SEC ADOPTS FINAL RULES ON INSIDER TRADING DURING PENSION PLAN BLACKOUT PERIODS

The Securities and Exchange Commission ("SEC") has adopted final rules[1] clarifying the application of Section 306(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), which prohibits an issuer's directors and executive officers from trading in equity securities of the issuer during a pension plan blackout period when other plan participants or beneficiaries are unable to engage in equity securities transactions. The rule, which is termed Regulation "Blackout Trading Restriction" ("BTR"), was first proposed on November 6, 2002.[2] The final rules are effective as of January 26, 2003.

Issuers and Persons Subject to the Trading Prohibition

The trading prohibition of Section 306(a) applies to directors and executive officers of "issuers," which are defined in the Securities Exchange Act of 1934 (the "Exchange Act") as companies (i) with securities registered under Section 12 of the Exchange Act, (ii) required to file reports under Section 15(d) of the Exchange Act, or (iii) that have filed a registration statement that has not yet become effective under the Securities Act of 1933. Accordingly, foreign private issuers,[3] banks and savings associations, small business issuers, and in certain instances registered investment companies[4] meeting the definition of issuer are also subject to the trading prohibition. In defining "directors," for domestic issuers Regulation BTR adopts the definition of Section 3(a)7 of the Exchange Act (i.e., individuals who, regardless of title, function as directors). The term "executive officer" for domestic issuers means any person who is an "officer" for purposes of Section 16 of the Exchange Act (generally, executive officers and other individuals that engage in policymaking functions).

For foreign private issuers, a "director" means any director who is also a management employee of the issuer, and executive officer means any of the principal executive, financial and accounting officers.

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[1] SEC Release No. 34-47225 (January 23, 2003).

[2] For a discussion of the proposed rules, see our Memorandum to Clients dated November 18, 2002.

[3] The prohibition would apply to foreign private issuers only if the blackout were to affect at least 50% of plan participants and beneficiaries located within the United States and such persons represented either (i) more than 15% of the worldwide workforce of the issuer or (ii) 50,000 individuals.

[4] Most registered investment companies do not have employees or employee pension plans; they therefore would typically not be subject to the prohibition.

Securities and Transactions Subject to the Trading Prohibition

For purposes of Regulation BTR, the term "equity security of the issuer" includes any equity security or derivative security relating to an issuer, whether or not issued by the issuer.[5] This includes exchange traded derivatives and derivatives that may be settled only in cash where the value is denominated or based on the issuer's equity, such as phantom stock.

Regulation BTR prohibits (i) any acquisition of equity securities of an issuer during a pension plan blackout period if the acquisition was in connection with service or employment as a director or an executive officer, and (ii) any disposition of equity securities during a blackout period if the securities were acquired, whether before or during the blackout period, in connection with service or employment as a director or executive officer. An equity security is considered to have been *acquired* in connection with service or employment as a director or an executive officer if the security was acquired:

- while the individual was an executive officer or director, pursuant to any compensatory plan, contract, authorization or arrangement with the issuer, or its parent, a subsidiary or an affiliate;

- while the individual was an executive officer or director, in connection with certain transactions or business relationships required to be reported pursuant to Item 404(a) or (b) of Regulation S-K, or Item 7.B of Form 20-F for foreign private issuers;

- while the individual was an executive officer or director, to satisfy certain minimum requirements that the individual be a security holder of the issuer in order to serve on the issuer's board of directors or to be an executive officer;

- before the individual became an executive officer or director, if acquired as an inducement to his or her service as an executive officer or director to the issuer; or

- before the individual became, or while the individual was, an executive officer or director where the equity security was acquired as a result of a merger, consolidation or other acquisition transaction involving the issuer in exchange for or in respect of an equity security of an entity involved in such transaction that such individual acquired in connection with his service as an executive officer or director of such entity.

The final rules modify the requirement in the proposed rules that *any* shares used to satisfy minimum ownership requirements of a company are considered "acquired in connection with service or employment", whether acquired prior to becoming or while serving as an executive officer or director. Under the final rules equity securities acquired prior to service as an executive officer or director that are used to satisfy certain minimum ownership requirements

[5] For foreign issuers the prohibition also applies to depositary shares evidenced by American Depositary Receipts.

will not be deemed to be "acquired in connection with service or employment". The final rules also clarify that an inducement award of equity securities to become an employee or non-executive officer, not directly related to service as an executive officer or director, will not be deemed "acquired in connection with service or employment" and that in a merger context an issuer's equity securities acquired in respect of another entity's equity securities will be deemed "acquired in connection with service or employment" only to the extent that the other entity's equity securities were previously acquired in connection with the individual's service as an executive officer or director of such entity.

Except as set forth above, securities acquired by an individual prior to becoming a director or an executive officer are exempt from this prohibition. However, equity securities acquired by a director or executive officer before a company constituted an "issuer" would remain subject to Regulation BTR, as would securities acquired before the effective date of Regulation BTR.

The trading prohibition encompasses all transactions, both direct and indirect, so that any transaction involving securities in which the executive officer or director has a "pecuniary interest"[6] will come under Regulation BTR.

Services or Employment Presumption

In an attempt to eliminate the need to trace the source of securities sold, the proposed rules established an *irrebuttable presumption* that any equity securities sold or otherwise transferred during a blackout period were acquired in connection with service or employment as a director or an executive officer, regardless of the actual source of the disposed securities. Recognizing the argument raised by commentators that the *irrebuttable* presumption would effectively nullify the "acquired in connection with" requirement, the SEC modified this provision in the final rules to provide that any equity securities sold or otherwise transferred during a blackout period will be presumed to have been "acquired in connection with service or employment as an executive officer or director" *unless* the officer or director establishes that the securities were not so acquired by identifying the origin of the securities transferred. The identification of any such securities must be consistent with tax reporting and any other applicable disclosure and reporting requirements.[7]

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[6] "Pecuniary interest" would be defined by reference to Section 16 of the Exchange Act and will include indirect interests held by immediate family members, or interests held through a partnership, corporation, limited liability company or trust, as determined in accordance with rules promulgated under Section 16.

[7] For example, where an executive officer owned 1,000 shares of an issuer's common stock, 250 shares of which were acquired as a result of the exercise of an employee stock option, the sale during a blackout period of any 250 shares of common stock owned by the executive will be treated as a sale of the option shares unless the executive can demonstrate that the transferred shares had a different source and such identification is consistent with tax reporting requirements.

Exempt Transactions

The following transactions would be exempt from the trading prohibition:

- acquisitions of equity securities under dividend or interest reinvestment plans;
- purchases or sales of equity securities pursuant to a contract, instruction or written plan satisfying the affirmative defense conditions of Exchange Act Rule 10b5-1(c), provided that the director or executive officer did not have an awareness of the actual or approximate beginning or ending dates of a specific blackout period at the time the contract or plan was entered into, or at the time the instruction was given, as applicable;[8]
- purchases or sales of equity securities pursuant to certain "tax-conditioned" plans,[9] other than "discretionary transactions" (i.e, transactions involving intra-plan transfers or cash distributions funded by volitional dispositions of an issuer equity security);
- increases or decreases in the number of equity securities held as a result of a stock split or stock dividend applying equally to all equity securities of that class;
- compensatory grants of securities pursuant to a non-discretionary formula plan where the terms and conditions of the award are pre-established;
- exercises, conversions or terminations of derivative securities that were not written or acquired by the executive or director during the blackout period or while aware of the dates of the blackout period, but only where the derivative security may be exercised, converted or terminated (i) on a fixed date or (ii) solely by a counterparty to the derivative security, where the executive or director doesn't have any influence on whether or when the security can be exercised, converted or terminated; and
- acquisitions or dispositions of equity securities (i) involving a *bona fide* gift, (ii) by will or the laws of descent and distribution, (iii) pursuant to a domestic relations order, (iv) compelled by law, and (v) in connection with a merger, acquisition, divestiture or similar transaction occurring by operation of law.

The final rules clarified some uncertainty in the proposed rules as to whether the awareness of any planned blackout period, where the dates of the blackout period were not established or known to the executive, would preclude the assertion of the affirmative defense of Rule 10b5-1(c). As modified, the "awareness" required must be awareness of the actual or approximate

[8] 17 CFR 240.10b5-1(c).

[9] Including Qualified Plans, Excess Benefit Plans, and Stock Purchase Plans as defined in Exchange Act Rule 16b-3(b).

beginning or ending dates of a specific blackout period. Further, the exemption for purchases or sales pursuant to certain "tax-conditioned" plans has been expanded to include transactions pursuant to an employee benefit plan of a foreign private issuer that has either been approved by the taxing authority of a foreign jurisdiction or is eligible for preferential treatment under the tax laws of a foreign jurisdiction because the plan provides for broad-based employee participation.

Determining the Blackout Period

The blackout period is any period of more than three consecutive business days when at least fifty percent (50%) of the participants or beneficiaries under all the individual account plans[10] maintained by the issuer are prevented from effecting any transactions in equity securities of the issuer under the individual account plans. This would include the suspension of transaction rights of individuals who are participants in 401(k) plans, profit sharing and savings plans, stock bonus plans and money purchase pension plans, as well as certain non-qualified deferred compensation plans, in each case where the individual holds *or could hold* equity securities of the issuer. For example a 401(k) plan with an "open brokerage window" permitting investment in any publicly traded company would have to be included. Single participant retirements plans and plans limited only to directors are excluded from the definition of individual account plans. The final rule clarifies that Regulation BTR does not apply to individual account plans maintained outside of the United States primarily for the benefit of nonresident aliens, and applies only to individual account plans that are primarily for the benefit of participants and beneficiaries located in the United States.

Once an issuer has identified the relevant individual account plans, it must determine whether the temporary suspension of trading in its equity securities affects 50% or more of the participants and beneficiaries. The 50% threshold is triggered if the number of participants or beneficiaries located in the United States and subject to the trading suspension represents at least 50% of the participants and beneficiaries located in the United States under all applicable individual account plans of the issuer. When calculating the 50% test, the issuer may use plan census data as of any date within the 12-month period preceding the beginning of the blackout period, unless there has been a significant change in plan participation since the date selected.

In an effort to strike an appropriate balance between protecting United States employees and accommodating the interests of foreign private issuers, Regulation BTR applies to foreign private issuers only when (i) the 50% test above is satisfied and (ii) the number of participants and beneficiaries located in the United States and subject to the trading suspension either (A) constitutes more than 15% of the worldwide *workforce* of the issuer or (B) exceeds 50,000. The test for foreign private issuers represents a change from the proposed rules which would have compared the number of participants or beneficiaries located in the United States subject to the

[10] An individual account plan is defined as a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses allocated to such participant's account.

trading suspension with the number of *participants or beneficiaries under all individual account plans* maintained by the issuer worldwide.

A suspension of trading under a plan would not be considered a blackout period in two instances:

- when it is a regularly scheduled suspension of transaction rights that is incorporated into the individual account plan or supplemental documentation, and is disclosed to the employees prior to or within 30 days after becoming plan participants or, in the case of a subsequent amendment to the plan, within 30 days after adoption of the amendment; and

- when it is done for the purpose of consolidating plans following a merger or similar transaction and its principal purpose is to allow individuals to become part of the plan or remove themselves from the plan, but only if the persons becoming participants are not permitted to participate in the same class of equity securities after the transaction as before the transaction (i.e., the exception is available where the trading suspension affects only persons employed by the acquired or divested entity in the transaction).

The final rules establish a transition rule relating to the 30-day notice requirement for issuers who may not have met the 30-day notice requirement prior to the effectiveness of Regulation BTR but have satisfied the disclosure requirement within the 90-day period required under rules promulgated by the Department of Labor ("DOL") under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), to provide plan information to a new participant. For issuers who maintained an individual account plan on January 26, 2003, the advance notice requirement relating to regularly scheduled trading suspensions will be satisfied if the issuer previously provided such information within the time period authorized by ERISA.[11]

Consequences of Violations of the Prohibition

An executive officer or director who violates the statutory trading prohibition would be subject both to civil penalties levied by the SEC and private actions brought by the issuer or, if the issuer fails to bring or prosecute the suit within 60 days, by any holder of an equity security of the issuer.[12] In a private action the executive officer or director would be held strictly liable for any profit realized from the transaction. However, no action may be brought more than two years after the date when the profits were realized.

The final rules address the calculation of profits as follows. Where a transaction involves an equity security of the issuer registered pursuant to Section 12(b) or 12(g) of the Exchange Act and listed on a national securities exchange or an automated inter-dealer quotation system of a

[11] For a discussion of the DOL rules relating to pension plan blackout periods, see our Memorandum to Clients entitled "DOL Issues Final Regulations on Pension Plan Blackout Periods" dated January 30, 2003.

[12] Unlike Section 16 of the Exchange Act, directors and executive officers of foreign private issuers would be subject to private actions for profit recovery under Section 306(a) of the Act.

national securities association, profit is to be measured by comparing the difference between the amount paid or received for the security on the date of the transaction during the blackout period and the average market price of the security calculated over the first three trading days after the ending date of the blackout period. Where a transaction does not lend itself to profit calculation in this manner, profit is to be measured in a manner that is consistent with the objective of identifying the amount of any gain realized or loss avoided as a result of the transaction taking place during the blackout period.

Notice to Executive Officers and Directors and the SEC of the Trading Prohibition Period

The proposed rules would have required all issuers to provide notice to all executive officers and directors who are subject to the prohibition at least 15 calendar days prior to the start of a blackout period. In an effort to coordinate the Exchange Act notice requirement with the notice of proposed blackout periods required to be provided to pension plan participants and beneficiaries under the new DOL rules, the final rules require that the notice be provided to executive officers and directors no later than five business days after the issuer receives the notice required by the DOL rules from the pension plan administrator. If the issuer does not receive any such notice, notice to officers and directors must be provided at least 15 calendar days before the actual or expected commencement date of the blackout period. If it is not feasible to provide this notice because of unforeseeable circumstances, the issuer would be excused if it makes a written determination that compliance with the 15-day rule was not possible, and notice was given as soon as reasonably practicable.

In addition to notification to those subject to the prohibition, an issuer will need to file a Form 8-K with the SEC disclosing the imposition of any blackout period on the same day as notice is required to be provided to the officers and directors. Because foreign private issuers are not required to file reports on Form 8-K, the rule requires these issuers to file a copy of the notice as an exhibit to their annual report on Form 20-F or 40-F.

Transition

Section 306(a) of the Act and Regulation BTR are effective as of January 26, 2003. For all blackout periods commencing between January 26 and February 10, 2003, issuers should provide notice as soon as possible to the executive officers and directors. To allow time for modifications to Form 8-K the rules requiring notice to the SEC will not become effective until 60 days after publication of the final rules in the Federal Register. In the interim, issuers should provide notice to the SEC in the first quarterly report filed by the issuer after commencement of the blackout period.

The foregoing is a summary of the principal provisions of the final rules. If you wish to obtain additional information regarding the final rules or assistance in developing a program to help ensure compliance, please contact Frank A. Daniele (212-728-8216, fdaniele@willkie.com), J. Pasco Struhs (212-728-8109, pstruhs@willkie.com) or the partner who regularly works with you.

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