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Securities Law Considerations for Trusts and Estates Advisors: Part II

Reporting and short-swing profit rules applicable to insiders

As trusts and estates advisors, we often counsel our high-net-worth (HNW) clients in connection with wealth transfers of their interests in various types of entities. In Part I of this series,[1] we discussed the U.S. securities law considerations for trusts and estates advisors in connection with common estate-planning vehicles investing in private investment funds. In addition, trusts and estates advisors should be aware of potential reporting and short-swing profit rules applicable to transactions involving interests in publicly traded companies, for clients who are considered "insiders" under Section 16 of the Securities Exchange Act of 1934 (the Exchange Act).

Specifically, if a client owns a significant interest in, or serves as a director or officer of, a publicly traded company, Section 16 may require him to report, in public filings made with the Securities and Exchange Commission, his transactions in and ownership of certain equity interests in such company. Although the timing of a proposed transaction may be beneficial for a client's wealth transfer planning, Section 16 may dictate that such a transaction may inhibit his ability to participate in future, non-wealth transfer planning transactions involving the same class of securities. That's why it's important for trusts and estates advisors to understand these U.S. securities law implications so that a client's wealth transfer doesn't overshadow his non-tax objectives.

Here's an overview of HNW clients deemed to be "insiders" under Section 16 and the potential reporting implications of common wealth transfer planning transactions.


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Overview of Section 16

Section 16 generally sets forth the disclosure requirements of certain transactions and holdings by insiders; prohibits those insiders from realizing profits derived from such transactions occurring within a period of less than six months; and prohibits those insiders from selling short (that is, selling shares not owned) the securities of their affiliated companies.[2] Although many clients hold publicly traded securities (or derivatives of a subject security), not all transactions in such securities will be subject to Section 16. The purpose of the reporting rules under Section 16 is to notify the public of insider trading and deter such insiders from gaining profit on such transactions when they possess material information not available to the general public.[3] In effect, an insider is deemed to have advantageous information regardless of whether the insider intends to profit from it. Therefore, if the insider profits from certain reportable transactions under Section 16, a strict liability, short-swing profit rule requires the insider to disgorge such profit even if no material, non-public information was part of the transaction.

To analyze a transaction under Section 16, one must determine whether the transaction is subject to reporting under Section 16(a) and, if so, whether the short-swing profit rule of Section 16(b) applies so that any purchase or sale within six months of the initial transaction will be subject to profit disgorgement.

Insiders

A threshold determination under Section 16(a)(1) is whether a person is subject to Section 16 reporting, that is, whether he's a principal stockholder, officer or director of an issuer (an insider). Generally, a person will

qualify as a principal stockholder if he holds more than 10 percent of a class of securities of an issuer, discussed below. A person who's serving as a director of the issuer is by definition a "director" under Section 16. As to an officer, a person's title alone won't trigger insider status; rather, such person must also perform policymaking functions of the issuer.[4]

Therefore, trusts and estates advisors should inquire whether a client is a potential insider as part of the client intake process. If so, a client should obtain securities law advice generally if at any time he's considered an insider unrelated to any wealth transfer planning issues and ensure his compliance with any reporting obligations.

Principal stockholder. For Section 16 purposes, a principal stockholder is a "person who is directly or indirectly the beneficial owner of more than 10 percent of any class of a subject security."[5] This status applies to stockholders who beneficially own a company's securities under Section 13(d) of the Exchange Act,[6] which is any person who has or shares voting power or investment power over such securities. It also applies to any person who has the right to acquire such beneficial ownership, generally within 60 days, but at any time in the case of securities or rights acquired to change or influence the control of the issuer or in a transaction with a similar purpose or effect. For example, an individual could be deemed to own a company's class of securities for Section 13(d) purposes if he's an investment trustee of a trust holding such securities.[7]

Although "beneficial ownership" for purposes of being subject to Section 16 as an owner of more than 10 percent of an applicable class of security is determined under Section 13(d), for all other purposes, Section 16 is concerned with a person's pecuniary interest in the securities. Specifically, "the term pecuniary interest in any class of equity securities shall mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities."[8] Although a client may not hold such an interest individually, he could hold an indirect pecuniary interest if a member of his immediate family sharing his household also owns the subject securities.[9] A person may also hold an indirect pecuniary interest in securities as a general partner of a partnership holding such securities, pro rata.[10]

Trusts as principal stockholders. A principal stockholder analysis applies to trustees, beneficiaries and settlors of trusts as well as individuals. If a trust holds more than 10 percent of a company's class of securities, the trustee will be deemed to be a beneficial owner of the trust's securities, and such trust's holdings will generally be counted in the trustee's individual holdings for Section 16 purposes if he has voting or investment control over securities in the trust (for example, as an investment trustee).[11] Further, as to a revocable trust, the settlor thereof will be treated as the beneficial owner of the securities if he has the power to revoke the trust without the consent of another person.[12] We'll discuss a trust's holdings and imputed beneficial ownership to settlors, trustees and beneficiaries in further detail in our analysis of trust transactions below.

If an insider transacts in an issuer's equity securities, then the transaction may be reportable to the SEC under Section 16.

Reporting Generally

If an insider transacts in an issuer's equity securities, then the transaction may be reportable to the SEC under Section 16. If so, the insider must report the transaction on a Form 3, 4 or 5, depending on the nature of the transaction.[13] All such forms must be filed electronically and may be accessed by the public through the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system or by reposting on the issuer's website.[14]

A Form 3—Initial Statement of Beneficial Ownership of Securities would be required for an event causing insider status (for example, the initial registration of the security under Section 12 of the Exchange Act (which is due by the effective date of registration statement), an

acquisition of more than 10 percent of the issuer's class of securities or on becoming an officer or director). Except in the case of the initial registration of an issuer's equity securities, a Form 3 must be filed within 10 days of the triggering event. An individual who's an insider would initially be required to file a Form 3.[15]

After becoming required to file a Form 3, the insider's changes in beneficial ownership of such securities (that is, acquisitions and dispositions) may be reportable on a Form 4—Statement of Changes in Beneficial Ownership, due within two business days of a reportable transaction, or on a Form 5—Annual Statement of Changes in Beneficial Ownership of Securities, due 45 days after the close of the company's fiscal year. A limited class of transactions, primarily bona fide gifts, is eligible for deferred reporting on a Form 5, but an insider could voluntarily report the gift soon after the transfer on a Form 4. Purchases and/or sales for wealth transfer purposes (for example, a sale by an insider to a grantor trust for the benefit of his family members), may be treated as a sale and purchase for Section 16 reporting purposes and should be reported on a Form 4.

A trust's holdings may be required to be reported if the trust holds more than 10 percent of the outstanding securities of an issuer.

Therefore, the primary securities law disclosure consideration for trusts and estates advisors should be whether a proposed wealth transfer transaction may be considered a change in beneficial ownership reportable on a Form 4 or a Form 5, but the short-swing profit rule (discussed further below) is also potentially relevant to such transactions.

Reporting by Trusts

A trust's holdings may be required to be reported if the trust holds more than 10 percent of the outstanding securities of an issuer.[16] If a single trust is divided into subtrusts, Rule 16(a)-8 under the Exchange Act will treat the subtrusts as one trust for reporting purposes. Further, if more than one person is deemed to be a beneficial owner of securities owned by a trust, both persons must report their beneficial ownership under Section 16, although such reports may be made individually or jointly.[17]

Trustee. Generally, the trustee will report for the trust's securities and may be required to report individually the trust's securities if he has a pecuniary interest in the trust, such as by reason of receiving a performance-based fee from the trust (in contrast with an asset-based fee, such as a trustee's annual statutory commissions). On the other hand, if the trustee or at least one beneficiary of the trust is a member of the trustee's immediate family, the trustee will be deemed to have a pecuniary interest in the trust's holdings. If an insider is a trustee of a trust and has a pecuniary interest in the trust, the insider-trustee's individual transactions and trust transactions could be subject to matching for purposes of the short-swing profit rule, discussed below.

Settlor. The settlor of a revocable trust will report the trust's securities if he has or shares investment control over them. If the settlor has ceded investment control to another person (for example, to a co-trustee), the trustee will report the trust's holdings when applicable, as described above.

Beneficiary. A beneficiary typically doesn't report trust transactions unless the beneficiary directs the trustee as to investments, for example, if the beneficiary is serving as an investment advisor to the trust. In that case, the trust's transactions may be matched with the beneficiary's individual transactions for purposes of Section 16(b).

If the beneficiary shares investment control over the trust's securities with a co-trustee, then both the trustee and the beneficiary individually must report the securities held in the trust, as applicable. That being said, if a beneficiary is deemed to be a beneficial owner of the securities, Section 16 deems the beneficiary to have only a pro rata interest in the trust's holdings, rather than an interest in the entire trust's holdings.[18]

Under the above rules, a "beneficiary" is generally limited to a current beneficiary of a trust. A remainder beneficiary's interest in a trust won't count as a beneficial interest unless the beneficiary also has investment control over the securities held in the trust (either

singly, as an investment trustee or investment advisor or shared with a trustee).

Short-Swing Profit Rule

Section 16(b) generally sets forth the short-swing profit rule applicable to disclosed transactions. If an insider engages in a purchase and sale (or sale and purchase) in a subject security, then engages in an opposite-way transaction (for example, a sale in which the first transaction was a purchase) within a period of less than six months, any profit realized on the transaction will be recoverable by the issuer of the subject securities. If the issuer doesn't take action to recover the profit, any shareholder of the issuer's securities may bring an action to recover such profits on the issuer's behalf. This right to recover profit arises regardless of the intention of the insider in entering into the transaction[19] and may neither be waived nor indemnified by the issuer.

As a result, trusts and estates advisors should counsel clients to consult with securities law advisors to evaluate whether a proposed transaction may be viewed as a purchase and sale for Section 16(b) purposes. If so, the client should avoid additional transactions for six months following such purchase and sale to reduce the risk of suit from the issuer or any shareholder seeking to sue on the issuer's behalf.

Exempt transfers. Despite the general rules stated above, certain transactions are exempt from Section 16(b), and a smaller class is also exempt from Section 16(a).[20] Generally, if a transaction is exempt from Section 16(a) reporting, it will also be exempt from the short-swing profit rule of Section 16(b).

Specifically, a change in form of beneficial ownership that doesn't change the insider's pecuniary interest in the securities is exempt from Section 16. For example, a transfer from an individual insider to a trust of which he's the sole beneficiary and investment trustee (for example, a revocable trust) will be exempt from Section 16. Although the insider has a pecuniary interest in the securities before and after the transfer to the trust, the insider should ensure that in future filings, he reports the securities as indirectly held rather than directly held by him.

As to Section 16(b), Rule 16b-5 under the Exchange Act exempts bona fide gifts and transfers by will from the short-swing profit rule.[21] Therefore, a gift transfer by an insider to a family member, whether outright or in trust, will be exempt from a matching transaction within six months of the gift. Note, however, that an exemption from the short-swing profit rule alone doesn't exempt the transaction itself from reporting under Section 16(a). Rather, such a gift transfer isn't required to be reported on a separate Form 4, but the transfer may be reflected on a Form 5.

Trusts for the Settlor's Benefit

Revocable trusts. As mentioned above, an insider's transfer of securities to a trust revocable by the settlor without the consent of any person (presumably for the benefit of the settlor alone) will be exempt from Section 16 because the transfer to the trust doesn't change the settlor's pecuniary interest in the subject securities. Further, the insider will continue to report the trust's transactions and holdings as part of his individual reports, although he'll report the trust's holdings as indirectly, rather than directly, held by him.

If the settlor doesn't have sole investment control over the securities held in a revocable trust, the trustee will report the securities held by the trust, rather than the settlor.[22] Therefore, to ensure a revocable trust qualifies for an exemption to Section 16 reporting and, following the transfer, the securities will be reported by the settlor only, a revocable trust agreement should give the settlor the unqualified power to revoke the trust and exclusive investment control over the transferred securities.

Irrevocable trusts. Even if a trust is irrevocable, a transfer by a settlor-insider to a trust of which he's the sole current beneficiary and investment trustee isn't reportable by the insider.[23] As a reminder, Rule 16a-8(c) ignores a remainder beneficiary's interest in the trust for the purpose of determining the beneficial ownership of a trust holding such securities.

In that connection, the SEC determined in *Peter J. Kight*[24] that an insider may create a grantor retained annuity trust (GRAT) with securities without reporting the initial transfer and annuity payments between him and the GRAT pursuant to Rule 16a-13, so long as the settlor is both a trustee and the sole current beneficiary. Specifically, at least three types of transfers will occur during the term of the GRAT: (1) the initial transfer by the insider to the trustee of the GRAT; (2) annuity payments from the trustee to the grantor-insider pursuant to the GRAT's terms; and (3) if the GRAT is successful, a final transfer of the remaining assets of the GRAT from

the trustee to the remainder beneficiaries or to one or more continuing trusts. We'll analyze the Section 16 implications of each of these transfers below.

Initial transfer to GRAT. During the GRAT term, the grantor-insider is the sole current beneficiary of the trust. Typically, the insider is also the sole trustee with investment control over the GRAT's securities. Under those facts, the insider's initial transfer to the GRAT will reflect a change in form of beneficial ownership of the securities without changing the insider's pecuniary interest in such securities.[25] Therefore, following the transfer from the insider to the GRAT, the insider's future reports should reflect that he holds the GRAT's securities indirectly rather than directly.

Annuity payments. During the GRAT term, the GRAT will pay the grantor-insider a series of annual annuity payments. An annuity payment made in the securities originally contributed to the GRAT is simply the reverse of the insider's initial transfer to the GRAT, and so any such annuity payment will also be exempt from reporting.[26] If the GRAT instead sells securities to generate proceeds to make the annuity payment in cash, the insider would report the sale by the GRAT. After an annuity payment, the insider should report the securities comprising the annuity payment as directly held, while the remaining securities held by the GRAT will continue to be treated as indirectly held by the insider.

Following the GRAT's termination. After the GRAT's final annuity payment to the insider, any remaining securities held in the GRAT will pass to the GRAT's remaindermen (that is, to beneficiaries other than the grantor-insider). In *Peter J. Kight*, the GRAT's securities passed to trusts for the benefit of the insider's minor children who shared his household, of which the grantor's spouse (or a corporate trustee) was the trustee, and the children had no investment control. Under those facts, the SEC determined that the transfer from the GRAT to the trusts for the insider's children would be exempt gift transfers under Rule 16b-5 and reportable on a Form 5.

Transfers to Others

Gratuitous transfers. Under Rule 16b-5, insiders may gift securities to third parties, either outright or in trust, and such gifts will be exempt from the short-swing profit rule of Section 16(b).[27] Any such gift would be eligible for deferred reporting on a Form 5. If a principal stockholder-insider transfers securities by gift to a member of his immediate family sharing his household or to a trust for the benefit of such family member, the insider would typically continue to count such gifted securities for purposes of determining his 10 percent principal stockholder status. Further, if an insider (by principal stockholder status or otherwise) is serving as a trustee of such trust, Section 16 will deem him to own a pecuniary interest in such securities, although his interest therein would change from direct to indirect.

In addition, Section 16 exempts transfers at death by will or by intestacy under Rule 16b-5.

Transfers for consideration. If an insider transfers securities to a trust for consideration, such transfer may not qualify for an exemption from Section 16(a) or (b) and, therefore, could be reportable on a Form 4 or be subject to the short-swing profit rule. Depending on the trustees and beneficiaries of the trust, the insider may have an indirect pecuniary interest in the securities (for example, if the insider is a trustee of the trust and his immediate family members are trust beneficiaries). Therefore, the transfer would be subject to matching with the insider's (or the trust's) transactions within six months.

A transfer for consideration may occur in the context of a sale to a grantor trust or a grantor-insider's exercise of his power to substitute securities for property of equivalent value.[28]

Note, however, that if the transfer is between two identical trusts, the transfer is arguably exempt if pecuniary interests don't change as a result of the transfer.

Distributions from or to trusts. Following a transfer of securities to a trust, distributions from the trust to a trust beneficiary may be reportable transfers. In the case of a GRAT, there's clear authority from the SEC that annuity payments from the GRAT to the grantor-insider are exempt from Section 16. For example, a distribution from a trust of which the insider is a trustee and the insider's immediate family members are the beneficiaries to an immediate family member may be deemed to be merely a change in the form of beneficial ownership without changing the insider's pecuniary interest. On those facts, the trust is deemed to be indirectly held by the trustee-insider, and the transfer to the immediate family member would be deemed indirectly held by the

insider. In other cases, trust distributions to beneficiaries may be subject to Section 16, although if made for no consideration, they typically wouldn't seem to give rise to the possibility of "profits" subject to the short-swing profit rule.

Further, a transfer by one trust to another trust without consideration is also seemingly exempt from Section 16 if the relevant material characteristics of both trusts are identical. For example, a transfer of securities from one trust to another pursuant to decanting to merely extend the term of a trust may be an exempt change in the form of beneficial ownership under Rule 16a-13. Conversely, decanting a trust to narrow the class of beneficiaries may be deemed to be a change in beneficial ownership. Therefore, a conservative approach to decanting trusts may be to report the transfer on a Form 4 and avoid similar transactions for six months, even though such transfer may be exempt from Section 16(b) and eligible for deferred reporting on a Form 5.

Advising Clients

Although the above summary of Section 16 rules and reporting isn't exhaustive, our intention in writing this article is to arm trusts and estates advisors with general information to highlight potential securities law issues when counseling clients on wealth transfer transactions. In our practice, we often recommend GRATs and sales to grantor trusts to clients who wish to engage in estate-planning freeze transactions. Although there are several non-tax considerations associated with choosing a GRAT over a sale to a grantor trust, the administrative costs of obtaining an annual valuation of illiquid assets could be a reason to choose a sale technique over a GRAT. If the client's illiquid assets are subject to Section 16 reporting, then opting for a GRAT, which has a clear exemption from Section 16 during the GRAT term, versus a non-exempt sale to a grantor trust, may be a decisive factor for a client who may wish to trade in the subject securities independent of the wealth transfer.

Therefore, a trusts and estates advisor who understands these potential consequences can be proactive and guide clients to wealth transfer transactions that meet their tax and non-tax objectives. In all cases, however, trusts and estates advisors should coordinate any potential transactions, including exempt transfers, with an insider's securities law advisors and the issuer's counsel to ensure the proper treatment and reporting of all such transactions.

Endnotes

1. Arlene Osterhoudt and Ivan Taback, "Securities Law Considerations for Trusts and Estates Advisors: Part I," *Trusts & Estates* (July 2016), at p. 19.
2. 15 U.S.C. Section 78p.
3. "Ownership Reports and Trading By Officers, Directors and Principal Security Holders," Exchange Act Release No. 34-28869 [1990–1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) par. 784,709 (Feb. 8, 1991).
4. 17 C.F.R. Section 240.16a-1(f).
5. 15 U.S.C. Section 78p(a)(1).
6. 17 C.F.R. Section 240.13d-3.
7. *Ibid.*
8. 17 C.F.R. Section 240.16a-1.
9. "The term immediate family shall mean any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and shall include adoptive relationships." *Ibid.,* Section 240.16a-1(e).
10. *Ibid.*, Section 240.16a-1(a)(2)(ii)(B).
11. We note, however, that a professional trustee is exempt if a 13G exemption applies. *Ibid.*, Section 240.16a-8(a)(1).
12. *Ibid.*, Section 240.16a-8(b)(4).
13. For general reporting rules, *see* Securities and Exchange Commission, "Fast Answers: Forms 3, 4, 5," *www.sec.gov/answers/form345.htm.* For equity securities rules, *see* SEC,"Fast Answers: Insider Trading," *www.sec.gov/answers/insider.htm.*
14. SEC,"Important Information About EDGAR," *www.sec.gov/edgar/aboutedgar.htm.*
15. 17 C.F.R. Section 249.103.
16. *Ibid.*, Section 240.16a-8.
17. *Ibid.*, Section 240.16a-1(a)(3).
18. *Ibid.*, Section 240.16a-8(b)(3)(iii).
19. 15 U.S.C. Section 78p(b).
20. 17 C.F.R. Section 240.16a-13.
21. *Ibid.*, Section 240.16b-5.
22. *See supra* note 12.
23. American Bar Association, SEC No-Action Letter, [1990–1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) par. 79,689 (May 2, 1991).
24. *Peter J. Kight,* SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) par. 77,403 (Oct. 16, 1997).
25. *See supra* note 20.
26. *See Kight, supra* note 24.
27. *See supra* note 21.
28. *Morales v. Quintiles Transnat'l Corp.*, 25 F. Supp.2d 369 (S.D.N.Y. 1998); Stanton P. Eigenbrodt, *Practical Guide to Section 16* (4th ed. 2016), at Section 8.05.