Who are your Section 16 officers?

By: Lee G. Lester

09.25.2013

For the most part, determining your Section 16 officers is a fairly routine matter, and the SEC respects and rarely challenges these determinations due to their fact-sensitive nature. The SEC recently made such a challenge, however, and lost in a federal court case involving a company?s conclusions regarding its own officers.

A definitional refresher

The SEC similarly defines an ?officer? in Rule 16a-1(f) and an ?executive officer? in Rule 3b-7, both under the Securities Exchange Act of 1934 (the ?Exchange Act?). Rule 16a-1(f) defines the term as the president, principal financial officer, principal accounting officer, any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer.

Rule 3b-7, applicable to the identification of executive officers in Exchange Act reports such as proxy statements and annual reports on Form 10-K, defines the term as president, any vice president of the registrant in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the registrant. A note to Rule 16a-1(f) indicates that the term ?policy-making function? is ?not intended to include policy-making functions that are not significant.?

Many times, the persons identified as executive officers in a proxy statement also will be Section 16 reporting officers, and vice versa. While little, if any, analysis is required to designate the individuals with titles enumerated above as executive officers, companies are faced with a factual determination of who performs a ?policy-making function.? Officers of a company?s parent or subsidiaries also may be executive officers of a company if they perform such policy-making functions for the company. Unfortunately, the SEC has issued surprisingly little guidance on this point. In the SEC?s recent challenge, however, the court?s decision centered primarily on this ?policy-making? function.

SEC v. Prince

The SEC brought several claims in a civil action against Gary Prince, an employee of Integral Systems, Inc., all of which were based on the allegation that Prince was a *de facto* officer of Integral, and, as a result, should have been disclosed in Integral?s Exchange Act filings. Prince also had a troubled legal history that, had he been identified as an executive officer in Integral?s filings, would have required disclosure.

Specifically, Prince pleaded guilty in 1995 to conspiracy to commit securities and bank fraud and to making false statements to SEC staff and was sentenced in 1997 to two months of incarceration, two months of home detention, and two years of probation. In 1997, the SEC also permanently enjoined Prince from appearing or practicing before the SEC as an accountant. Following Prince?s short prison term, Integral hired him in 1998 with two goals: (1) to create a position that would not require disclosure of his legal history in its public filings and (2) to create procedures to ensure that he would not be involved with Integral?s accounting department.

It is undisputed that Prince, whose title was Director of Mergers and Acquisitions, had a significant amount of influence at Integral. Among other things, he:

- Headed the mergers and acquisitions program, with primary responsibility for the day-to-daydetails regarding potential acquisitions and supervision of those previously acquired;
- Acted as an equal, vocal member of a management group referred to internally as the Gang of Six (or Gang of Seven) that met to discuss important policy decisions and make recommendations to the CEO;
- Was a highly valued employee, who worked closely with and whose office was right next to the CEO?s;
- Assessed and recommended compensation and bonus amounts for others;
- Supervised employees;
- Reviewed and approved significant contracts;
- Made regular presentations to the Board of Directors; and
- Was one of the five highest paid individuals at the company.

After reviewing these facts, the court reasoned that, independently and taken together, they were not enough to show that Prince performed a policy-making function. While he exercised significant influence and was very close to the CEO, he did not have the final authority to make or implement policy decisions. Ultimately, the decision rested on the court?s distinction between influence and decision-making authority; in Integral?s case, all final decisions were made by the CEO.

Implications

This decision provides an interesting and well-reasoned analysis of determining the point at which an employee performs policy-making functions. In this case, a highly-valued member of the CEO?s inner

circle was not performing such a function, because the CEO retained final decision-making authority. This analysis suggests that high-level, influential employees may not be performing a policy-making function where they do not exercise final decision-making authority over major policy decisions.

While this analysis is helpful, it is important to keep in mind that Prince headed the company?s M&A program, an area in which final decisions necessarily are made at the highest corporate levels. In addition, the court opened the door for the SEC to argue in the future that the type of influence and authority enjoyed by Prince with respect to the M&A program, even without final decision-making authority, is similar to the policy-making function of a ?vice president in charge of a principal business unit, division or function??who, by definition, would be an officer or executive officer under Rule 16a-1(f) or Rule 3b-7, respectively. The SEC did not present this argument, however, and the court did not directly address it.

Related People

- Lee G. Lester ? 804.420.6583 ? llester@williamsmullen.com

Related Services

- Securities & Corporate Governance
- Solar & Energy Storage - SAMPLE PRACTICE