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## SEC ADOPTS REGULATION BLACKOUT TRADING RESTRICTION

*By Richard B. Montgomery IV and Margaret F. Murphy*

On January 22, 2003, the SEC adopted Regulation Blackout Trading Restriction ("Regulation BTR") to address the operation of Section 306(a) of the Sarbanes-Oxley Act of 2002 (the "Act"). Section 306(a) prohibits directors and executive officers from trading or otherwise acquiring or transferring equity securities of the issuer acquired in connection with service or employment when a substantial number of the issuer's employees are unable to engage in transactions through their individual plan accounts. ([Click here to link to our E\\*Zine regarding proposed Regulation BTR.](#))

### *Transactions Subject to Trading Prohibition*

The trading prohibitions of Regulation BTR apply to transactions by any director or executive officer in any equity security of the issuer, including derivative securities, such as options, that are acquired in connection with service or employment under the following circumstances:

- at a time when he or she was a director or executive officer of the issuer, under a compensatory plan, contract, authorization or arrangement, including option, pension, retirement, deferred compensation, bonus, incentive or profit-sharing plans or arrangements, including a compensatory plan, contract, authorization or arrangement with a parent, subsidiary or affiliate of the issuer;
- at a time when he or she was a director or executive officer of the issuer, as a result of any transaction or business relationship required to be disclosed in the issuer's proxy statement to the extent that he or she has a pecuniary interest in the equity securities acquired;
- at a time when he or she was a director or executive officer, as "director's qualifying shares" or other securities that he or she must hold to meet an issuer's minimum ownership requirements for directors or executive officers;
- 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 as a director or executive officer; or

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- prior to becoming, or while, a director or executive officer if the equity security was received as a result of a business combination in respect of an equity security of an entity involved in the business combination that he or she had acquired in connection with service or employment as a director or executive officer of that entity.

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, with certain exceptions, 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.”

### *Exempt Transactions*

The following transactions are exempt from the prohibitions of Regulation BTR:

- acquisitions of equity securities under dividend or interest reinvestment plans;
- purchases or sales of equity securities pursuant to a Rule 10b5-1(c) trading arrangement if certain requirements are met;
- purchases or sales of equity securities pursuant to certain “tax-conditioned” plans, such as 401(k) plans, Section 423 employee stock purchase plans and ESOPs, other than discretionary transactions through those plans;
- 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 and awards of equity securities (including options and stock appreciation rights) pursuant to a plan that, by its terms, permits directors or executive officers to receive grants or awards automatically and specifies the terms and conditions of the grants or awards;
- exercises, conversions or terminations of derivative securities that were not acquired by a director or executive officer during

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the blackout period in question or while aware of the actual or approximate beginning or ending dates of the blackout period, and where (i) the derivative security, by its terms, may be exercised, converted or terminated only on a fixed date, or (ii) the derivative security is exercised, converted or terminated by a counterparty and the director or executive officer does not exercise any influence over the counterparty;

- acquisitions or dispositions of equity securities involving a *bona fide* gift or transfer by will or the laws of descent and distribution;
- acquisitions or dispositions of equity securities pursuant to a domestic relations order;
- sales or other dispositions of equity securities compelled by law; and
- acquisitions or dispositions of equity securities in connection with a merger, acquisition, divestiture or similar transaction occurring by operation of law.

### *Blackout Period*

Blackout periods typically occur as a result of administrative changes to a benefit plan. The most common reasons for imposing a blackout period include:

- changes in investment alternatives;
- changes in the frequency of portfolio valuations;
- changes in plan record-keepers or other service providers;
- changes in plan trustees; and
- corporate mergers, acquisitions and spin-offs that affect the pension coverage of groups of participants.

Under Section 306(a) of the Act, a "blackout period" is a period of more than three consecutive business days during which the ability of not fewer than 50% of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell or otherwise acquire or transfer an interest in any equity security of such issuer held in such an

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individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan. Regulation BTR clarifies the scope, and addresses the application, of this definition.

Under the Act, the term “individual account plan” is defined to include a variety of pension plans, such as Section 401(k) plans, profit-sharing and savings plans, stock bonus plans, and money purchase pension plans, and certain non-qualified deferral compensation arrangements. A one-participant retirement plan and plans in which participation is limited to directors of the issuer are excluded from the definition of individual account plan.

Regulation BTR clarifies that, in determining whether a temporary trading suspension in issuer equity securities constitutes a “blackout period,” the individual account plans to be considered are those that permit participants or beneficiaries in the United States to acquire or hold equity securities of the issuer. This would include individual account plans that:

- permit participants or beneficiaries to invest their plan contributions in the equity securities of the issuer;
- include an “open brokerage window” that permits participants or beneficiaries to invest in the equity securities of any publicly-traded company, including the issuer;
- match employee contributions with equity securities of the issuer; or
- reallocate forfeitures that included equity securities of the issuer to the remaining plan participants.

For purposes of Section 306(a) of the Act, once an issuer has identified the relevant individual account plans for purposes of the 50% test, it must apply the test by comparing the number of participants or beneficiaries located in the United States who are subject to a temporary suspension of trading in such equity securities to the overall number of participants or beneficiaries located in the United States under all individual account plans maintained by the issuer. If this percentage is at least 50%, the statutory trading prohibition would apply to the directors and executive officers. Regulation BTR provides rules for applying the 50% test.

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Section 306(a) of the Act expressly excludes the following transactions from the definition of blackout period:

- a regularly scheduled period that is incorporated into the individual account plan and timely disclosed to employees before they become participants; and
- any suspension that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries, because of a merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor.

Regulation BTR clarifies the application of these exceptions as follows:

- the requirement that the blackout period be incorporated in the individual account plan may be satisfied by including a description of the regularly scheduled trading suspension, including the suspension's frequency and duration and the plan transactions to be suspended or otherwise affected, in either the official plan documents or other documents or instruments that govern plan operations;
- the disclosure of the blackout period to an employee will be timely if provided no later than 30 calendar days after he or she formally enrolled in the plan or, in the case of a subsequent amendment to the plan, within 30 calendar days after the adoption of the amendment (the notice may be in any graphic form that is reasonably accessible to the included recipient, including e-mail); and
- in the case of a temporary trading suspension in issuer equity securities imposed in connection with a plan following a merger, acquisition, divestiture or similar transaction, the temporary suspension will not constitute a "blackout period" if its principal purpose is to enable individuals to become participants or beneficiaries in a plan by reason of the transaction, or to terminate participation in the plan, even though the suspension is also used to effect other incidental administrative actions. In addition, the new rule clarifies that the exception is available only as to participants or beneficiaries of the acquired or divested entity.



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## *Remedies*

A violation of the trading prohibition of Section 306(a) is subject to a possible SEC enforcement action or a required disgorgement of profits, with a strict standard of liability similar to that under Section 16(b) of the Securities Exchange Act of 1934. Profits are calculated on the basis of the difference between the actual amount paid or received by a director or executive officer as a result of the acquisition or transfer of an equity security during a blackout period and the market value of the issuer's equity securities on the first date after the end of the blackout period. To provide guidance to courts, Regulation BTR provides that:

- where a transaction involves an acquisition or transfer (other than a grant, exercise, conversion or termination of an option or other derivative security) of an equity security of the issuer that is publicly traded, profit is to be measured by comparing the difference between the amount paid or received for the equity security on the date of the transaction during the blackout period and the average market price of the equity security calculated over the first three trading days after the ending date of the blackout period; and
- for other transactions, 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.

No suit may be brought more than two years after the date on which the recoverable profits were realized.

## *Notice*

Under Regulation BTR, whenever a director or executive officer of an issuer is subject to the statutory trading prohibition, the issuer must provide notice of the blackout period to the director or executive officer, as well as to the SEC on Form 8-K.

The notice must include the following information:

- the reason or reasons for the blackout period;
- a description of the plan transactions to be affected by the blackout period;

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- the description of the class of equity securities subject to the blackout period;
- the actual or expected 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, 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 (such as via a toll-free telephone number or access to a specified web site) and the notice describes how to access the information; and
- the name, address and telephone number of the person to respond to inquiries about the blackout period.

Regulation BTR provides that the notice to directors and executive officers will be considered timely if an issuer provides it no later than five business days after the issuer receives the notice from the pension plan administrator required by rules under Section 306(b) of the Act adopted by the U.S. Department of Labor. If the issuer does not receive such notice, the issuer must deliver, with certain limited exceptions, notice to directors and executive officers at least 15 calendar days in advance of commencement of the blackout period. This notice requirement applies to blackout periods commencing on or after January 26, 2003.

Beginning March 31, 2003, notice to the SEC of a blackout period must be provided on Form 8-K no later than the date by which notice to directors and executive officers is required as described above. In addition, beginning March 31, 2003, issuers must provide the SEC with notice on Form 8-K of any change in the beginning or ending date of a blackout period "as soon as reasonably practicable."

Except as otherwise described above, Regulation BTR became effective January 26, 2003. ([Click here to link to the full text of Regulation BTR.](#))

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*Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:*

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