KIRKLAND & ELLIS Alert

Employee Benefits Practice Area **February 2003**

FINAL SEC RULE ON EMPLOYEE BENEFIT PLAN BLACKOUT PERIOD PROVISIONS OF THE SARBANES-OXLEY ACT

In our December 2002 Alert[1] we discussed a proposed Securities and Exchange Commission ("SEC") rule on Sarbanes-Oxley Act ("Act") securities trading restrictions for a public company's directors and executive officers during benefit plan blackout periods. The SEC has now issued a final rule effective 1/26/03 ("Final Rule") which differs in certain respects from the proposed rule ("Proposal"). This Alert discusses the Final Rule and its material differences from the Proposal.

In General. The Act prohibits any director or executive officer of an **issuer**[2] from directly or indirectly acquiring or disposing of an equity security received in connection with such person's service or employment as a director or executive officer while the security is subject to a "blackout period." The Final Rule adopts new Regulation BTR[3] which interprets the Act broadly to preclude acquisitions or dispositions by directors and executive officers of any equity security of an issuer received in connection with service or employment while any equity security of the issuer is subject to a blackout period.[4]

Issuers Subject to Trading Prohibition. The Final Rule provides that an "issuer" includes domestic issuers, foreign private issuers, banks and savings associations, small business issuers and, in rare instances, registered investment companies. With respect to foreign private issuers, the Final Rule differs from the Proposal and applies the trading restrictions only when (1) 50% or more of the participants or beneficiaries in individual account plans maintained by

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[1] Copies of our December 2002 Alert entitled "Proposed Securities and Exchange Commission and Final Department of Labor Rules on Employee Benefit Plan Blackout Period Provisions of the Sarbanes-Oxley Act" can be obtained on the firm's website at ***www.kirkland.com***. In addition, you will receive shortly a copy of a separate Alert on final blackout period rules recently issued by the Department of Labor ("DOL").

[2] For this purpose, an "**issuer**" means a company (1) with equity or debt securities traded on a national securities exchange, or (2) with a class of equity securities held by 500 or more shareholders of record, or (3) required to file 1934 Act § 15(d) reports with the SEC (*i.e.*, a company which has previously sold equity or debt securities pursuant to a 1933 Act registration statement, until the registered securities are held by less than 300 persons on the first day of a subsequent fiscal year), or (4) which has filed a 1933 Act registration statement, not yet effective and not withdrawn.

[3] Regulation BTR ("Blackout Trading Restriction") is issued under the 1934 Act. The Final Rule also amends 1934 Act Rules 13a-11 and 15d-11 and Forms 20-F, 40-F and 8-K.

[4] The preamble to the Final Rule states that "[w]hen a director or executive officer engages in a transaction involving issuer equity securities at a time when participants or beneficiaries in the issuer's pension plans cannot engage in similar transactions through their plan accounts, the director or executive officer obtains an unfair advantage that the [Act] seeks to ameliorate."

the issuer who are located in the United States[5] are subject to a blackout period, and (2) the affected participants and beneficiaries represent an "appreciable portion" of the issuer's worldwide employees.[6] The Final Rule, like the Proposal, states that the Act does not apply to blackout periods of foreign employee benefit plans. While the Proposal requested comment on whether directors and executive officers of small business and investment company issuers should be excluded from the trading restrictions of the Act, the Final Rule states that the restrictions apply to any entity that satisfies the definition of "issuer" without regard to the entity's size.

Persons Subject to Trading Prohibition. The Final Rule defines the term "director" as set forth in 1934 Act § 3(a)(7), *i.e.*, as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated." This definition is intended to reflect a "functional and flexible" approach to determining whether a person is a director, so that an individual's title is not dispositive as to his status. Instead, as under 1934 Act § 16, attention is given to the individual's underlying responsibilities or privileges and whether the individual has a significant policy-making role. Similarly, the term "executive officer" is defined with reference to the term "officer" in 1934 Act Rule 16a-1(f), *i.e.*, as "an issuer's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer."[7] However, because foreign private issuers are not subject to 1934 Act § 16, the Final Rule specifically defines "director" to mean only a director who is a management employee and the term "executive officer" to mean the principal executive officer(s), the principal financial officer(s), and the principal accounting officer(s) (or, if there is none, the controller) of the foreign private issuer.

Securities Subject to Trading Prohibition. The Act's trading prohibition applies to any equity security[8] of an issuer, which the Final Rule defines to include any equity security or derivative security relating to an issuer even if the security is issued by a third party. In the case of foreign issuers, this definition includes depositary shares evidenced by American Depositary Receipts ("ADRs"). The term "derivative security" has the same meaning as set forth in 1934 Act Rule 16a-1(c) and will be interpreted in a manner consistent with 1934 Act § 16, so that, *e.g.*, an interest that may be settled only in cash but the value of which is based on an equity security (such as phantom stock) is considered a derivative security subject to the Act.

Transactions Subject to Trading Prohibition. The statutory trading prohibition applies to an acquisition of equity securities during a blackout period if the acquisition is in connection with an individual's service or employment as a director or executive officer of an issuer, and a disposition of equity securities during a blackout period if the disposition involves equity securities acquired in connection with such service or employment.[9] The Proposal construed

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[5] For purposes of the Final Rule, "United States" includes all States of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States.

[6] *See* more detailed discussion under "Blackout Period Definition" regarding application of the Final Rule to foreign private issuers and differences from the Proposal.

[7] 1934 Act Rule 16a-1(f) further provides that: "Officers of the issuer's parent(s) or subsidiaries shall be deemed officers of the issuer if they perform . . . policy-making functions for the issuer. In addition, when the issuer is a limited partnership, officers or employees of the general partner(s) who perform policy-making functions for the limited partnership are deemed officers of the limited partnership. When the issuer is a trust, officers or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust."

[8] Other than certain "exempt securities" defined with reference to 1934 Act § 3(a)(12).

[9] The Act prohibits both "direct" and "indirect" acquisitions and dispositions of securities. The Final Rule retains the Proposal's definition of "indirect" as extending to any acquisition or disposition of issuer equity securities in a transaction involving immediate family members sharing the same household, a partnership, corporation, limited liability company or trust if a director or executive officer has an

the term "acquired in connection with service or employment" quite broadly, and in response to comments the Final Rule narrows the term's scope to include equity securities acquired by an individual: (1) at a time when he is a director or executive officer of an issuer (A) 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, including a compensatory plan, contract, authorization or arrangement with a parent, subsidiary or affiliate of the issuer, (B) as a result of any related-party transaction or business relationship described in Item 404 of Regulation S-K, or (C) as "director's qualifying shares" or other securities that he must hold to meet an issuer's minimum ownership requirements or guidelines for directors or executive officers; or (2) prior to becoming, or while, a director or executive officer of the issuer (A) where the equity security was acquired as a direct or indirect inducement to service or employment as a director or executive officer, or (B) where the equity security was received as a result of a business combination in respect of a security acquired in connection with service or employment as a director or executive officer of an entity involved in the business combination.

The Final Rule notes that this definition may reach securities that are acquired in arm's-length commercial transactions but states that the SEC believes inclusion of such securities is necessary to prevent evasion of the statutory trading prohibition. However, in contrast to the Proposal, the Final Rule provides that equity securities purchased in the open market before an individual becomes a director or executive officer are not subject to the trading prohibition, even if such securities are subsequently used to satisfy minimum director or officer ownership requirements. The Final Rule also revised the Proposal to make clear that equity securities awarded to an individual "as a direct or indirect inducement to service or employment as a director or executive officer" will be considered subject to the trading prohibition even if the individual initially accepts such securities in connection with employment as a non-executive officer. In the context of mergers and other business combinations, the Final Rule clarifies that securities acquired by an individual who was a director or executive officer of the target and who becomes a director or executive officer of the acquirer will only be subject to the trading prohibition to the extent the securities are received "in respect of" equity securities of the target acquired in connection with the individual's service or employment as a director or executive officer of the target.

The Final Rule retains the requirement that equity securities acquired by an individual in connection with service or employment as a director or executive officer before a company is an issuer will be subject to the trading prohibition if the company later becomes an issuer, and states that equity securities acquired in connection with an individual's service or employment as a director or executive officer before the effective date of the Act will be subject to the Act. However, the Final Rule eliminates the Proposal's 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. Instead, under the Final Rule any such equity securities will be considered subject to the Act unless the director or executive officer establishes that the securities were not "acquired in connection with service or employment as a director or executive officer" by (1) specifically identifying the origin of the equity securities, and (2) demonstrating that this identification is consistent for all purposes related to the transaction (*e.g.*, tax reporting and any applicable disclosure requirements).

The Final Rule adopts the Proposal to exempt from the Act (1) acquisitions of equity securities under broad-based and non-discriminatory dividend or interest reinvestment plans, (2) non-discretionary purchases or sales made pursuant to advance election under a contract, instruction or written plan that satisfies 1934 Act Rule 10b5-1(c) (provided that the advance election is not made or modified during the blackout period or at a time the director or executive officer is aware of the impending blackout), (3) non-discretionary purchases or sales of equity securities made pursuant to advance election under a tax-qualified employee benefit plan, excess benefit plan, or stock purchase plan, and (4) increases or decreases in the number of

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opportunity to profit or share in any profit derived from the transaction.

equity securities held as a result of a stock split or dividend applying equally to all equity securities of that class. The Final Rule also states that a director or executive officer is "aware" of a blackout period for purposes of (2) above if he "is aware of the actual or approximate beginning or ending dates of the blackout period" -- whether or not he has received official notice of the blackout period -- and includes for purposes of (3) above employee benefit plans of foreign private issuers which are "substantially similar" to the types of plans listed.

The Final Rule further exempts from the trading prohibition any acquisitions or dispositions made in connection with death, disability, retirement or other termination of employment, and other non-discretionary transactions involving a "diversification or distribution required by the Internal Revenue Code" (which presumably would include, *e.g.*, minimum required distributions or minimum lump sum cash-outs). In addition, the Final Rule contains the following exemptions that were not included in the Proposal: (1) compensatory grants and awards made during a blackout period pursuant to a plan that provides that such grants and awards are automatic and specifies their terms and conditions; (2) exercises, conversions or terminations of derivative securities that were not written or acquired by a director or executive officer during the blackout period or while aware of the blackout period and where the derivative security, by its terms, may be exercised, converted or terminated only on a fixed date or by an independent counterparty; (3) acquisitions or dispositions involving a *bona fide* gift or transfer by will or the laws of descent and distribution; (4) acquisitions or dispositions made pursuant to a domestic relations order; (5) dispositions of equity securities "compelled by the laws or other requirements of an applicable jurisdiction"; and (6) acquisitions or dispositions of equity securities affecting substantially all of an entity's equity security holders that occur upon a statutory merger, acquisition, divestiture or similar transaction.

"Blackout Period" Definition. The Act defines "blackout period" as a period of more than 3 consecutive business days during which there is a temporary suspension of the ability of at least 50% of the participants or beneficiaries in all individual account plans maintained by an issuer to acquire or dispose of any equity security of the issuer held in the plans. The Final Rule retains the statutory "more than 3 consecutive business days" language but, curiously, states that the SEC is concerned that the problems intended to be addressed by the Act may not be limited to blackout periods that last longer than 3 consecutive business days and that it "will continue to consider these issues, to attempt to ascertain whether blackout periods of 3 business days or less are or may become a concern and to talk to the [DOL] about possible solutions."

The Final Rule also expressly excludes from the definition of "individual account plan"[10] any pension plan (or deferred compensation plan) in which participation is limited to directors of an issuer, and states that the individual account plans "maintained by the issuer" considered for purposes of the 50% test include only individual account plans in which participants or beneficiaries located in the United States hold or could hold equity securities of the issuer (regardless of whether the plan actually contains such equity securities), *i.e.*, plans that: (1) permit participants to invest their plan contributions in equity securities of the issuer; (2) include an "open brokerage window" that permits participants 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 include equity securities of the issuer to remaining plan participants. The Final Rule also states that, for purposes of determining the individual account plans "maintained by the issuer," the controlled group rules under § 414 of the Internal Revenue Code (generally requiring 80% common ownership) will apply. However, in response to comments the Final Rule also clarifies that an individual account plan maintained outside of the United States primarily for the benefit of non-resident aliens will not count for purposes of the 50% test, even if the plan has a small number of participants or beneficiaries located in the United States.

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[10] The Act defines this term with reference to § 3(34) of ERISA to include a variety of qualified plans such as 401(k) plans, profit-sharing and savings plans, stock bonus plans and money purchase pension plans.

The Final Rule acknowledges that it may be difficult for an issuer to determine precisely the number of participants and beneficiaries covered by its individual account plans, and therefore permits issuers to apply the 50% test on the basis of estimates. Specifically, the Final Rule provides that an issuer may use plan census data as of any date within the 12-month period preceding the beginning date of the blackout period, provided that if there has been a significant change in participation since the date selected (*e.g.*, because of a merger or divestiture) the issuer must use plan census data "as of the most recent practicable date that reflects such change." The Final Rule also states that issuers may determine the total number of participants or beneficiaries under all individual account plans without regard to whether an individual participates in more than one plan.

In the case of a foreign private issuer, the Proposal applied a second test not contained in the Act to determine if the statutory trading prohibition was triggered. That test would have compared the number of participants or beneficiaries located in the United States under all individual account plans maintained by the issuer subject to the blackout period to the overall number of participants or beneficiaries under all individual account plans maintained by the issuer worldwide. If the resulting percentage was greater than 15% and the concurrent 50% test was also met, the Proposal would have applied the statutory trading prohibition to the directors and executive officers of the foreign private issuer. However, commenters expressed a concern that the 15% test would not operate as intended because foreign employees are typically covered by defined benefit plans and not individual account plans. As the 15% test was based on the percentage of an issuer's employees who participate in individual account plans, the 15% test would almost always be met even where the number of participants subject to a blackout period in United States plans was insignificant. In response, the Final Rule modifies the test for foreign private issuers to provide that if the number of participants and beneficiaries located in the United States who are subject to a blackout period either exceeds 15% of the total number of employees of the issuer or 50,000 affected participants and beneficiaries -- and the concurrent 50% test is satisfied -- the trading prohibition will apply.

In addition, under the Act neither a regularly scheduled suspension of trading incorporated in the terms of a benefit plan document and adequately disclosed to participants nor a suspension imposed solely in connection with a participant or beneficiary becoming or ceasing to be a plan participant or beneficiary by reason of a merger, acquisition, divestiture or similar transaction is a "blackout period." The Final Rule states that the requirement that a blackout period be incorporated in the benefit plan is satisfied by including a description of the regularly scheduled blackout period (including the plan transactions to be suspended during, or otherwise affected by, the blackout and its frequency and duration) in the plan documents; and that disclosure is considered adequate if an employee is provided notice of the blackout period provisions at any time prior to or within 30 calendar days after plan enrollment, or within 30 days after adoption of a subsequent plan amendment.[11] In the case of a blackout imposed to consolidate plans following a merger or acquisition, divestiture or similar transaction, the blackout period will not trigger the trading prohibition if its principal purpose is to enable individuals to become participants or beneficiaries in the plan or to terminate participation in the plan, even if the blackout is also used to effect other administrative actions that are incidental to the admission or withdrawal of plan participants or beneficiaries. However, this exemption is only available with respect to the participants or beneficiaries of the acquired or divested entity, and pursuant to the Final Rule only if the individuals becoming participants or beneficiaries are not permitted to participate in the same class of equity securities after the transaction as before the transaction. The purpose of this restriction is to limit the scope of the exception to temporary trading suspensions affecting persons employed by the acquired or divested entity.

Notice Requirements. If a director or executive officer of an issuer is subject to the blackout period trading restrictions, the issuer must "timely notify" the director or officer and the SEC of the occurrence of the blackout period. Under the Proposal, the notice was

[11] The notice can be provided in any graphic form that is reasonably accessible to the intended recipient.

required to include the following information: (1) the reason(s) for the blackout period; (2) a description of the plan transactions to be suspended during, or otherwise affected by, the blackout period; (3) the 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 Final Rule retains the requirements of the Proposal, with the exception that the length of a blackout period may be specified using either the actual or expected beginning date and ending date of the blackout period, or the calendar week or weeks during which the blackout period is expected to begin and end -- provided that during such week or weeks information as to whether the blackout period has begun or ended is readily available (without charge) to affected directors and executive officers.

The Proposal had required that the notice be provided to directors and executive officers at least 15 calendar days in advance of the blackout period. The Final Rule changes this requirement to coordinate with DOL blackout period notice requirements. Thus, under the Final Rule, notice to directors and executive officers will be considered timely if provided by the issuer no later than 5 business days after the issuer receives the required DOL notice from the benefit plan administrator. If the issuer does not receive such notice, however, the issuer must provide its own notice to directors and executive officers at least 15 calendar days before the actual or expected beginning date of the blackout period. The Final Rule retains the exception that if the blackout period is unforeseeable or results from circumstances beyond the reasonable control of the issuer (*e.g.*, a major computer or other technical failure), an issuer is excused from the advance notice requirement where the issuer makes a written determination that the circumstances preclude compliance with the requirement and provides the notice as soon as reasonably practicable.

For domestic issuers notice to the SEC must be made on Form 8-K and include the same content as described above for the notice to directors and executive officers. However, the Final Rule modifies the timing of the required filing to coordinate with the DOL blackout notice. Specifically, the Final Rule states that the instructions to Form 8-K have been revised to provide that the SEC notice must be filed on the same day as notice is transmitted to directors and executive officers (*i.e.*, within 5 days following receipt of the DOL blackout notice from the plan administrator). Foreign private issuers are required to file as an exhibit to Form 20-F and 40-F reports copies of any blackout period notices given to directors and executive officers during the previous fiscal year, unless the notices were provided to the SEC in a Form 6-K report. In addition, registered investment companies are subject to Form 8-K filing requirements for the sole purpose of meeting any filing obligation that arises under the Final Rule.

Remedies. The Final Rule provides that any director or executive officer who violates the trading prohibition is subject to possible civil injunctive actions, cease-and-desist proceedings, civil penalties and any other remedies available to the SEC to redress violations of the 1934 Act; and under appropriate circumstances the director or executive officer may be subject to criminal liability. In addition, any profits realized in violation of the trading restrictions are recoverable by the issuer, or in a derivative action by an owner of any security of the issuer if the issuer has failed to take action within 60 days of a request for such action (subject to a 2-year statute of limitations). The Proposal noted that the question of whether a transaction has resulted in the realization of recoverable profits is complex and did not specify an approach for calculating profits. However, the Final Rule provides that: (1) where a transaction involves an acquisition or transfer of a listed equity security that is registered under §12(b) or (g) of the 1934 Act, 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 equity security calculated over the first 3 trading days after the end of the blackout period; and (2) for any other transaction, 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 rather than taking place outside of the blackout period."

Effective Date and Transition Period. The new blackout period trading restrictions are effective on 1/26/03, and the notice requirement applies to blackout periods commencing on or after 1/26/03. However, for blackout periods commencing between 1/26/03 and 2/25/03, the Final Rule states that issuers should furnish notice to directors and executive officers "as soon as reasonably practicable." For notices to the SEC, the specific Form 8-K notice requirements will not be effective until 60 days after publication of the Final Rule in the *Federal Register*.[12] In the interim, an issuer may provide the required SEC notice by disclosing the information under Item 4 of Form 10-Q or 10-QSB in the first quarterly report filed by the issuer after commencement of the blackout period.

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[12] The Final Rule indicates that this delay is necessary to allow time for the addition of new Form 8-K Item 11 to the EDGAR system.