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A Primer on Section 16 Officers

Your old college buddy Sam Baker has just been appointed CFO of Dixie Candles, Inc. While telling Sam about her promotion, Dixie's CE mentioned in passing that of course Sam was now a "Section 16 officer" given that the CFO serves as both principal financial officer and principal accounting officer for the company. In her excitement, Sam forgot to ask exactly what was a Section 16 officer, so she calls you for a quick primer.

Here is what you need to know about Section 16 officers:

Obligations of Section 16 officers

Under Section 16(a) (<https://www.law.cornell.edu/uscode/text/15/78p>) of the Exchange Act, each person deemed to be an "officer" in accordance with Rule 16a-1(f) (<https://www.law.cornell.edu/cfr/text/17/240.16a-1>) is required to file with the SEC various forms indicating their ownership of or transactions in the company's securities, including common stock and derivative securities, such as stock options and restricted stock units. Each newly minted Section 16 officer must file an "Initial Statement of Beneficial Ownership of Securities" on Form 3 (<https://www.sec.gov/answers/form345.htm>) listing the amount of the company's securities that the officer beneficially owns within 10 days of his or her designation. Changes in the beneficial ownership of the company's securities, with certain exceptions, must be reported on Form 4 (<https://www.sec.gov/answers/form345.htm>) generally within two business days of the date on which the change occurs. In addition, each Section 16 officer is required to file a Form 5 (<https://www.sec.gov/answers/form345.htm>) within 45 days after the company's fiscal year-end unless the officer has previously reported on Form 4 all changes in beneficial ownership.

In addition to these reporting requirements, Section 16 officers are subject to civil liability for certain short-term transactions under Section 16(b) (<https://www.law.cornell.edu/uscode/text/15/78p>) of the Exchange Act. In particular, to prevent the unfair use of information which may have been obtained by an officer, Section 16 (<https://www.law.cornell.edu/uscode/text/15/78p>) authorizes the company to recover any profits realized by the officer from any purchase and sale of securities (or sale followed by a purchase) during a six-month period. Liability is absolute even if the purchase or sale took place after full disclosure and without the use of any inside information. The officer would be liable even if compelled to sell for personal reasons.

Who is a Section 16 officer?

The definition of "officer" under Section 16 (<https://www.law.cornell.edu/uscode/text/15/78p>) can be found in Rule 16a-1(f) (<https://www.law.cornell.edu/cfr/text/17/240.16a-1>). Certain officers are specifically deemed to be an "officer" under Section 16, including the company's president, principal financial officer, principal accounting officer (or, if there is no principal accounting officer, the controller and any vice president in charge of a principal business unit, division or function (such as sales, administrative or finance). In addition, any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the company is considered an "officer" under Rule 16a-1(f) (<https://www.law.cornell.edu/cfr/text/17/240.16a-1>). Any officers of subsidiaries who also perform policy-making functions for the company are deemed to be officers under the definition.

Determining whether a person performs a policy-making function often involves careful consideration and varies significantly depending on the nature and structure of the company's business. A note to Rule 16a-1(f) (<https://www.law.cornell.edu/cfr/text/17/240.16a-1>) provides two guideposts: First, the term "policy-making function" does not include insignificant policy-making functions. Second, person

designated as “executive officers” under Item 401(b) of Regulation S-K are presumed to be “officers” under Section 16 (<https://www.law.cornell.edu/uscode/text/15/78p>).

The definition of Section 16 officer is designed to apply narrowly to the small subset of executives in the company who have significant policy-making functions. In addition to a factual analysis of a person’s duties and responsibilities, a company’s corporate organization and reporting lines often will help inform the analysis.

What is the difference between a company’s Section 16 officers and “executive officers?”

The following table breaks down the differences between the definition of “officer” in Rule 16a-1(f) (<https://www.law.cornell.edu/cfr/text/17/240.16a-1>) and “executive officer” under Item 401(b) (<https://www.law.cornell.edu/cfr/text/17/229.401>) of Regulation S-K, which definition can be found in Exchange Act Rule 3b-7 (<https://www.law.cornell.edu/cfr/text/17/240.3b-7>). As discussed below, the definitions are in practice nearly identical except for two differences, one that is substantive and one that is not.

Position or Criteria	"Officer" Under Rule 16a-1(f)	"Executive Officer" Under Rule 3b-7
President	Yes	Yes
Principal financial officer	Yes	No
Principal accounting officer (or controller)	Yes	No
Vice President in charge of principal business unit, division or function	Yes	Yes
Any other officer who performs a policy-making function	Yes	Yes
Any other person who performs similar policy-making functions for the company	Yes	Yes
Executive officers of subsidiaries who perform policy-making functions for the company	Yes	Yes

For a printable version of this chart, click here (<http://wow.lw.com/Article/Index/193?refertype=Category&refname=Tools&refid=22>).

As noted in the table, the positions of “principal financial officer” and “principal accounting officer (or controller)” are not specifically mentioned in the definition of “executive officer” under Rule 3b-7 (<https://www.law.cornell.edu/cfr/text/17/240.3b-7>). However, virtually every company considers its principal financial officer to be an “executive officer” (either as a vice president in charge of a principal function, finance, or as a significant policy-maker) and Item 402(a)(3)(ii) (<https://www.law.cornell.edu/cfr/text/17/229.402>) of Regulation S K automatically defines the principal financial officer as one of the named executive officers (NEOs), so Rule 3b-7 (<https://www.law.cornell.edu/cfr/text/17/240.3b-7>)’s omission of this position is in practice inconsequential. Often, the principal financial officer also serves as the principal accounting officer. However, if the principal accounting officer is a different person from the principal financial officer, many companies do not consider the principal accounting officer or controller to be an executive officer. As a result, the principal accounting officer is the one position where a company’s lists of executive officers and Section 16 officers may potentially diverge.

Who should determine Section 16 officer status?

Decisions regarding who is a Section 16 officer are generally made each year by the company’s Board of Directors, usually with input from management and company counsel. The SEC Staff has stated that it will not advise registrants regarding the determination of executive officers and will neither object to nor concur in those determinations. Instead, the Staff has explained that the “determination depends on the facts and circumstances and must be analyzed and determined by the issuer and its counsel.” As a result, executive officer status will vary from time to time, depending on the nature and structure of a company’s business and the category of persons who serve in a policy-making function. In general, executive officer status will not be challenged after the determination by a Board of Directors acting in good faith and with a reasonable basis.

How many Section 16 officers should a company have?

Of course, each company should examine its own facts and circumstances and apply the criteria in Rule 16a-1(f) (<https://www.law.cornell.edu/cfr/text/17/240.16a-1>) to determine who within the company should be deemed to be a Section 16 officer. Companies may typically have between six and 12 Section 16 officers. Some companies tend to broaden the category beyond what is necessary, increasing their administrative burden without any corresponding benefit. Companies with an over-inclusive designation of Section 16 officers may face challenges administering timely Section 16 reporting and may unnecessarily subject some employees to the scrutiny and burdens of Section 16 (<https://www.law.cornell.edu/uscode/text/15/78p>).

Where a company has fewer than five executive officers, its executive compensation disclosure will include fewer than five NEOs, which may prompt a comment from the SEC Staff seeking confirmation that the disclosure includes all of the company’s NEOs. The Staff typically will not object where a company has fewer than five NEOs if the company can confirm that the number of NEOs is the same as the number of executive officers and that its executive compensation disclosure includes all of the NEOs.

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