations under the short-swing profit rules is tolled during any period when a required filing has not been made for the transaction in question.

Expansion of Section 16 to foreign private issuers

SEC rules applicable to foreign private issuers generally defer to home country standards and allow for accommodations in form and other requirements in order to encourage foreign company listings in the United States. However, one recent study has linked this disparity in part to a significant amount of opportunistic selling by corporate insiders at certain foreign companies listed in the United States. In response, certain lawmakers have sought to impose the same level of disclosure to transactions by insiders of foreign private issuers, despite the lack of any groundswell of interest from investors for this information.

The SEC has recently imposed a number of new substantive reporting requirements on foreign private issuers, and we are concerned that the potential impact of this change could further discourage foreign issuers from listing in the United States. Indeed, SEC Commissioner Uyeda recently lamented the change in approach towards foreign private issuers and what he views as an insufficient recognition of the important differences between foreign private issuers and domestic issuers. Notably, the SEC has recently adopted a proscriptive clawback rule that applies to foreign private issuers and their executive officers and a rule mandating quarterly disclosure of stock repurchases.

Though prior efforts to expand Section 16 to foreign private issuers in the Holding Foreign Insiders Accountable Act introduced in 2022 and again in 2023 have failed, this most recent effort through the annual defense bill has advanced significantly further. It remains to be seen whether Section 6081 survives in the final version of the bill that is sent to President Biden's desk for his signature. We are hopeful that legislators slow down and consider the implications. Should Section 6081 pass unaltered, the SEC will have 90 days to issue final regulations implementing the changes.

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