SEC PROPOSES RULES ON INSIDER TRADES DURING RETIREMENT PLAN BLACKOUT PERIODS

SIMPSON THACHER & BARTLETT LLP

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On November 15, 2002, the Securities and Exchange Commission ("SEC") proposed new rules (the "Proposed SEC Rules") under Section 306 of the Sarbanes-Oxley Act of 2002 (the "Act") relating to restrictions on insider trades during retirement plan blackout periods.[1] The Act requires that the SEC adopt rules giving effect to Section 306 of the Act no later than January 26, 2003.[2]

STATUTORY BACKGROUND

Section 306(a) of the Act:

- imposes trading restrictions on directors and executive officers of issuers of equity securities (other than exempt securities)[3] during certain retirement plan blackout periods; and
- requires notice of blackout periods by issuers of equity securities to the SEC and affected directors and executive officers.

The term "issuer" for these purposes means an issuer, the securities of which are registered under Section 12 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that

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1 SEC Release No. 34-46778; IC-25795; 67 FR 69430 (the "SEC Release"). This memorandum supplements our many memoranda regarding the Sarbanes-Oxley Act and related SEC rulemaking. These memoranda are available upon request or at our website: *www.simpsonthacher.com.*

2 The Act requires the SEC to issue final rules, in consultation with the Department of Labor, to clarify the application, and prevent evasion, of Section 306(a) of the Act. The SEC has requested comments on the Proposed SEC Rules on or before December 16, 2002.

3 For these purposes, an "exempt security" would have the meaning set forth in Section 3(a)(12) of the Exchange Act.

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statement that has not yet become effective under the Securities Act of 1933, as amended, and that has not been withdrawn. The definition of issuer includes domestic issuers, foreign private issuers, banks and savings associations, small business issuers and registered investment companies.

PROPOSED SEC RULES

The Proposed SEC Rules would clarify the scope and application of Section 306(a) of the Act in a number of significant respects, including its application in non-U.S. jurisdictions, the types of retirement plans covered, the scope of several important exceptions, and the timing and content requirements for the notices regarding blackout periods that issuers must provide to their directors and executive officers and to the SEC.

Trading Restrictions

It is unlawful under Section 306(a) of the Act for any director or executive officer of an issuer of any equity security (other than an exempt security), directly or indirectly, to purchase, sell or otherwise acquire or transfer any equity security of the issuer (other than an exempt security) during certain individual account retirement plan blackout periods with respect to the equity security if the director or executive officer acquired the equity security in connection with his or her service or employment as a director or executive officer. The Proposed SEC Rules would clarify many of these concepts, as described below.

- Definitions of "Director" and "Executive Officer." Under the Proposed SEC Rules, in the case of a domestic issuer, the term "director" would have the meaning set forth in Section 3(a)(7) of the Exchange Act, which defines a "director" to mean any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated. In the case of a foreign private issuer, the term "director" would include individuals within the meaning of Section 3(a)(7) of the Exchange Act, provided that such individuals are also management employees of the issuer.

  In the case of a domestic issuer the term "executive officer" would have the same meaning as the term "officer" has under Exchange Act Rule 16a-1(f), which defines an "officer" to mean 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. Officers of the issuer's parents or subsidiaries are deemed officers of the issuer if they perform such policy-making functions for the issuer. In

the case of a foreign private issuer, the term "executive officer" would mean the principal executive officer or officers, the principal financial officer or officers, and the principal accounting officer or officers (or, if none, the controller), of the issuer.

The SEC Release indicates that the SEC borrowed certain Section 16 concepts in order to facilitate enforcement of the trading prohibitions of Section 306(a) of the Act by allowing reference to trading reports filed pursuant to Section 16(a) of the Exchange Act. Reference to Section 16 reports for the purposes of enforcement will only be possible in relation to domestic issuers, as foreign private issuers remain exempt from Section 16.

- Equity Securities. The term "equity security of the issuer" would include any equity security or derivative security[4] relating to the issuer, whether or not issued by that issuer. This would include, for example, phantom stock and, in the case of foreign private issuers, American Depositary Receipts (ADRs).

- In Connection With Service or Employment.

  -- Scope. The Proposed SEC Rules would clarify that the phrase acquired "in connection with his or her service as a director or executive officer" includes equity securities acquired, directly or indirectly:

    - at a time when the individual was a director or executive officer of the issuer, under compensatory plans and arrangements, such as option plans, retirement plans, deferred compensation plans, and bonus arrangements, with the issuer or any of the issuer's affiliates;

    - at a time when the individual was a director or executive officer of the issuer, as a result of certain affiliated party transactions as described in paragraph (a) or (b) of Item 404 of Regulation S-K or, in the case of a foreign private issuer, Item 7.B of Form 20-F (in each case without application to the disclosure thresholds for these provisions), to the extent the individual has a pecuniary interest in the equity securities;

    - 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

[4] For these purposes, "equity security" would have the meaning set forth in Section 3(a)(11) of the Exchange Act and Exchange Act Rule 3a11-1, and "derivative security" would have the meaning set forth in Exchange Act Rule 16a-1(c).

issuer, or as a result of a merger, consolidation or other transaction involving the issuer; or

- as directors' qualifying shares or other shares required to be held to meet an issuer's minimum ownership guidelines, including such shares acquired on the open market.

Equity securities acquired in connection with service or employment before the issuer became subject to the Act or before the effective date of the Act would be within the scope of the statutory prohibition.

-- Special Ordering Rule Applicable to Dispositions. Under the Proposed SEC Rules, the actual source of the securities disposed of in a transaction would be irrelevant. The Proposed SEC Rules would establish an irrebuttable presumption that the securities disposed of were acquired "in connection with service or employment" as a director or executive officer to the extent the director or executive officer actually held securities so acquired.[5] In effect, this presumption would prevent insiders from trading any equity securities of the issuer during blackout periods, if the director or executive officer then held any equity securities of the issuer acquired in connection with service or employment as a director or executive officer.

- Certain Transactions Exempted from Prohibitions on Trading. The Proposed SEC Rules would clarify that the following transactions are exempt from the insider trading prohibitions:

  - purchases under certain broadly-based dividend reinvestment plans;

  - purchases or sales pursuant to 10b5-1(c) contracts, instructions or plans; provided that the contract was executed, the instruction was given, or the plan was adopted, before the director or executive officer became aware of the blackout period;

  - stock splits or stock dividends applying equally to all securities of that class, and acquisitions of security holder rights pursuant to a pro rata

[5] The SEC Release provides the following example of the application of this presumption: if an executive officer owns 1,000 shares of the issuer's common stock, 250 of which were acquired as a result of the exercise of employee stock options ("Option Shares"), a sale of 250 shares of common stock during a blackout period would be presumed to be a sale of the Option Shares and therefore subject to the statutory prohibitions of Section 306(a) of the Act, without regard to the shares' actual source. A subsequent sale of 250 shares during the same blackout period would not trigger the statutory trading prohibition, since the Option Shares would have been deemed sold in the first transaction.

grant to all holders of the same class of equity securities registered under Section 12 of the Exchange Act; or

- purchases or sales under qualified employee benefit plans, excess benefit plans or stock purchase plans (in each case, as defined in Exchange Act Rule 16b-3),[6] unless the transaction is a "discretionary transaction" that does not otherwise meet the 10b5-1(c) exemption specified above. Discretionary transactions would include intra-plan transfers involving the issuer's equity securities, and cash distributions funded by a volitional disposition of an issuer's equity securities. Discretionary transactions would not include acquisitions or dispositions of securities in connection with termination of employment, or a transaction involving a diversification or distribution that is required by the U.S. Internal Revenue Code to be made available under the plan.

Blackout Periods

For purposes of the trading restrictions, a "blackout period" generally means any 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" retirement plans maintained by the issuer to purchase, sell or otherwise acquire or transfer an interest in any equity of the issuer held in the individual account retirement plan is temporarily suspended by the issuer or by a fiduciary of the plan. Blackout periods most commonly occur in connection with changes in retirement plan investment alternatives or recordkeepers, and in connection with corporate transactions, such as mergers and acquisitions.

- Individual Account Plans. The Proposed SEC Rules would clarify that prohibitions on insider trades would apply in the event of blackout periods under non-qualified deferred compensation plans as well as tax-qualified retirement plans such as 401(k) plans, profit sharing plans, saving plans, stock bonus plans and money purchase pension plans.[7]

- Definition of Blackout Period – 50% Test / Foreign Private Issuers. In general, the statutory prohibition on insider trades does not apply unless a significant portion (not fewer than 50%) of the participants or beneficiaries under all individual account

[6] The SEC Release states that plans maintained by foreign private issuers that are not required to satisfy the U.S. Internal Revenue Code, but are intended to satisfy foreign tax and other laws, would *not* qualify for this exception. The SEC has requested comments as to whether these plans maintained by foreign private issuers should qualify for this exception.

[7] Otherwise, the definition of an "individual account plan" closely tracks the definition set forth in Section 3(34) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

retirement plans "maintained by"[8] the issuer are affected by the restrictions under the plan. The Proposed SEC Rules would clarify the application of this 50% test in several key respects.

- The 50% test would only be met if at least 50% of plan participants or beneficiaries in the United States (and its territories and possessions) are restricted from trading under all individual account retirement plans maintained by the issuer that hold or could hold equity securities of the issuer. The prohibitions on insider trading would not apply if a blackout period affected only plan participants or beneficiaries located outside the United States.

- In addition to the 50% test described above, in order for the prohibition on insider trading to be applicable to the directors and executive officers of a foreign private issuers, the participants and beneficiaries in the United States that are restricted from trading under the issuer's individual account plans would need to constitute more than 15% of the participants and beneficiaries under all individual account plans maintained by the issuer worldwide that hold or could hold equity securities of the issuer.

- Certain Transactions Exempted from Definition of Blackout Period. A "blackout period" for purposes of the prohibitions on insider trades would not include:

  - blackout periods imposed to permit employees to become or cease to be participants in an individual account plan following certain corporate transactions involving the plan or plan sponsor; or

  - regularly scheduled periods under the plan in which participants and beneficiaries may not purchase, sell, or otherwise acquire or transfer an interest in any equity of the issuer, if the period is included in the plan documents and timely disclosed to affected employees and participants.

Notice Requirements

In any case in which a director or executive officer of an issuer is subject to the Act's prohibitions on insider trades, the issuer must timely notify the director or executive officer, as

[8] A plan would be considered maintained by the issuer if the issuer was part of the same controlled group as the plan sponsor under Section 414 of the U.S. Internal Revenue Code.

well as the SEC. The Proposed SEC Rules describe certain content requirements, including the requirement that the notice explain the reason for the blackout period and the actual or expected duration of the period.

- Notice to directors and executive officers would be considered timely if it is provided at least 15 days[9] in advance of the commencement of the blackout period, unless notice cannot be timely given due to events that were unforeseeable or due to circumstances beyond the reasonable control of the issuer (as reasonably determined in writing by an authorized representative of the issuer), in which case notice (and representative's determination) must be given as soon as reasonably practicable before the blackout period commences.

- Notice to the SEC would be considered timely if:

    - the issuer files a Form 8-K within the time prescribed for filing such report (generally, within two business days after the earlier of (1) receipt of notice of the blackout period from the plan administrator, or (2) actual knowledge of the blackout period by the person designated by the issuer to oversee the issuer's pension plans, or if none, the issuer's human resources director or person performing the equivalent function); or

    - the issuer is a foreign private issuer and includes the notice information in the first annual report on Form 20-F or Form 40-F required to be filed after receipt of notice of a blackout period.

Remedy for Violations

Any profit realized by a director or executive officer of the issuer from any transactions in violation of the trading restrictions will be recoverable by the issuer, irrespective of the director or executive officer's intention in entering into the transaction. An action to recover profits may be instituted by the issuer, or by the owner of any security of the issuer in the name and on behalf of the issuer if the issuer does not bring the action within 60 days after the date of request, or fails diligently to prosecute the action thereafter. No such suit, however, may be brought more than two years after the date on which the profit was realized.

A violation of the statutory trading prohibitions of Section 306 also is subject to possible SEC enforcement action.

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[9] The notice requirements would apply to blackout periods commencing on or after January 26, 2003. However, for blackout periods commencing between January 26, 2003 and February 10, 2003 (15 days after the effective date of Section 306 of the Act), issuers should provide notice as soon as reasonably possible.

INTERIM FINAL DOL RULES

On October 21, 2002, the Department of Labor ("DOL") issued interim final rules (the "Interim Final DOL Rules") pursuant to Section 306(b) the Act relating to advance notice requirements for retirement plan blackout periods.[10] The Interim Final DOL Rules specify the content and timing of blackout period notices that must be provided to participants and beneficiaries under individual account retirement plans, as well as to issuers of employer securities subject to the blackout period. The Interim Final DOL Rules also provide model notice language to assist plan administrators in complying with these new notice requirements.

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Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, www.simpsonthacher.com.

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[10] 67 FR 64766. The Act required the DOL to issue interim final rules no later than October 13, 2002 to carry out the amendments to ERISA made by Section 306(b) of the Act, and initial guidance and a model notice no later than January 1, 2003. The DOL requested comments on the Interim Final DOL Rules on or before November 20, 2002. The Interim Final DOL Rules will become effective January 26, 2003, and will apply to blackout periods commencing on or after that date. In this ERISA context, the term "blackout period" has a broader meaning than in the context of the insider trading prohibitions discussed above.