

**MEMO# 15593**

January 29, 2003

## **SEC ADOPTS RULES REGARDING INSIDER TRADES DURING PENSION BLACKOUT PERIODS**

[15593] January 29, 2003 TO: PENSION MEMBERS No. 6-03 PENSION OPERATIONS ADVISORY COMMITTEE No. 6-03 SEC RULES MEMBERS No. 11-03 CLOSED-END INVESTMENT COMPANY MEMBERS No. 8-03 RE: SEC ADOPTS RULES REGARDING INSIDER TRADES DURING PENSION BLACKOUT PERIODS The Securities and Exchange Commission has adopted rules that implement Section 306(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), which prohibit directors and officers of issuers from trading equity securities of the issuer during pension blackout periods.<sup>1</sup> Consistent with proposed Regulation Blackout Trading Restriction ("Regulation BTR"), the final rule applies to investment companies in certain instances.<sup>2</sup> The elements of Regulation BTR that are of most significance to investment companies are summarized below.

I. Blackout Period Definition As in the proposal, Regulation BTR generally defines "blackout period" as any period of more than three consecutive business days during which the ability to purchase, sell, or transfer an interest in any equity security of an issuer held in an individual account plan is temporarily suspended by such issuer or the 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. Regulation BTR, as adopted, reflects a number of modifications to the rules as proposed.<sup>3</sup>

1 SEC Release No. 34-47225, IC-25909 (January 22, 2003) ("Release"). A copy of the Release is available on the SEC's website at <http://www.sec.gov/rules/final/34-47225.htm>. 2 See Memorandum to Pension Members No. 54-02, SEC Rules Members No. 100-02, Closed-End Investment Company Members No. 58-02, dated November 14, 2002. 3 While Regulation BTR retains the "more than three consecutive business days" language in the definition, the Commission expressed concern that a sharp decline in securities could occur in a period of less than three days, and that to the extent such a decline occurs during a temporary trading suspension, the issuer's directors and executive officers could trade the restricted securities, while rank-and-file employees would be unable to do so. The Release, therefore, states that the Commission will continue to consider these issues to ascertain whether blackout periods of three business days or less are of concern and discuss possible solutions with the Department of Labor.

2 A. Definition of Individual Account Plan Unlike the proposal, and consistent with the Institute's comments, the final rules define "individual account plan" to exclude pension plans, including deferred compensation plans, in which participation is limited to directors of the issuer. The Release explains that in the case of a temporary trading suspension in issuer equity securities in such a plan, the unfairness of directors being able to trade their equity securities while an issuer's employees are unable to do so does not exist. B. 50%

Test Regulation BTR provides several clarifications with regard to the 50% threshold component of the blackout period definition. First, for purposes of identifying the relevant individual account plans (to determine the relevant participant base), Regulation BTR excludes individual account plans maintained outside of the United States primarily for the benefit of nonresident aliens from the determination of whether a blackout period has occurred. Second, for purposes of determining whether the trading restriction affects more than 50% of the participants or beneficiaries under these plans, Regulation BTR permits greater flexibility by allowing issuers to use plan census data as of any date within the 12-month period preceding the commencement of the temporary trading suspension. However, where a significant change in plan participation has occurred (e.g., because of a merger or divestiture), the most recent practicable date reflecting the change must be used. Finally, Regulation BTR allows issuers to aggregate participants or beneficiaries without regard to their participation in more than one plan maintained by the issuer.

**C. Exclusions from Blackout Period Definition** Regulation BTR reiterates and provides additional clarification on the two statutory exclusions from the definition of “blackout period.” First, Regulation BTR provides that the term “blackout period” does not include a regularly scheduled period in which participants and beneficiaries may not purchase, sell or otherwise acquire or transfer an interest in any equity security of an issuer, if a description of the period, including its frequency and duration and the plan transactions to be suspended or otherwise affected, is (i) incorporated into the individual account plan or included in documents or instruments under which the plan operates, and (ii) disclosed (in any graphic form reasonably accessible to the employee) to an employee before he or she formally enrolls (or within 30 days following formal enrollment) as a participant or, in the case of a subsequent amendment to the plan, within 30 days after the adoption of a plan amendment. The Release further provides that ERISA Section 404(c) notices or advance notices included in either a plan’s summary plan description or any other official plan communication qualify as “documents or instruments under which the plan operates.”

Second, Regulation BTR excludes from the blackout period definition any trading suspension that is imposed in connection with a corporate merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor, the principal purpose of which is to permit persons affiliated with the acquired or divested entity to become participants or beneficiaries in a plan — provided that the persons who become participants or beneficiaries in the plan are not able to participate in the same class of equity securities after the merger, acquisition, divestiture or similar transaction as before the transaction.

**II. Transactions Subject to Trading Prohibition**

**A. Service or Employment Presumption** Unlike the proposal, and consistent with the Institute’s comments, Regulation BTR, as adopted, does not establish an irrebuttable presumption that any equity securities sold or otherwise transferred during a blackout period were acquired in connection with service 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. Rather, new Rule 101(b) of Regulation BTR provides that any equity securities sold or otherwise transferred during a blackout period by a director or executive officer of an issuer will be considered to have been “acquired in connection with service or employment as a director or executive officer” to the extent that the director or executive officer owned such securities at the time of the transaction, unless he or she establishes that the equity securities were not “acquired in connection with service or employment as a director or executive officer.” To establish this defense, a director or executive officer must specifically identify the origin of the equity securities in question and demonstrate that this identification of the equity securities is consistent for all purposes related to the transaction (e.g., tax reporting).

**B. Exempted Transactions** In addition to the exempted transactions set forth in the release proposing Regulation BTR,<sup>4</sup> the final regulation exempts a number of other transactions

because, in the Commission's view, they occur automatically, are made pursuant to an advance election or are otherwise outside the control of the director or executive officer. These additional exempted transactions are as follows: (1) acquisitions or dispositions of equity securities pursuant to a domestic relations order; (2) sales or other dispositions of equity securities compelled by the laws or other requirements of an applicable jurisdiction; (3) acquisitions or dispositions of equity securities in connection with a merger, acquisition, divestiture or similar transaction occurring by operation of law; (4) certain compensatory grants and awards of equity securities; and (5) certain exercises, conversions or terminations of derivative securities.

III. Notice of Blackout Period to Directors, Officers and the SEC The Act requires an issuer to provide timely notice to its directors, executive officers and the Commission of the imposition of a blackout period that triggers the trading restriction. Regulation BTR, as adopted, reflects several modifications to the rules as proposed.

A. Content of Notice Regulation BTR tracks the notice content requirements of the rules as proposed — with one exception. Consistent with the Institute's comments and the Department of Labor's final 4 See Memorandum to Pension Members No. 54-02, SEC Rules Members No. 100-02, Closed-End Investment Company Members No. 58-02, dated November 14, 2002. 4 rules on the Act's blackout notice provision, Regulation BTR provides issuers with additional flexibility in describing the length of a blackout period by allowing the use of either (i) the actual or expected beginning date and ending date of the blackout period, or (ii) the calendar week or weeks during which the blackout period is expected to begin and end. To the extent that the latter approach is used, the issuer must make readily available during such period information on whether the blackout period has begun or ended, without charge, to affected directors and executive officers (such as by a toll-free telephone number or website). The notice also must set forth this information.

B. Timing of Notice Regulation BTR provides that an issuer must provide a blackout notice to directors and executive officers no later than five business days after the issuer receives the notice from the pension plan administrator required by the Department of Labor's final rules. Consistent with the proposal, if the issuer does not receive the notice from the plan administrator, the issuer must provide its notice to directors and executive officers at least 15 calendar days before the actual or expected beginning date of the blackout period. Notwithstanding this requirement, however, Regulation BTR reiterates that advance notice is not required where an unforeseeable event or circumstances beyond the issuer's reasonable control prevent the issuer from providing advance notice to its directors and executive officers.

C. Notice to the Commission on Form 8-K Regulation BTR, as adopted, requires all issuers, including investment companies, to file a notice with the Commission on Form 8-K, with the same content as the required notice to directors and executive officers. This approach is consistent with proposed Regulation BTR. The Release states that because the Commission's believes that registered investment companies should be subject to the same filing obligations as other issuers in the infrequent instances where the Form 8-K filing requirement would be triggered, it is not appropriate to create a filing requirement for investment companies that is different from that applicable to other issuers under Regulation BTR. Consistent with the Department of Labor's blackout notice requirements (and unlike proposed Regulation BTR), final Regulation BTR provides that the Form 8-K must be filed on the same day that the notice is transmitted to directors and executive officers — instead of 2 business days after the earlier of the receipt of a blackout notice from the plan administrator or the issuer's actual knowledge of the blackout.

IV. Remedies Regulation BTR provides additional guidance on the calculation of realized profits in violation of the statutory trading restriction by providing a rule to measure the recoverable profit based on a three-day average trading price of a security. Examples are also set forth in the Release to illustrate the operation of the rule.

5 V. Effective Date Section 306(a) of the Act took effect on January 26, 2003. As a result, the notice

requirement of Section 306(a) of the Act applies to blackout periods commencing on or after January 26, 2003. According to the Release, for blackout periods commencing between January 26, 2003 and February 25, 2003, issuers should furnish notice to directors and executive officers as soon as reasonably possible. In the case of notice to the Commission, Regulation BTR is effective 60 days after publication in the Federal Register. The delayed effective date is to allow time for the addition of a new Item 11 to Form 8-K to the Electronic Data Gathering, Analysis and Retrieval System. In the interim, an issuer may provide notice to the Commission by disclosing the information described on Item 11 under Item 5 of Form 10-Q, "Other Information," in the first quarterly report filed by the issuer after commencement of the blackout period. The Release also notes that notice is not required for a blackout period that commenced before January 26, 2003 and remains in effect on that date. Dorothy M. Donohue Associate Counsel Thomas T. Kim Associate Counsel

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