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New Insider Trading Prohibitions During Pension Fund Blackout Periods

One of the many unfair practices alleged against the directors and officers of Enron involved the exercise and cashing out of stock options by those individuals as prices fell, while employees lost retirement savings because they were forbidden to sell company stock in their pension plan accounts during “blackout periods.” Pension fund blackout periods occur fairly rarely, usually in connection with a change in investment alternatives or record keepers, or a corporate transaction that affects the pension coverage of groups of participants. Nonetheless, Congress responded to the high-profile Enron case by including in the Sarbanes-Oxley Act of 2002 (the “Act”) provisions that address insider trading during pension fund blackout periods by imposing new prohibitions and penalties. Directors, officers and plan administrators need to be aware of these provisions, and related rules issued by the Securities and Exchange Commission (“SEC”) thereunder.

In general, Section 306(a) of the Act provides that it is unlawful for directors or executive officers of an issuer directly or indirectly to purchase or sell equity securities of the issuer during a blackout period of a pension fund that permits investment in the issuer’s securities, if the security was (or would be) acquired in connection with such person’s service or employment as a director or executive officer. This advisory summarizes a new SEC regulation implementing Section 306(a).

Regulation Blackout Trading Restriction

The SEC recently adopted Regulation Blackout Trading Restriction (“Regulation BTR”) to clarify the scope and application of Section 306(a) and to prevent evasion of the trading prohibition.

When the Trading Prohibition Applies

Blackout period. The ban on director and executive officer trading applies during any period of more than three consecutive business days during which the ability of 50% or more of the participants or beneficiaries, under all individual account plans maintained by the issuer, to purchase or sell any equity security of the issuer is temporarily suspended by the issuer or by a plan fiduciary. Two types of blackout periods are excepted from the general rule:

- A regularly scheduled blackout period banning trading in the issuer’s securities if the period is incorporated into the plan documents and disclosed to employees (before they become participants, within 30 days after enrollment or within 30 days after adoption of an amendment to add such a period); or
- A suspension imposed to consolidate plans following a merger, acquisition or similar transaction, if the principal purpose is to enable individuals to become participants or terminate participation by reason of the transaction. Essentially, the scope of this exemption is limited to temporary trading suspensions affecting employees of the acquired entity if investments in the acquired entity’s securities will no longer be possible or permitted.

Individual Account Plans. Regulation BTR’s definition of “individual account plan” is based on the definition in the Employee Retirement Income Security Act of 1974 (“ERISA”) and encompasses most 401(k) plans, profit-sharing and savings plans, stock bonus plans, money purchase pension plans and certain nonqualified deferred compensation plans that permit participants to hold equity securities of the issuer. The rules exclude plans maintained outside of the United States primarily for the benefit of nonresident aliens, as well as one-participant retirement plans and plans only available to directors.

The 50% Test. The 50% test is calculated by comparing the number of participants located in the U.S. under all individual account plans subject to the blackout to the overall number of participants located in the U.S. under all individual account plans that permit investments in issuer equity, whether or not subject to the blackout. If the percentage is at least 50% and the blackout is for more than three consecutive days, the trading prohibition is triggered. Because it may be difficult to determine the number of participants or beneficiaries of individual account plans as of the day just prior to the blackout period, the issuer may calculate participation as of any convenient date within the 12 month period prior to the suspension. However, if a significant change in the number of participants has occurred, the issuer must use a more recent date reflecting such change. Additionally, an issuer may calculate the aggregate number of participants and beneficiaries under each of its individual account plans without regard to whether an individual participates in multiple plans.

Foreign private issuers.¹ The trading prohibitions apply to a foreign private issuer if (1) the 50% test is met and (2) the number of participants located in the U.S. under all individual account plans subject to the blackout period (a) is greater than 15% of the overall number of participants under all plans maintained by the issuer worldwide, or (b) exceeds 50,000.

To Whom the Trading Rules Apply

Director. Generally director means any director of a corporation, but also any person performing similar functions with respect to any organization, whether incorporated or unincorporated. Since many foreign companies have lower level employees serve on their boards, for a foreign private issuer, the definition is limited to a director who is also a management employee of the issuer.

Executive officer. Executive officer means the issuer's president, principal financial officer, principal accounting officer (or, if none, controller), any vice-president in charge of a principal business unit, or any other officer who performs a policy-making function. For a foreign private issuer, an executive officer means the principal executive officers, the principal financial officers, and the principal accounting officers.

Issuer. Generally issuer means any entity with a class of securities registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act"), that is required to file reports under Section 15 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 and that has not been withdrawn. This includes domestic issuers, foreign private issuers, banks and savings associations, small business issuers and, in rare instances, registered investment companies.

Securities Subject to the Trading Prohibition

Regulation BTR defines "equity securities" broadly to encompass any equity security, including a derivative security relating to an issuer but not necessarily issued by that issuer (e.g., an option to purchase shares in the issuer's parent company). Whatever the security, it must have been acquired "in connection with service or employment."

In Connection with Service or Employment. This condition will be met if the securities are acquired by a director or executive officer:

- while a director or executive officer, under plans relating to options, warrants, pension, bonus, profit-sharing and phantom stock and similar arrangements with a parent, subsidiary or affiliate of the issuer;
- while a director or executive officer, as a result of most related party transactions or business relationships (to the

¹ Regulation BTR adopts the definition of Rule 3b-4(c) of the Securities and Exchange Act of 1934 (the "Exchange Act") which defines "foreign private issuer" to mean any foreign issuer other than a foreign government, except an issuer meeting the following conditions: (1) more than 50% of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the U.S., and (2) any of the following: (a) the majority of executive officers or directors are U.S. citizens or residents, (b) more than 50% of the assets of the issuer are located in the U.S., or (c) the business of the issuer is administered principally in the U.S.

extent the director or executive officer has a pecuniary interest in the securities) required to be disclosed in the nonfinancial statement portions of most registration statements and annual reports;²

- while a director or executive officer, as shares that must be held to meet minimum ownership requirements per company policy (commonly known as “qualifying shares”);
- prior to becoming a director or executive officer, as an inducement to service or employment with the issuer, parent, subsidiary or affiliate; or
- prior to becoming a director or executive officer, as a result of a business combination in respect of an equity security of an entity involved in the business combination that the director or officer acquired in connection with his or her service or employment as a director or executive officer of that entity.

Transactions Subject to the Trading Prohibition.

Regulation BTR prohibits direct or indirect acquisitions of equity securities by a director or executive officer during a blackout period if the acquisition is in connection with such person’s service or employment, as well as direct or indirect dispositions of equity securities that had been acquired in connection with such person’s service or employment.

Indirect interests. The trading prohibition applies to transactions by immediate family members sharing the same household, as well as entities in which a director or executive officer has financial involvement to the extent the director or executive officer has a pecuniary interest in the transaction.

Presumption of Service or Employment. Regulation BTR creates a presumption that any equity securities sold or transferred by a director or executive officer during a blackout period were acquired in connection with service or employment as a director or executive officer. A director or executive officer may rebut the presumption by specifically identifying the origin of the equity securities in question. This identification must be consistent with the treatment of the identified securities for tax purposes and all other disclosure and reporting requirements.

Exemptions. Regulation BTR exempts certain transactions which the SEC believes do not fall within the purpose of the trading prohibitions of Section 306(a), including:

- acquisitions of equity securities under dividend or interest reinvestment plans;
- trades under plans that satisfy the affirmative defenses related to purchases or sales alleged to have been made on the basis of material, nonpublic information (commonly known as “10b5-1 plans”);³
- nondiscretionary trades pursuant to certain tax-conditioned plans, such as Qualified Plans, Excess Benefit Plans, or Stock Purchase Plans⁴ and their foreign equivalents;

² These transactions and business relationships are described in Item 404(a) and (b) of Regulation S-K, and, in the case of foreign private issuers, Item 7.B of Form 20-F (but are applied without application of the disclosure thresholds of such provisions).

³ These defenses are described in Exchange Act Rule 10b5-1(c) and include trades pursuant to a contract or plan if the director or executive officer demonstrates that before becoming aware of the blackout, (1) he or she had entered into a binding contract to purchase or sell the security, instructed another person to trade the security for his or her account, or adopted a written plan for trading securities; (2) the contract or plan specified the amount of securities to be traded and the price at which the securities were to be traded, included a written formula for determining the amount to be traded and the price at which and the date on which the securities were to be traded, or did not permit the person to exercise any subsequent influence over how, when or whether to effect purchases or sales (provided that any person who did exercise such influence must not have been aware of the blackout); and (3) the purchase or sale that occurred was pursuant to the contract or plan.

⁴ As defined in Exchange Act Rules 11b-3(4), (2) and (5), respectively.

- changes in the number of equity securities held as a result of stock splits or stock dividends applying equally to the securities' class;
- compensatory awards of equity securities pursuant to a plan that provides for such awards to occur automatically and specifies the terms and conditions of the awards;
- exercises, conversions or terminations of certain derivative securities which by their terms occur only on a fixed date or are exercised, converted or terminated by a counter-party who is not subject to the influence of the director or executive officer;
- acquisitions or dispositions of equity securities involving a bona fide gift, transfer by will or the laws of descent and distribution;
- acquisitions or dispositions of equity securities pursuant to a domestic relations order; and
- sales or other dispositions of equity securities in connection with a merger, acquisition, divestiture or similar transaction occurring by operation of law (e.g., an exchange of equity securities affecting substantially all of the issuer's equity security holders due to a statutory merger or similar transaction that closes during a blackout period).

Notice Required

The issuer of equity securities must provide notice of a blackout period to directors, executive officers, and the SEC.

To Directors and Executive Officers. Notice will be considered timely if an issuer provides it no later than five business days after the issuer receives notice from its pension plan administrator.⁵ If the issuer does not receive such notice, then it must provide notice to its directors and executive officers at least 15 calendar days before the actual or expected beginning date of the blackout period. However, advance notice is not required in any case where an unforeseeable event or circumstances beyond the issuer's reasonable control prevent the issuer from providing such notice.

The notice must state (1) the reason for the blackout period, (2) a description of the plan transactions to be suspended, (3) a description of the class of equity securities subject to the blackout, (4) the beginning and ending dates of the blackout period or the calendar week or weeks during which the blackout period is expected to begin and end and (5) the contact information of the person designated by the issuer to respond to any questions about the blackout period. If the issuer chooses to specify the expected beginning and ending dates of the blackout period in the required notice and either or both dates change, the issuer must provide an updated notice identifying the changed dates, the reasons for the change and any material change in the information contained in the prior notice. If the issuer opts to specify only the calendar week or weeks during which the blackout period is expected to begin and end, then during such weeks information as to whether the blackout period has begun or ended must be readily available, without charge, to affected directors and executive officers and the notice must describe how to access such information.

To the SEC. The issuer must provide notice to the SEC on a Current Report on Form 8-K and include the same content as the notice provided to directors and executive officers. The Form 8-K must be filed on the same day notice is transmitted to directors and executive officers. Notice of changes in the blackout period must also be filed with the SEC on Form 8-K as soon as reasonably practicable. Foreign private issuers must file a copy of each notice provided to directors and executive officers as an exhibit to their annual reports on Form 20-F or 40-F, unless notice was previously provided to the SEC on Form 6-K (a practice encouraged by the SEC).

⁵ New Department of Labor rules implementing Section 306(b) of the Act generally require that plan administrators give at least 30 days (but not more than 60 days) notice of any blackout period of more than three days to any affected participants and beneficiaries of individual account plans, as well as to issuers. Failure to provide the notice will result in a penalty of up to \$100 per day per affected participant.

Remedies

The SEC, issuers and shareholders may bring suit against directors and executive officers under Regulation BTR within a two-year statute of limitations.

Enforcement by the SEC. A director or executive officer that violates the trading prohibition is subject to civil injunctive actions, cease-and-desist proceedings, civil penalties and all other remedies available to the SEC under the Exchange Act. Willful violations could result in criminal liability.

Private Right of Action. The issuer may bring an action to recover any profits (or loss avoided) realized by a director or executive officer through violating the trading prohibition, regardless of any intent on the part of the director or executive officer. If the issuer does not bring an action within 60 days after a request, any owner of equity securities of the issuer may bring a derivative suit. If the equity security is registered and listed nationally, profit (or loss avoided) is measured by the difference between the amount paid or received on the date of the transaction during the blackout period and the average market price calculated over the first three trading days after the ending date of the blackout period. Otherwise, such amount will be measured in any manner 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.

The SEC has said that an issuer's failure to provide notice will not preclude an enforcement action against a director or executive officer and may even lead to an enforcement action against the issuer, whether or not a director or executive officer violates the trading prohibition.

Effective Date

Section 306(a) of the Act and Regulation BTR became effective January 26, 2003. The notice requirement applies to blackout periods commencing on or after January 26, 2003.⁶ For blackout periods commencing between January 26, 2003 and February 25, 2003, issuers must furnish notice to directors and executive officers as soon as reasonably practicable. For domestic issuers, until March 29, 2003, notice to the SEC may be provided in the first quarterly report filed after commencement of the blackout period. After that time, notice must be provided on Form 8-K. For foreign private issuers notice to the SEC must be provided as discussed above.

Conclusion

The Act provides numerous changes to existing law. This advisory addresses the most significant elements of the Act and related rules regarding trading prohibitions during pension fund blackout periods. For a more comprehensive discussion of the topics covered in this advisory, the Act generally or compliance with the new rules in your particular case, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult or one of the lawyers below.

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Because sound legal advice must necessarily take into account all relevant facts and developments in the law, the information you will find in this memorandum is not intended to constitute legal advice or a legal opinion as to any particular matter.

⁶ The new Department of Labor rules also became effective January 26, 2003 and apply to blackout periods commencing on or after January 26, 2003.