

INSIGHTS

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CORPORATE GOVERNANCE

Director Equity Awards to PE Fund Representatives on Public Company Boards

Directors of public companies often are compensated for their service in the form of equity awards. While the practice with respect to director compensation for board representatives of private equity funds varies, private equity firms that permit their board representatives to receive equity awards should be mindful that these awards can raise a variety of issues that are not present in the case of cash director fees.

By Carol Anne Huff and Elisabeth Martin

Most private equity (PE) fund agreements provide that some or all of the benefit of director and consulting fees received by the fund sponsor (the PE firm) and its professionals from the PE fund's portfolio companies accrues to the applicable PE fund in the form of a reduction in the management fee payable by the PE fund to the PE firm. As a result, most PE firms require that compensation received by the PE firm's investment professionals as director or consulting fees be paid over to the PE firm. Because the director equity grants are for the benefit of the

PE firm (and ultimately, at least in part, the PE fund), PE firms generally take one of three approaches: (1) the director transfers the award to the PE firm, (2) the director transfers the proceeds from the sale of the equity to the PE firm, or (3) the PE firm directly receives the director award. Prior to taking any of these approaches (or deciding to permit a director to receive an equity award at all), PE firms and their public portfolio companies should carefully consider: (1) the treatment of the awards under the relevant fund agreements; (2) the implications under the Section 16 "short swing" profit rules; (3) whether the award is permitted under the portfolio company's equity incentive plan and applicable stock exchange rules; and (4) what SEC disclosures and corporate approvals are required.¹

Fund Agreements and Treatment of Director Awards

While fund agreements vary, as noted above, most provide that compensation paid to the PE firm's investment professionals for serving on boards of directors of portfolio companies results in a reduction of the management fee payable by the PE fund to the PE firm. For example, a PE fund's governing agreements may provide that the PE firm

retains 20 percent of the fees it receives, without offset, and that the remaining 80 percent will reduce the management fee dollar-for-dollar and therefore benefit the limited partners of the PE fund. In order to share the benefit of these director fees as among the PE firm principals in the same way that the management fees would have been shared, most PE firms require that director fees received by the PE firm's investment professionals be paid over to the PE firm. In this case, the director would often not have an economic interest in the award, other than indirectly as a limited partner in the PE fund or as a limited partner in its general partner.

Fund agreements vary with respect to the timing and mechanism by which some or all of the economic benefit of an equity award must be transferred to the PE fund. Often management fee offsets are taken as and when cash proceeds are received upon disposition of the securities, though some fund agreements provide that the securities be valued upon receipt and the offset taken immediately. The timing and means by which the investment professional transfers to the PE firm fees that are received "in kind" also varies. For example, a PE firm may require the designated director to transfer the securities to the PE firm upon receipt, require the director to hold the securities for the benefit of the PE firm until vesting (at which time the securities are transferred to the PE firm) or require the director to hold the securities until the securities are sold, at which time the proceeds from the sale are turned over to the PE firm. As discussed below, who has the economic interest in an award, when the economic interest arises and when and how an award is transferred can have implications under Section 16 of the Securities Exchange Act of 1934 (the Exchange Act).

The "Short Swing" Profit Rules

Section 16 of the Exchange Act applies to directors, officers, and holders of 10 percent or more of a class of public equity securities (10 percent holders).² Section 16 provides a private right of action for plaintiffs to recover

"short swing" profits from any of these covered persons. "Short swing" profits are created by matching any purchase with any sale of an equity security made by the covered person within any six-month period.³ If a sale is made at a price higher than a purchase within the same six-month period, the profit is subject to disgorgement, with no requirement that a plaintiff prove the insider traded on non-public information or had a fraudulent intent.⁴

Section 16 has two main parts. Section 16(a) governs which transactions are required to be reported to the Securities and Exchange Commission (SEC). The requirement under Section 16(a) that covered persons report transactions by filing a Form 4 Statement of Change in Beneficial Ownership (Form 4) with the SEC provides an effective means by which the plaintiffs' bar can monitor transactions that might give rise to "short swing" liability.⁵ Section 16(b) governs which transactions are subject to the "short swing" matching rules. Some transactions are reportable under Section 16(a) but exempt from matching under Section 16(b) due to the application of various exemptive rules adopted by the SEC under the Exchange Act. A common example is an equity award made to an officer or director that is reportable on a Form 4 but exempt from the "short swing" matching rules by virtue of Rule 16b-3 under the Exchange Act (Rule 16b-3) provided that certain conditions are met.⁶

Rule 16b-3 does not, however, exempt transactions between a company and a 10 percent holder that is not an officer or director.⁷ Because directors and 10 percent holders are treated differently under certain of the Section 16 rules, it is important to consider whether the lack of this exemption could result in a director award creating a potentially matchable purchase transaction for the PE fund or, in some cases, whether the PE fund itself might be deemed a director for purposes of the Section 16 rules. While it is far from intuitive that a PE fund could be deemed a director, courts have taken this position, as discussed below, on the basis that the PE fund has "deputized" a person to serve on the

board on its behalf and that it is therefore a “director by deputization.” As discussed below, the PE fund’s status as a “director by deputization” may have positive or negative implications under Section 16, depending on the circumstances.

Under What Circumstances Can a PE Fund Be Deemed to Be a “Director by Deputization” for Section 16 Purposes?

Courts have created a theory under which a corporation, partnership, or other entity may be treated as a director for purposes of Section 16 if the entity “deputizes” a person to serve as its representative on another company’s board of directors.⁸ Courts have found entities that are investors to be “directors by deputization” where (1) the investor places a representative on the board of directors to protect the interests of the investor, (2) the director acquires confidential and proprietary information about the company, (3) the director routinely uses this information for the investor’s benefit or shares this information with other employees or partners of the investor who can use this information for the investor’s benefit, and (4) the company is aware that the director would share with the investor the confidential and proprietary information the director acquired in his role as a director.⁹

The SEC has recognized this theory but has not adopted specific guidance on “director by deputization” status, leaving it instead to a case-by-case determination.¹⁰ The question of whether a PE fund could be deemed a director under the “director by deputization” theory is highly fact-dependent,¹¹ and, as a result, the outcome in any given situation is inherently uncertain. A PE fund that does not wish to be considered a “director by deputization” should consider taking steps to reduce the likelihood a court would find that its representative on the board was acting as a “deputy” for the PE fund. For example, a PE fund might put in place informational barriers to prevent information sharing between the director and the PE fund and should not take steps to influence the director’s actions in his or her capacity as a director.

Does Being a “Director by Deputization” Subject a PE Fund That Is Already a 10 Percent Holder to Different Rules Under Section 16?

Yes—in some cases for the better and in some cases for the worse. Although Rule 16b-3 is not available for 10 percent holders, courts have held that “directors by deputization” are entitled to rely upon Rule 16b-3 in the same manner as individual directors,¹² which means that equity awards by a public company to a PE fund that is a “director by deputization” can be exempted from the “short swing” matching rules.

However, the rules regarding transactions before and after becoming subject to Section 16 are less favorable with respect to directors than 10 percent holders. Transactions prior to becoming a 10 percent holder or after ceasing to be a 10 percent holder are not subject to matching, including the transaction in which a 10 percent holder becomes a 10 percent holder.¹³ In contrast, transactions by a director in the six-month period prior to becoming subject to Section 16 as a result of a company’s IPO (the “look-back” period) are generally subject to matching with any opposite-way transaction in connection with or after the IPO.¹⁴ Similarly, a director who resigns and ceases to be subject to Section 16 will be subject to the “short swing” matching rules for any transaction following the director’s resignation (the “tail” period) to the extent there was an opposite-way transaction while the person was a director, if that transaction was within the six months preceding the opposite-way transaction.¹⁵

If a PE fund is a “director by deputization,” a court also might find that it is subject to these six-month “look-back” and “tail” periods. As a result, a PE fund that may be a “director by deputization” should carefully consider whether any transactions in the “look-back” period are potentially matchable against transactions occurring in connection with the IPO, such as a sale in the IPO or a recapitalization in connection with the IPO, or any transaction occurring following an

IPO, such as a planned secondary offering within six months of a pre-IPO purchase transaction. In addition, a PE fund that ceases to be subject to Section 16 as a result of its equity ownership falling below 10 percent and its director representative resigning from the board of directors may nevertheless be subject to the “tail” period.¹⁶

If the PE Fund Does Not Expect to Directly Receive Equity Awards, Does It Need to Be Concerned About Whether It Can Rely upon Section 16b-3?

Yes. If the equity award is being made to the PE fund’s designated director rather than to the PE fund itself, some PE firms mistakenly think that there are no Section 16 issues. The award to the director is exempt under Rule 16b-3. Unfortunately, even awards made to the director rather than the PE firm can create reportable (and potentially matchable) transactions for the PE fund.

As discussed above, most PE fund agreements provide some mechanism whereby some or all of the economic benefit of the award goes to the PE fund. Under Section 16, a person is deemed to have a reportable indirect pecuniary interest in a security if the person has the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the security.¹⁷ As a result, these types of provisions in fund agreements can cause the PE fund itself to have a reportable interest in the director equity award even if the grant is made to the director and not the PE firm. The grant made to the director could be deemed an acquisition by the PE fund, assuming it is otherwise subject to Section 16 as a 10 percent holder, and, to the extent the PE fund is not a “director by deputization,” that acquisition may not be exempt under Rule 16b-3.¹⁸ In any particular case, the question of whether the PE fund has an indirect reportable pecuniary interest in securities held by a director and when that reportable interest arises will be based upon the actual terms of the fund agreements.¹⁹

Does a PE Fund Need to Disclose Whether It Is a “Director by Deputization”?

Form 4s require reporting persons to indicate the capacity or capacities in which they are filing reports, *i.e.*, as a 10 percent holder, an officer, a director or some combination of these. PE funds therefore have an opportunity to take a position as to whether they consider themselves a “director by deputization” by checking the director box on the Form 4. It also is recommended that the reporting person indicate by notation or footnote that it is taking the position it is a “director by deputization.”²⁰ This reporting position is not dispositive because a court will take into account various factors in determining deputization status, but does provide an indication to plaintiffs and the SEC with respect to the view of the reporting person.

Can a PE Fund Maintain Flexibility by Not Checking the Director Box?

Yes, at least initially. In cases in which a PE fund is uncertain as to whether this reporting position will be advantageous to it, caution may counsel against “checking the box.” For example, this might be the case if the PE fund engaged in transactions prior to the portfolio company’s IPO that might be matchable and it is not clear whether the PE fund intends to engage in an opposite-way transaction following the IPO and within six months of a pre-IPO transaction. The failure to do so does not preclude the PE fund from later checking that box in connection with a subsequent transaction. For example, a PE fund that did not check the director box in its Initial Statement of Beneficial Ownership on Form 3 filed at the time of the IPO could nevertheless check the director box at a later date on which it reports receipt of a director equity award. Once the PE firm has checked the box indicating it is a director by deputization, it should be consistent in its reporting position. The failure to check the box could be viewed as evidence that the PE fund did not in fact consider itself to be a director by deputization.

What Are the Section 16 Consequences of a Director Transferring a Stock Award to a PE Firm That Is a 10 Percent Holder?

If a PE firm requires its director designees to transfer securities received from a portfolio com-

pany to the PE firm, either upon receipt or vesting (subject to any limitations on transfer imposed by the portfolio company), then, as a result, the PE fund ordinarily would be deemed to have a reportable interest in the award and would be required to report beneficial ownership on a Form 4 at the time the award is made to the director. In this case, the subsequent receipt by the PE firm of the stock from the director should be deemed to be a mere change in the form of beneficial ownership, *i.e.*, the position is that the transfer is a non-event because the PE fund had beneficial ownership both before and after the transfer and the transfer did not change anyone's beneficial ownership or pecuniary interest in the stock.²¹ A change in form of beneficial ownership is exempt from reporting and from the "short swing" matching rules under Rule 16a-13.²² The next time the PE fund files a Form 4 it merely would reflect the change in the form of its ownership.

In contrast, if the PE firm had not previously reported beneficial ownership of the equity award, the receipt by the PE firm of the award will not be exempt under Rule 16a-13 as a change in the form of beneficial ownership. The receipt by the PE firm of the award also would not be exempt under Rule 16b-3, even if the PE firm is a director by deputization, because the transaction is not with the issuer. However, this situation would not ordinarily arise. If the director was required to turn over the equity award upon receipt or upon vesting, the PE firm would likely have reported beneficial ownership of the award when it was granted. PE firms that are 10 percent holders should be mindful of the Section 16 consequences when a director designee receives an equity award to ensure it is properly reported by the PE fund and the director at the time of the grant to avoid the situation where the subsequent transfer of the award could result in a reportable acquisition by the PE fund.

The director also will need to analyze whether he or she is required to file a Form 4 to report the transfer to the PE firm. The treatment of the transfer to the PE firm will similarly depend on how the director elected to report the initial grant of the equity award. In some cases, a director may have an indi-

rect reportable pecuniary interest in shares owned beneficially by a PE firm due to the director's interest in the PE fund or its general partner. For example, a director may be a limited partner in the PE fund's general partner. Generally, a limited partner will not be deemed to have a reportable pecuniary interest in a partnership's securities. However, if the limited partner has control over the general partner or exercises investment control over the securities, the limited partner may be deemed to have a reportable pecuniary interest in the partnership's securities.²³ To the extent the director would be deemed to have a reportable indirect interest in securities beneficially owned by the PE firm, the director would report this indirect interest on a Form 4 when the grant is made.²⁴

To the extent the director initially reported indirect beneficial ownership of the award by virtue of the director's interest in the PE fund and/or its general partner, the transfer by the director to the PE firm should be a change in the form of beneficial ownership and should be exempt under Rule 16a-13. If the director did not have a reportable pecuniary interest in the equity award at the time the grant was made, the director likely would have taken one of two approaches when the grant was made—either (1) filed no Form 4 due to the director's lack of pecuniary interest (in which case the director would similarly not report the transfer) or (2) filed a Form 4 but disclaimed beneficial ownership. If the director reported the initial grant on Form 4 but disclaimed beneficial ownership of the award, the director would likely file a Form 4 to report the transfer to the PE firm for no value.

The chart accompanying this article summarizes the likely treatment under Section 16(a)'s reporting rules (whether a Form 4 is required) and Section 16(b)'s matching rules (whether a transaction is exempt from matching) of common transactions involving director equity awards.

Should a PE Fund Affirmatively Take the Position That It Is a "Director by Deputization"?

If the PE fund is not a 10 percent holder, it is likely not beneficial for the PE fund to affirmatively take the position that the PE fund is a “director by deputization” because the PE fund itself would not otherwise be subject to Section 16.²⁵

If a PE fund is already subject to Section 16 due to its status as a 10 percent holder, the decision is less clear. If the PE fund believes that it has a good argument for being a “director by deputization,” affirmatively taking this position may be beneficial if (1) the PE fund has no transactions within the six months prior to the company’s IPO that it is concerned with matching (or is sure that it will not engage in an opposite way transaction following the IPO and within six months of a pre-IPO opposite way transaction) and (2) the PE fund anticipates that the portfolio company will issue stock to (or purchase stock from) the PE fund or its director designees and the PE fund wishes to avail itself of the Rule 16b-3 exemption for that issuance (or purchase). As discussed above, an equity award made directly to a PE fund that is subject to Section 16 as a 10 percent holder will be exempt from the “short swing” matching rules under Rule 16b-3 only if the PE fund is a “director by deputization.”²⁶ In addition, the indirect acquisition of the equity award by a PE fund as result of the PE fund being entitled to the economic benefits of the award will likely only be exempt from matching under Section 16b-3 if the PE fund is a “director by deputization.” One disadvantage of taking the position that the PE fund is a “director by deputization” is that it may be subject to the six-month “tail” period discussed above.

It also is important to note that Rule 16b-3 is not limited to exempting compensatory transactions with a director. A transaction between a company and a director need not be pursuant to an employee benefit plan or any compensatory program to be exempt.²⁷ As a result, Rule 16b-3 also could be used by a PE fund to exempt other purchases and sales between it and a portfolio company, not merely director equity awards.

Stock Plan Matters and Other Reporting Issues for the Portfolio Company

A public company typically has an equity incentive plan under which it can make equity awards to natural persons—directors, officers, employees, and consultants. Shares issued pursuant to these equity incentive plans are registered under the Securities Act of 1933 (the Securities Act), by filing a Form S-8 registration statement (Form S-8) with the SEC. In structuring equity awards being made to a PE fund or its representatives, a portfolio company will need to consider: (1) the terms of the equity incentive plan and whether it permits the issuance of equity to a PE fund or the transfer of an award made to a director to the PE fund (either at the time of grant or upon vesting); (2) whether there is an exemption from the registration requirements of the Securities Act for the issuance of equity to the PE firm or the transfer of an award from the director to the PE fund; (3) whether issuing equity to a PE firm outside of the shareholder approved equity incentive plan complies with applicable stock exchange rules; and (4) what the portfolio company’s reporting requirements and corporate approval requirements are with respect to an equity award made directly to a PE firm.

Restrictions in Equity Incentive Plans

Equity awards made directly to a PE firm are fairly uncommon. This may be because equity incentive plans often provide that the persons who are eligible to receive awards under the plan are only directors, officers, employees and consultants who are natural persons. While the “director by deputization” theory may make a PE fund a director for purposes of Section 16, it is unlikely that a PE fund would be considered a “director” under the terms of a typical equity incentive plan. As a result, an equity award made to a PE firm directly will often need to be made outside of the equity incentive plan.

The director and the PE firm also will need to comply with any restrictions on transfer provided in the equity incentive plan or grant agreement. Often, equity incentive plans provide that unvested options and restricted stock cannot be transferred. As a result, regardless of whether a fund agreement provides that

a director must turn over any compensation received from a portfolio company, the director may as a practical matter need to hold the equity award for the benefit of the PE fund until it vests. Once an option has vested, an equity incentive plan may nevertheless restrict transfer of a stock option to transfers by will, by the laws of descent and distribution or to family members. As a result, the director may need to hold a stock option until such time as the PE fund directs the director to exercise the award. The director then could transfer the stock to the PE fund or sell the stock and transfer the cash proceeds to the PE firm. As discussed above, the PE fund and the director will want to consider the Section 16 consequences of these transactions. A summary of the likely treatment under Section 16 of various transactions is provided in the chart accompanying this article.

Securities Law Issues

A public company typically registers the issuance of equity under its stock incentive plan on a Form S-8. While a Form S-8 may be used to register issuances of equity to directors, a PE firm would not technically be a director, and while Form S-8's instructions provide for issuances to other advisors and consultants, the instructions are clear that those other advisors and consultants must be natural persons.²⁸ As a result, a public company will need to rely upon an exemption from the registration requirements of the Securities Act to make a director award directly to a PE firm. A portfolio company likely would rely upon the private placement exemption provided by Section 4(2) of the Securities Act or the safe harbor provided by Regulation D under the Securities Act, and the shares issued to the PE firm therefore would be "restricted securities" under the federal securities laws. The PE firm would need to rely upon Rule 144 or another exemption from registration to resell these shares.²⁹ A portfolio company also would need to find an exemption for the issuance under the applicable state securities "blue sky" laws.

If the portfolio company issues the equity to the director instead of the PE firm, the director will need to find an exemption from registration under

the Securities Act to transfer the equity award to the PE firm. The director would likely rely upon the so-called "Section 4(1)½ exemption," based upon the sophisticated nature of the PE firm and the private nature of the transfer. As with stock issued directly from the company to the PE firm in a private placement, the PE firm would need to rely upon an exemption from registration under the Securities Act, such as Rule 144, to resell the shares.

Stock Exchange Rules

Stock exchange rules generally require a company to seek shareholder approval prior to issuing securities to affiliates in a private placement. Issuances of equity to directors and officers therefore typically are made pursuant to a shareholder approved equity incentive plan. As discussed above, it is often the case that a company's shareholder approved plan will not cover an award to a PE firm. As a result, the portfolio company will need to see that an issuance to a PE firm otherwise complies with applicable stock exchange shareholder approval rules or amend the equity incentive plan.

The Nasdaq Stock Market, LLC (Nasdaq) considers issuances of equity to "affiliated entities" of directors to be compensatory and requires shareholder approval if the stock is issued at a price below market value.³⁰ An "Affiliated Entity" is any entity where an officer, director, employee or consultant of the company (1) is a partner, executive officer, or controlling shareholder, or (2) would be the beneficial owner of or have a pecuniary interest in the securities issued by the company. Because director awards are not made in exchange for a payment from the PE firm, shareholder approval likely would be required to issue a director's equity award directly to a PE firm unless the award was made pursuant to a shareholder approved plan.

Similarly, the New York Stock Exchange (NYSE) rules provide that shareholder approval is required prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions to a "Related Party." "Related Parties"

include a director, officer, or substantial security holder of the company, or any subsidiaries, affiliates, or other closely-related persons of a Related Party or any entity in which a Related Party has a substantial direct or indirect interest. There is a one percent *de minimis* exception to this rule,³¹ but the NYSE may view this type of award as an equity award and consider it within the context of the shareholder approval rules relating to equity compensation plans rather than those relating to private placements.

If an equity incentive plan does not cover equity awards to a PE firm, a board of directors wishing to make a compensatory award to the PE firm rather than the director representative could amend the plan to provide for this flexibility. If so, the relevant question will be whether this amendment to the incentive plan is “material” such that shareholder approval would be required for the amendment. Although we are not aware of any formal guidance on this question, it would not appear that this type of amendment would be “material” if the award is made to the PE firm solely to accommodate the director’s request and is treated as compensation in the portfolio company’s financial statements and in the director compensation table in the portfolio company’s proxy statement. A portfolio company whose shareholder approved plan does not cover awards to entities should consult with the stock exchange in advance of making an award directly to a PE firm.

What Will Need to Be Disclosed About These Director Awards?

In addition to the Section 16(a) reporting obligations discussed above, an equity award made to a director will be described in the portfolio company’s annual proxy statement under a discussion of director compensation. “Compensation” in Regulation S-K Item 402 is defined very broadly and includes transactions between a registrant and a third party where the purpose of the transaction is to furnish compensation to the director.³² As a result, compensation paid to an entity in lieu of

being paid to a director should therefore arguably be included in the director compensation table. The instructions to the director compensation table also contemplate disclosure of whether any director has a different compensation arrangement and the terms of that arrangement.³³ To the extent not included in the director compensation table, the portfolio company nevertheless would provide disclosure regarding payment of compensation to a PE fund rather than the director in the narrative accompanying the table. The portfolio company also should evaluate whether an equity award made directly to a PE fund that is an affiliate or that is affiliated with a director should be disclosed in the portfolio company’s annual proxy statement as a related party transaction. If the award is reported in the director compensation table, Instruction 5.b. to Regulation S-K Item 404(a) suggests that it would not.³⁴

What Corporate Approvals Are Needed to Make These Director Awards?

An equity award to a director under an equity incentive plan likely will need to be approved by a listed portfolio company’s compensation committee. If the equity award is made directly to the PE firm, the award should be approved by the compensation committee if it is considered compensatory, and, if it is not issued under an equity incentive plan, by the board of directors (with the PE fund representatives abstaining) if the board has not otherwise delegated authority to issue equity to a committee. If the PE fund is an affiliate of the portfolio company, the equity award also would need to be approved by the portfolio company’s audit committee or other body of independent directors under stock exchange corporate governance rules³⁵ and any policy the portfolio company may have governing approval of related party transactions.

One of the conditions for qualifying for the exemption under Rule 16b-3 is that the specific transaction between the company and its director be approved by the board of directors or by a com-

**Summary of Likely Treatment Under Section 16(A)'S
Reporting Rules and Section 16(B)'S Matching Rules of Common Transactions
Involving Director Equity Awards**
(Provided by Carol Anne Huff and Elisabeth Martin)

	PE fund has a reportable interest in the equity held by director at time of grant*		PE fund does <u>not</u> have a reportable interest in the equity held by director at time of grant*	
	PE fund is a director by deputization	PE fund is <u>not</u> a director by deputization	PE fund is a director by deputization	PE fund is <u>not</u> a director by deputization
Equity award to director	Form 4 filed by both director and PE fund; exempt for both under 16b-3.	Form 4 filed by director; exempt for director under 16b-3. Form 4 filed for PE fund if subject to §16 as 10 percent holder; <u>not</u> exempt under 16b-3 for PE fund.	Form 4 filed by director; exempt under 16b-3. No report for PE fund.	
Equity award to PE firm**	Form 4 filed by PE fund; exempt under 16b-3.	Form 4 filed by PE fund; <u>not</u> exempt under 16b-3.	Form 4 filed by PE fund; exempt under 16b-3.	Form 4 filed by PE fund; <u>not</u> exempt under 16b-3.
Transfer of award from director to PE firm	No Form 4 should be required for PE fund to the extent the transfer represents a change in form of beneficial ownership; should be exempt under 16a-13. Treatment for director depends on the specific facts.***		n/a	
Exercise of in-the-money option by director and transfer of cash to PE firm	Form 4 filed by director and PE fund to report exercise and sale; exercise exempt under 16b-3 and 16b-6; sale of underlying shares <u>not</u> exempt.	Form 4 filed by director and PE fund to report exercise and sale; exercise exempt under 16b-3 and 16b-6 for director and under 16b-6 for PE fund; sale of underlying shares <u>not</u> exempt.	n/a	

* Generally, a PE fund would have a reportable interest in an equity award made to its director designee if the director is required to transfer the award to the PE firm.

** A Form 4 also would be filed for the director if the director has a reportable indirect pecuniary interest in the equity award held by the PE fund. The receipt of this indirect interest would be exempt under Rule 16b-3 if the conditions to the rule were met. The board resolutions approving the award should note the existence and extent of the director's interest in the equity award.

*** If the director previously had filed a Form 4 indicating he or she had an indirect interest in the equity award at the time of the grant, no Form 4 would be required to the extent the transfer represented a change in form of beneficial ownership. If the director does not have a reportable pecuniary interest in the equity beneficially owned by the PE fund and did not file a Form 4 to report the equity award, the director would likewise not file a Form 4 to report the transfer to the PE fund. If the director does not have a reportable pecuniary interest in the equity award beneficially owned by the PE fund but reported the award on a Form 4 and disclaimed beneficial ownership, the director likely would report the transfer on a Form 4.

mittee of the board of directors that is composed solely of two or more “non-employee directors.”³⁶ In order to meet this approval condition, the board members approving the transaction must be made aware of the PE fund’s status as a “director by deputization.”³⁷ Similarly, any corporate approval of an award directly to the PE firm also should include approval of any indirect interest the director has in the equity held by the PE firm. This approval should specify the existence and extent of the director’s indirect interest in the transaction.³⁸

Conclusion

A PE firm should review its relevant fund agreements to determine how those agreements will treat equity compensation received by the PE firm or the PE firm’s employees prior to accepting a director equity award. The treatment of the award under the PE fund’s agreements will impact the reporting position taken for Section 16 purposes. The PE fund also should make a determination whether it may be deemed a “director by deputization” and consider the possible consequences under the Section 16 “short swing” profit rules and whether there may be a benefit to affirmatively taking the position that it is a “director by deputization” depending upon the PE fund’s individual circumstances. Lastly, a PE fund and its public portfolio company should review the eligibility and transfer restrictions in the portfolio company’s equity incentive plan and be mindful of securities and stock exchange requirements that may be applicable.

Notes

1. This Article does not address the tax treatment of director equity grants.
2. See Exchange Act § 16(a).
3. See Exchange Act § 16(b).
4. See *id.*
5. See Exchange Act Rule 16a-3(g).
6. These conditions include: (1) having the transaction approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more “non-employee directors” (as defined in Rule 16b-3) or (2) having the transaction approved or ratified by a majority of the issuer’s shareholders, as long as the ratification occurs no later than

the date of the next annual meeting of shareholders. See Rule 16b-3 under the Exchange Act. The approval condition is met only if the specific transaction is approved. The approval requirement is not satisfied by approval of the plan generally. See Note 3 to Rule 16b-3 under the Exchange Act. A “non-employee director” is defined as a director who: (A) is not currently an officer of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer; (B) does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to Rule 404(a) of Regulation S-K; and (C) does not possess an interest in any other transaction for which disclosure would be required pursuant to Rule 404(a) of Regulation S-K. Rule 16b-3(b)(3)(i). Public company compensation committees are often composed of directors who meet both the independence requirements of the applicable stock exchange listing rules and the definition of “non-employee director.”

7. Rule 16b-3(a) under the Exchange Act provides: “A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or director of the issuer that involves issuer equity securities shall be exempt from Section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.”

8. See, e.g., *Blau v. Lehman et al.*, 368 U.S. 403 (1962) (*hereinafter* “*Blau v. Lehman*”); *Feder v. Martin Marietta Corporation*, 406 F.2d 260 (2d Cir. 1969) (*hereinafter* “*Feder*”).

9. See *Andrew E. Roth, derivatively on behalf of Beacon Power Corporation, v. Perseus, L.L.C., et al.*, 522 F.3d 242 (2d Cir. 2008) (*hereinafter* “*Roth v. Perseus*”). On the other hand, the Supreme Court did not apply the “director by deputization” theory where a director, who was a member of an investor in a public company, exercised no power of approval over the investor’s investment, was not consulted for advice, had no advance knowledge of the investor’s intention to trade in the public company’s securities and never discussed the operating details of the public company’s affairs with any member of the investor. See *Blau v. Lehman*.

10. See *Ownership Reports and Trading by Officers, Directors and Principal Stockholders*, Exchange Act Release No. 34-26333 (Dec. 13, 1998) (“In determining whether a person has been deputized for purposes of Section 16, the courts have looked at a variety of factors, focusing primarily on the alleged deputy’s position of control within the deputizing entity and the deputy’s independent qualifications to serve on the board of the issuing corporation.”)

11. See *Feder supra* note 8 at 263 (citing *Blau v. Lehman* at 409) (“[T]he issue of deputization is a question of fact to be settled case by case and not a conclusion of law”) and *Lewis v. The Dekcraft Corporation, et al.*, 1974 WL 418 at p. 4 (S.D.N.Y., 1974) (citing *Feder* at 263) (“The question whether deputization has occurred is one of fact rather than law, and should be determined case by case.”).

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12. See *Roth v. Perseus* *supra* note 9.
 13. Rule 16a-2(c) under the Exchange Act.
 14. Rule 16a-2(a) under the Exchange Act.
 15. Rule 16a-2(b) under the Exchange Act.
 16. See *Feder* *supra* note 8 at 269 (“[W]e hold that § 16(b) applies to a sale of corporate stock by a former director of that corporation if the stock were purchased by him (or purchased by any jural person that had ‘deputized’ him) during the time he was a director and the sale was made within six months after purchase.”).
 17. Rule 16a-1(a)(2)(i) under the Exchange Act. Compare to the definition of beneficial ownership set forth in Rule 13d-3 under the Exchange Act: “For the purposes of Section 13(d) and 13(g) of the Act, a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.”
 18. While it is not clear that affiliates of a “deputizing” entity can be indirect “directors by deputization,” there are cases that have suggested that affiliates of a “director by deputization” can avail themselves of Rule 16b-3. See *Roth v. Perseus* *supra* note 9; *Segen v. CDR-Cookie Acquisitions, L.L.C.*, 2006 WL 59550 (S.D.N.Y. 2006). We are not aware of any cases holding that an entity that is not a “director by deputization” and that acquires indirect beneficial ownership of an equity security as the result of the issuance of equity to a director can avail itself of Rule 16b-3. The cases cited in the preceding sentence may provide some support for this position. However, these cases involve situations in which the entities relying upon Rule 16b-3 may have themselves also been considered “directors by deputization” (although perhaps indirectly) and it is not clear whether the rationale for extending Rule 16b-3 would be applied to an entity that is not a “director by deputization.”
 19. For example, if an equity award made to a director is valued by a PE firm at the time of grant and the management fee offset taken at that time, without regard to future fluctuations in the value of the securities or the price at which the securities are ultimately sold, arguably the PE fund would not have a pecuniary interest in the securities held by the director (although the PE firm might).
 20. Peter J. Romeo and Alan L. Dye, *Alan Dye’s Section 16 Forms and Filings Handbook*, Seventh Edition (June 1, 2009), Model Form 77, reporting principle (4).
 21. See Rule 16a-13 under the Exchange Act.
 22. See Rule 16a-10 under the Exchange Act (“...any transaction exempted from the requirements of Section 16(a) of the Act, insofar as it is otherwise subject to the provisions of Section 16(b), shall be likewise exempt from Section 16(b) of the Act.”).
 23. See Rule 16a-1(a)(2)(iii) under the Exchange Act; *Widett, Slater and Goldman, P.C.*, SEC No-Action Letter, 1992 WL 59851 (March 25, 1992).
 24. The director’s proportionate interest in portfolio securities held by a limited partnership is the greater of the director’s share of the partnership’s profits and the director’s share of the partnership capital account, including the share of profits or capital account attributed to any limited partnership interests held by the director. See Rule 16a-1(a)(2)(ii)(B). A director may report his or her proportionate interest in the securities held by the limited partnership, or may instead (and more typically) report the entire amount of the limited partnership’s holdings in the securities. See Instruction 4(a) (iv) to Form 4. The receipt of this indirect interest by the director would be exempt under Rule 16b-3 assuming the conditions of the rule were met. See American Bar Association, SEC No-Action Letter, 1999 WL 61837 (February 10, 1999) (“[T]he approving entity must know and the document evidencing the approval must specify the existence and extent of the officer’s or director’s indirect interest in the transaction; and that the approval is granted for purposes of making the transaction exempt under Rule 16b-3.”); see also *Donoghue v. Casual Male Retail Group*, 375 F. Supp. 2d 226 at 235-36.
 25. Even if the PE fund does not affirmatively take the position that it is a “director by deputization,” because deputization status is a factual question, it could nevertheless be deemed a director by deputization by a court.
 26. While exempt from matching under Rule 16b-3, an equity grant is not exempt from reporting and must be reported on Form 4 under Section 16(a).
 27. SEC Release No. 34-37260, *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, May 31, 1996.
 28. See General Instruction A.1.(a)(1) to Form S-8, which provides that Form S-8 is available for the issuance of securities to consultants or advisors only if they are natural persons.
 29. With respect to shares issued upon the exercise of options, the Rule 144 holding period for the shares would begin upon exercise of the options. See Compliance and Disclosure Interpretations, Securities Act Rules, Question 132.11:
“Question: On what date does the holding period begin for restricted securities acquired under an employee stock option?
Answer: The holding period for restricted securities acquired under an employee stock option always begins on the exercise of the option and full payment to the issuer of the exercise price. The date of the option’s grant may never be used for this purpose, even if the exercise involves no payment of cash or other consideration to the issuer. Because the option is issued to the employee without any payment for the grant, the optionee holds no investment risk in the issuer before the exercise. [Jan. 26, 2009]”
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Alternatively, if the PE fund has registration rights, it might require the portfolio company to include the equity received as a director grant in a registration statement covering the resale by the PE fund.

30. NASDAQ OMX Listing Center Corporate Governance FAQs, “Does a sale of securities in a private placement at a discount to the market value to officers, directors, employees, or consultants require shareholder approval under Listing Rule 5635(c)?” (Updated: April 13, 2009).

31. NYSE Listed Company Manual Rule 312.03(b).

32. *See* Regulation S-K Item 402(a)(2).

33. *See* Regulation S-K Item 402(k)(3)(ii).

34. *See* Regulation S-K Item 404 and Instruction 5.b. to Item 404(a) (“Disclosure of compensation to a director need not be provided pursuant to paragraph (a) of this Item if the compensation is reported pursuant to Item 402(k)”).

35. *See* NYSE Listed Company Manual Rule 314.00 (“Each related party transaction is to be reviewed and evaluated by an appropriate group within the listed company involved. While the Exchange does not specify who should review related party transactions, the Exchange believes that the Audit Committee or another comparable body might be considered as an appropriate forum for this task. Following the review, the company should determine whether or not a particular relationship serves the best interest of the company and its shareholders and whether the relationship should be continued or eliminated.”) and Nasdaq Listing Rule 5630 (“Each Company that is not a limited partnership shall conduct an appropriate review and oversight of all related party transactions for potential conflict of interest situations on an ongoing basis by the Company’s audit committee or another independent body of the board of directors.”).

36. *See* note 6 *supra*.

37. *See Dreiling v. American Express Co.*, 458 F.3d 842 (9th Cir. 2006).

38. *See* note 24 *supra*.

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