

**MEMO# 15355**

November 14, 2002

## **SEC PROPOSED RULES ON INSIDER TRADES DURING PENSION BLACKOUT PERIODS**

[15355] November 14, 2002 TO: PENSION COMMITTEE No. 44-02 PENSION OPERATIONS ADVISORY COMMITTEE No. 73-02 RE: SEC PROPOSED RULES ON INSIDER TRADES DURING PENSION BLACKOUT PERIODS The Securities and Exchange Commission has proposed rules that implement section 306(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), which prohibits directors and officers of issuers from trading equity securities of the issuer during pension blackout periods.<sup>1</sup> As discussed below, these proposed rules could have implications for certain investment companies that compensate their directors with their shares, as well as fund companies that provide recordkeeping and other plan services to retirement plans that permit investment in employer securities.<sup>2</sup> The blackout trading restrictions in section 306(a) become effective on January 26, 2003. Comments on the SEC's proposed rules are due 30 days after publication in the Federal Register. The SEC is seeking comment on numerous aspects of the proposed rules. ACTION REQUESTED: To the extent that you have any comments or issues with regard to the SEC's proposed rules, please provide them to the undersigned by Monday, November 25, 2002. I can be reached by phone (202-326-5837) or email (tkim@ici.org). I. General Rule Proposed Regulation BTR — Blackout Trading Restriction<sup>3</sup> would prohibit any director or executive officer of an issuer of any equity security (other than an exempt security), directly 1 SEC Release 34-46778, IC-25795 (November 6, 2002) ("Release"). A copy of the Release is available on the SEC's website at <http://www.sec.gov/rules/proposed/34-46778.htm>. 2 The Department of Labor recently issued regulatory guidance under section 306(b) of the Act, which requires administrators of individual account plans to notify affected participants and beneficiaries 30 days in advance of any blackout period. See Institute Memorandum to Pension Members No. 50-02, dated October 23, 2002. The Act directed the SEC, in consultation with the Department of Labor, to issue rules that clarify the application of the statutory trading restriction of section 306(a) and to prevent the evasion thereof. 3 17 C.F.R. 245.100-104. 2 or indirectly, from purchasing, selling or otherwise acquiring or transferring any equity security of the issuer (other than an exempt security) during any blackout period with respect to such equity security, if such director or executive officer acquires or previously acquired such equity security in connection with his or her service or employment as a director or executive officer. The proposed rules also would require an issuer to provide a timely notice to its directors, executive officers and the SEC of the commencement of a blackout period. Additionally, remedies for violations of the statutory trading prohibition are set forth in the proposed rules. Various elements of the proposed rules are discussed in greater detail below. II. Blackout Period Definition The proposed rules would define "blackout period" to mean any period of more than three consecutive business days during

which the ability to purchase, sell or otherwise acquire or transfer an interest in any equity security of such issuer held in an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan. The suspension must apply to at least 50% of the participants or beneficiaries under all individual account plans maintained by the issuer that permit participants or beneficiaries located in any state to acquire or hold equity securities of the issuer.

4 Definition of Individual Account Plan. The term “individual account plan” is defined by reference to ERISA section 3(34),<sup>5</sup> which generally includes section 401(k) plans, profit sharing and savings plans, stock bonus plans, and money purchase plans. The proposed rules also would include in this definition non-qualified deferred compensation arrangements “that reflect the elements described in the [ERISA] definition.”

50% Test. For purposes of the 50% test, the proposed rules would clarify that individual account plans “maintained by the issuer” would include only such plans in which participants or beneficiaries held or could hold equity securities of the issuer, whether or not the plan actually contained equity securities of the issuer at the time of the calculation. Such plans would include individual account plans that (1) permit participants or beneficiaries to invest their plan contributions in the equity securities of the issuer; (2) provide an “open brokerage window” that permits participants or beneficiaries to invest in the equity securities of any publicly-traded company, including the issuer; (3) match employee contributions with equity securities of the issuer; or (4) reallocate forfeitures that included equity securities of the issuer to the remaining plan participants.<sup>6</sup>

4 The definition of blackout period under section 306(a) differs from that in section 306(b). Specifically, the Department of Labor’s guidance, which tracks the statutory language of section 306(b), defines the term “blackout period” as any period of more than 3 consecutive business days for which any ability of participants and beneficiaries, which is otherwise available under the terms of the plan, to direct or diversify the assets credited to their accounts, or to obtain loans or distributions from the plan, is temporarily suspended, limited, or restricted.

5 The term “individual account plan” or “defined contribution 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, and any forfeitures of accounts of other participants which may be allocated to such participant’s account.” ERISA section 3(34). One-participant retirement plans, however, would be excluded from the definition for purposes of the proposed rules.

6 The proposed rules provide examples illustrating the application of the 50% test.

3 Additionally, for purposes of the 50% test, all such plans of the issuer must be aggregated with plans of its affiliates, as determined under the “controlled group” rules of Internal Revenue Code section 414(b), (c), (m) and (o).

Exceptions to Blackout Period Definition. Section 306(a) of the Act and the proposed rules exclude two types of suspensions from the definition of blackout period: (1) a regularly scheduled period in which participants and beneficiaries are restricted, if the period is (a) incorporated into the individual account plan, and (b) timely disclosed to employees before they become participants under the individual account plan or as a subsequent amendment to the plan; and (2) any suspension that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries, by reason of a corporate merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor.<sup>7</sup>

Under the first exception, a blackout period would be considered to be incorporated in the plan if a description of the regularly scheduled blackout period, including the plan transaction to be suspended during or otherwise affected by the blackout and its frequency and duration, is included in the documents or instruments under which the plan operates. The disclosure of the blackout period (in such documents or instruments) would be timely if the employee is provided the disclosure at any time prior to, or within 30 days after, the employee formally enrolls in the plan, or, in the case of a subsequent amendment to the plan, within 30 days

after the adoption of the amendment. The notice may be in any graphic form that is reasonably accessible to the intended recipient. Under the second exception, a suspension would not constitute a blackout period if its principal purpose is to enable individuals to become participants or beneficiaries in the plan, or to terminate participation in the plan, even though the blackout also is used to effect other administrative actions that are incidental. This exception would be available only with regard to participants or beneficiaries of the acquired or divested entity.

III. Issuers Subject to Trading Prohibition

Definition of Issuer. The proposed rules generally would apply to directors and executive officers of domestic issuers, foreign private issuers, banks and savings associations, small business issuers, and in certain instances, registered investment companies. Specifically, the term “issuer” would mean an issuer defined in section 3 of the Securities Exchange Act of 1934 (“Exchange Act”), the securities of which are registered under section 12 of the Exchange Act or that is required to file reports under section 15(d) of the Exchange Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (“Securities Act”).

Application to Registered Investment Companies. The proposed rules provide that 7 The exclusions from the blackout period definition under section 306(b) of the Act and the Department of Labor’s interim rules are suspensions, limitations, or restrictions that (1) occur by reason of the application of the securities laws; (2) are a change to the plan that provides for a regularly scheduled suspension, limitation or restriction that is disclosed through any summary of material modifications, any materials describing specific investment alternatives, or any changes thereto; or (3) apply only to 1 or more individuals, each of whom is the participant, an alternate payee, or any other beneficiary, pursuant to a qualified domestic relations order. 4 section 306(a) of the Act applies to directors and executive officers of registered investment companies that otherwise meet the definition of the term “issuer.” The Release notes that investment companies typically do not have employees because they are externally managed, with investment advisory and other services provided by affiliated and unaffiliated parties pursuant to contracts with the investment company. Without employees, investment companies typically do not maintain employee pension plans, and as a practical matter, there would generally be no blackout periods triggering the statutory trading prohibition. The Release provides, however, that there could be some cases (for example, internally managed closed-end investment companies and investment companies that compensate their directors with their shares) where the statutory trading prohibition could apply in practice. In light of such situations, the proposed rules would require registered investment companies to notify the SEC of the commencement of a blackout period. Specifically, investment companies would have to file Form 8-K8 for the sole purpose of meeting any notice obligation that might arise under the proposed rules. The Release states that the principal purpose of providing notice to the SEC is to ensure that an issuer’s security holders can monitor compliance with the blackout period rules. Notably, the SEC has specifically asked for comment on whether investment companies should be excluded from the proposed rules (and the rationale for the exclusion) and whether there are feasible alternatives to the Form 8-K filing requirement that would minimize the reporting burdens on registered investment companies. The SEC is also seeking comment on the utility to investors of the reports to the SEC in relation to the costs to registered investment companies and their affiliated persons of providing those reports.

Equity Securities of Issuer. Section 306(a) of the Act applies to any equity security of an issuer (other than an exempted security). The proposed rules would define “equity security of the issuer” by reference to section 3(a)(11) of the Exchange Act and Exchange Act rule 3a11-1; this term would include any equity security or derivative security relating to an issuer, whether or not issued by that issuer.<sup>9</sup> Thus, the proposed rules would apply to any equity security that relates to an equity security of the director or executive officer’s company, even if the

security is issued by a third party. IV. Directors and Executive Officers Subject to Trading Prohibition Section 306(a) of the Act imposes the trading restriction on directors and executive officers of issuers. The proposed rules define the term "director" by reference to section 3(a)(7) of the Exchange Act.<sup>10</sup> The proposed rules clarify that an individual's title would not be dispositive as to his or her status as a director; an individual may be a director without holding the title if that person functions as a director. The term "executive officer" is defined by 8 Form 8-K is the "current report" used to report the occurrence of any material events or corporate changes which are of importance to investors or security holders and previously have not been reported by the registrant. <sup>9</sup> Examples of such securities would include security-based swap agreements, standardized options, security futures on equity securities and security futures on narrow-based security indexes. <sup>10</sup> This provision defines "director" as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated." <sup>5</sup> reference to the definition of "officer" in Exchange Act Rule 16a-1(f).<sup>11</sup> The proposed rules also would clarify that the blackout trading prohibition would not apply to an individual who ceases to be a director or executive officer of an issuer. V. Notice to Officers, Directors and the SEC The proposed rules would require the issuer of the equity security to timely notify each director, executive officer and the SEC of a blackout period with respect to any equity security. Notice to Directors and Executive Officers. The notice must include the following information: (1) the reason or reasons for the blackout period; (2) a description of the plan transactions to be suspended during, or otherwise affected by, the blackout period; (3) a description of the class of equity securities subject to the blackout period; (4) the actual or expected beginning and ending dates of the blackout period; and (5) the name, address and telephone number of the person designated by the issuer to respond to inquiries about the blackout period, or, in the absence of such a designation, the issuer's human resources director or person performing equivalent functions. The proposed rules would require that the notice be provided to directors and executive officers at least 15 calendar days in advance of commencement of the blackout period. The notice may be in any graphic form that is reasonably accessible to the intended recipient. Additionally, the notice would be considered provided as of the date of mailing, if mailed by first class mail, or as of the date of electronic transmission, if transmitted electronically. An exception from the 15-day advance notice requirement is provided where the blackout period is due to events that were unforeseeable or circumstances that were beyond the reasonable control of the issuer, and the issuer reasonably so determines in writing (dated and signed by an authorized representative of the issuer). Where this exception applies, the notice and a copy of the written determination must be provided to all affected directors and executive officers as soon as reasonably practicable before the blackout period commences. Notice to the SEC. As previously discussed, the proposed rules would require that notice to the SEC be provided on Form 8-K. The content of the report in Form 8-K would be the same as that of the notice to directors and executive officers. The Form would be required to be filed 2 business days after the earlier of (1) the receipt of notice of a blackout from the plan administrator,<sup>12</sup> or (2) actual knowledge of the blackout period by the person designated by the issuer to oversee the issuer's pension plans, or in the absence of such a designation, the issuer's human resources director, or a person performing equivalent functions.<sup>13</sup> <sup>11</sup> The Release notes that this broader term is used, rather than the term "executive officer" as defined in Exchange Act Rule 3b-7, because of the former term's focus on the policy-making functions of the individual. <sup>12</sup> The Department of Labor's interim rules under section 306(b) of the Act would require a plan administrator to provide a notice (similar to that furnished to affected participants and beneficiaries) to the issuer of any employer securities held by the plan and subject to the blackout period. <sup>13</sup> The Release states that this proposed amendment to Form 8-K would

supersede the SEC's proposal to add an item requiring disclosure of any known event that would have the effect of materially limiting, restricting or prohibiting participants in an employee benefit, retirement or stock ownership plan from acquiring, disposing or converting their holdings, other than a periodic or other limitation, restriction or prohibition based on presumed or actual knowledge 6 Effective Date and Transition Period for Notices. Under the proposed rules, the notice requirement would apply to blackout periods commencing on or after January 26, 2003. For blackout periods occurring between January 26, 2003 and February 10, 2003 (i.e., 15 days after the effective date), issuers must furnish notices as soon as reasonably possible.<sup>14</sup>

**VI. Transactions Subject to Trading Prohibition**

**Nexus to Service or Employment as Director or Executive Officer.** The statutory trading restriction is limited to equity securities that a director or executive officer acquires in connection with his or her service or employment. Under the proposed rules, the term "acquired in connection with service or employment" includes equity securities acquired by a director or executive officer:

- At a time when the individual was a director or executive officer of the issuer, under a compensatory plan, contract, authorization or arrangement, including, but not limited to, plans relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit-sharing (whether or not set forth in any formal plan document), including a compensatory plan, contract, authorization or arrangement with a parent, subsidiary or affiliate of the issuer;
- At a time when the individual was a director or executive officer of the issuer, as a result of any transaction or business relationship that is described in paragraph (a) or (b) of Item 404 of Regulation S-K to the extent that the individual has a pecuniary interest in the equity securities;
- As directors' qualifying shares or other securities that the individual must hold to meet an issuer's minimum ownership requirements for directors or executive officers; or
- Prior to becoming or while a director or executive officer of the issuer if the equity security was acquired as an inducement to service or employment with the issuer or a parent, subsidiary or affiliate of the issuer or as a result of a merger, consolidation or other acquisition transaction involving the issuer.

**Service or Employment Presumption.** The proposed rules would establish 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 executive officer — without regard to the actual source of the securities disposed — to the extent that the director or executive officer holds such securities.<sup>15</sup> However, in a given blackout period, equity securities held by a director or executive officer that were acquired in connection of or access to material non-public information, if that plan is broadly available to the issuer's employees. See Release No. 33-8106 (June 17, 2002) (Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date). <sup>14</sup> A similar transition rule is provided in the Department of Labor's guidance under section 306(b) of the Act with regard to blackout notices required to be furnished to affected participants and beneficiaries. See Institute Memorandum to Pension Members No. 50-02, dated October 23, 2002. <sup>15</sup> The Release notes that the purpose of the irrebuttable presumption is to "simplify identification and eliminate tracing the source of equity securities involved in a disposition transaction and to prevent possible evasion of the statute." <sup>7</sup> with his or her service or employment could only count against a single disposition transaction during that blackout period.<sup>16</sup>

**Indirect Interests.** Section 306(a) of the Act applies to indirect, as well as direct, purchases, sales or other acquisitions or transfers of equity securities of an issuer. The proposed rules, therefore, would provide that to the extent that a director or executive officer has a "pecuniary interest" in the equity security, an acquisition or disposition of an equity security of the issuer during a blackout period would be deemed to be a transaction involving an equity security "acquired in connection with service or employment as a director or executive officer." The proposed rules would apply the definition of "pecuniary interest" in section 16 of the Exchange Act.<sup>17</sup>

Accordingly, a purchase, sale or other acquisition or transfer of equity securities by immediate family members sharing the same household, partnership, corporation, limited liability company or trust would be attributable to a director or executive officer. Exempt Transactions. The proposed rules exempt the following types of transactions from the statutory trading prohibition: (1) purchases or sales of equity securities pursuant to qualified plans, excess benefit plans or stock purchase plans — other than discretionary transactions<sup>18</sup>; (2) acquisitions of equity securities under dividend or interest reinvestment plans; (3) purchases or sales of equity securities pursuant to a contract, instruction or written plan that satisfies the affirmative defense conditions of Exchange Act Rule 10b5-1(c); and (4) 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, including a stock dividend in which equity securities of a different issuer are distributed, and acquisitions of rights, such as shareholder or pre-emptive rights, pursuant to a pro rata grant to all holders of the same class of equity securities registered under section 12 of the Exchange Act. VII. Remedies The proposed rules set forth two remedial schemes for violations of the statutory trading restriction. First, the SEC may institute enforcement actions and sanctions under the Exchange Act pursuant to which a director or executive officer could be subject to possible civil injunctive actions, cease-and-desist proceedings, civil penalties and other remedies available to the SEC to redress violations of the Exchange Act. 16 The Release provides an example illustrating this rule: If an executive officer owned 1,000 shares of the issuer's common stock, 250 of which were acquired as a result of the exercise of an employee stock option, a sale of 250 shares of common stock during a blackout period would be presumed to be a sale of the option shares — regardless of the actual source of the shares sold — and therefore subject to the statutory trading prohibition. A subsequent sale of 250 shares during the same blackout period, however, would not trigger the trading restriction because the option shares would have been deemed to have been sold in the first transaction. 17 See Exchange Act Rule 100(l). 18 Exchange Act rule 16b-3(b)(1) defines the term "discretionary transaction" as a transaction pursuant to an employee benefit plan that (1) is at the volition of a plan participant; (2) is not made in connection with the participant's death, disability, retirement or termination of employment; (3) is not required to be made available to a plan participant pursuant to a provision of the Internal Revenue Code; and (4) results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security. 8 Second, the issuer may institute an action to recover a director or executive officer's realized profits from a violation of the statutory trading restriction. If the issuer fails or refuses to bring an action within 60 days after the date of a request or fails to diligently pursue the action thereafter, the owner of any equity security of the issuer may bring an action on behalf of the issuer. The Release provides that all holders of the equity securities of the issuer, including plan participants and beneficiaries who hold equity securities of the issuer in their individual account plans as of the date of the transaction at issue, would have standing to bring such an action. Thomas T. Kim Associate Counsel