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New Rules for Black-out Periods Under Sarbanes-Oxley Act[1]

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The Sarbanes-Oxley Act[2] contains new requirements that apply to so-called "black-out periods" in participant-directed retirement plans. Black-out periods occur when the ability of plan participants to take certain actions is temporarily suspended. Sarbanes-Oxley requires that participants receive advance written notice of certain black-out periods, and restricts the ability of insiders to trade in employer securities during certain black-out periods. These provisions became effective on January 26, 2003 and the Department of Labor ("DOL") and the Securities and Exchange Commission ("SEC") have issued final rules implementing the new requirements.[3]

Substantial penalties may be imposed for non-compliance with the black-out notice requirement or the insider trading prohibition under Sarbanes-Oxley. We have summarized these new black-out requirements and the potential penalties for violations of the rules below.

Black-out Notice Rules

Sarbanes-Oxley added a new § 101(i) to ERISA that requires plan administrators of ERISA-covered plans to provide affected participants and beneficiaries with at least 30 days' written notice before any black-out period with respect to an individual account plan. An amendment to ERISA § 502(c) gives the DOL authority to assess a civil penalty of up to $100 per day per individual for failures to satisfy this notice requirement. Key features of these new ERISA provisions and the DOL rules implementing them are summarized below.

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2 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204.

3 The DOL issued "interim final rules" on October 21, 2002 (67 Fed. Reg. 64766 and 64774) and final rules on January 24, 2003 (68 Fed. Reg. 3716 and 3729). The SEC issued proposed rules on November 15, 2002 (67 Fed. Reg. 69429; SEC Rel. 34-46778) and final rules on January 28, 2003 (68 Fed. Reg. 4338; SEC Rel. 34-47225).

Timing of Notice

Sarbanes-Oxley requires that black-out notices be provided to affected participants and beneficiaries at least 30 days in advance of the black-out period. The DOL rules clarify that the 30-day minimum notice period applies with respect to the last date on which affected participants and beneficiaries could exercise the rights impacted by the black-out. The rules also require that the notice not be provided more than 60 days before the last date on which affected participants and beneficiaries could exercise their affected rights. Individuals who become participants after notices are provided to other participants must be provided with notices as soon as possible.

Content of Notice/Model Notice

As set forth in the DOL rules, black-out notices must include:

- reasons for the black-out;
- in addition to an identification of any investments subject to the black-out period, a description of the rights otherwise available to participants and beneficiaries under the plan that will be temporarily suspended, limited, or restricted by the black-out period (e.g., the right to obtain loans);
- the expected beginning date and ending date of the black-out;
- in the case of affected investments, a statement that the participant or beneficiary should evaluate the appropriateness of their current investment decisions in light of their inability to direct or diversify assets during the black-out;
- in any case in which the notice is not furnished at least 30 days before the last date, affected participants and beneficiaries could exercise their affected rights, a statement that Federal law generally requires that the notice be furnished at least 30 days in advance of such date (inclusion of the statement in paragraph 5 of the DOL model notice satisfies this requirement), and an explanation of the reasons why at least 30 days' advance notice could not be furnished; and
- the name, address and telephone number of the plan administrator or other person responsible for answering questions about the black-out.

As directed by Sarbanes-Oxley, the DOL rules contain a model notice. The use of the model is not mandatory, but a notice that includes the statements in paragraphs 4 and 5 of the model will be deemed to have satisfied certain notice content requirements described above.

The requirement that notices must include an expected end date for a black-out period generated some controversy. Sarbanes-Oxley requires only that the notice include the expected beginning date and length of the black-out period. Comments submitted to DOL explained that it is difficult to predict in advance an exact beginning and end date for a black-out period since various factors (e.g., problems with records or computer systems) can affect the actual black-out dates. In order to provide some additional flexibility, the final rules allow the notice to specify a calendar week during which the black-out is expected to begin and end, so long as participants have access to information during that week (e.g., by a toll-free line) about whether the black-out has begun or ended.

The final DOL rules also clarify that:

- the contact person for answering questions about the black-out period does not have to be a specific person and could, for example, be the "benefits department;"
- the black-out notice may be furnished with other plan information (e.g., benefit statements) so long as the black-out notice information is prominently identified; and
- black-out notices will be considered furnished on the date of mailing if accomplished by first class mail, certified mail, or Express mail, or on the date of delivery to a "designated private delivery service."

Definition of "Black-out Period"

The definition of "black-out period" contained in the DOL rules is virtually identical to the definition contained in new ERISA § 101(i). The term is defined generally as any period for which the ability of a participant to direct assets, obtain distributions, or obtain loans, "which is otherwise available under the terms of such plan," is temporarily suspended for a period of more than three consecutive business days. Excluded from this definition are:

- suspensions required by federal securities laws;
- suspensions in accordance with qualified domestic relations orders ("QDROs"); and
- any regularly scheduled suspension which is disclosed to participants.

In the final rules, the DOL provided some important clarifications relating to the definition of a black-out period. First, the regulation provides that "regularly scheduled suspensions" could also be disclosed to participants in a summary plan description, a summary of material modifications, materials describing specific investment alternatives under the plan (including limits on or changes to investment alternatives), participation or enrollment forms, or any other documents under which the plan is operated and that are provided to participants and beneficiaries. DOL also clarified that restrictions on investments or delays in transfer of payments for certain investments (e.g., equity wash or other similar rules affecting certain plan investments) are treated as "regularly scheduled suspensions" if disclosed to participants. In addition, permanent restrictions, such as on new contributions to an investment option, replacement of one option with another, or a plan termination, do not in and of themselves give rise to a black-out notice obligation. However, if certain rights are temporarily suspended in connection with implementing a permanent restriction, the black-out notice requirements could apply to the temporary suspension.

The final rules specifically provide that the QDRO exception applies to a suspension resulting from a pending determination by a plan administrator or court whether a domestic relations order is a QDRO. Also excluded are suspensions which occur "by reason of an act or a failure to act on the part of an individual participant or by reason of an action or claim by a party unrelated to the plan involving the account of an individual participant." According to the preamble to the final rules, this exclusion is intended to address suspensions triggered by individual participant actions, such as the receipt of a tax levy or the failure of a participant to obtain a PIN number.

Notice of Change in Black-out Period

If there is a change in the beginning or ending date of the black-out period as specified in the black-out notice, the plan administrator is required to furnish all affected participants and beneficiaries (and the issuer of any employer securities subject to the black-out) with an updated notice explaining the reasons for the change in the date(s) and identifying all material changes in the information contained in the prior notice. This subsequent notice is required to be furnished as soon as reasonably possible, unless providing the notice before the black-out period terminates is impracticable. The DOL also explains that, where a plan administrator has the ability to provide notice to some participants earlier than others, the administrator should provide the notice even if notice to other participants would not be practicable.

Exceptions to 30-Day Notice Requirement

Sarbanes-Oxley provides exceptions to the 30-day notice requirement for any case in which:

- a deferral of the black-out period would result in a violation of the exclusive purpose and prudence rules in ERISA section 404(a);
- the inability to provide the notice was due to events that were unforeseeable or beyond the reasonable control of the plan administrator; or
- the black-out is imposed on participants who are becoming or ceasing to be plan participants in connection with a merger or acquisition or similar transaction.

If the exception is based on a possible violation of ERISA or an unforeseeable event, the plan administrator or another responsible plan fiduciary must determine that the exception applies in a dated and signed writing.

In the case of any of these exceptions, the notice still must be provided as soon as reasonably possible under the circumstances, unless providing the notice before the black-out period ends is impracticable. The preamble to the DOL's interim final rules confirms that no notice is required if the plan administrator determines that a notice could not be furnished in sufficient time before the termination of the black-out to alert participants to the resumption of plan rights (e.g., where the need for the black-out is determined only a few days before the beginning of the black-out and the black-out lasts for only a few days).

Use of Electronic Media

Sarbanes-Oxley provides that the black-out notice must be in writing, but may be in electronic form "to the extent that such form is reasonably accessible to the recipient." The final rules clarify that the notice may be furnished to affected participants in any manner consistent with the requirements of DOL Reg. § 2520.104b-1, including paragraph (c) of that section relating to the use of electronic media.

Civil Penalties for Failures

Sarbanes-Oxley added a new paragraph (7) to ERISA § 502(c) to give the DOL the authority to assess a civil penalty of up to $100 per day from the date of the plan administrator's failure to satisfy the notice requirement. New § 502(c)(7) also provides that each violation with respect to any single participant or beneficiary is treated as a separate violation.

The final rules on civil penalties clarify that a failure for purposes of the penalty includes a failure, in whole or in part, to provide notice to an affected participant or beneficiary at the time and in the manner required by new ERISA

§ 101(i). The rules confirm that a failure to provide the notice to a single participant or beneficiary is treated as a separate violation for purposes of computing the penalty, and provides that the amount of the penalty shall be determined by DOL, "taking into consideration the degree and/or willfulness of the failure." The maximum penalty is $100 per day, computed from the date of the administrator's failure to provide the notice up to and including the date that is the final day of the black-out period.

Commentators requested that the rule provide that the penalty computation period would end on the date a notice is given. The DOL did not take this view, however. According to the DOL, the failure to provide a timely notice deprives affected participants of the full period of time Congress concluded was the minimum period necessary to consider the effects of the black-out period, and providing a late notice does not correct the violation. Whether and when a plan administrator provides a late notice will, however, be a factor the DOL will take into account in determining the amount of the penalty.

Notice to Issuer of Securities

As required by Sarbanes-Oxley, the DOL rules require the plan administrator to provide an issuer of employer securities offered under a plan (i.e., the employer or its parent company) with a similar black-out notice (the same form that is provided to participants may be used), within the same time frame, if employer securities will be subject to the black-out period. However, if an issuer designates the plan administrator as the person to be furnished the notice, the issuer will be deemed to have received its notice on the same date as notice is provided to participants and beneficiaries. The DOL noted in the preamble to its final rules that the $100 per day penalty did not apply to a failure to provide a notice to the issuer.

Insider Trading Prohibition During Black-outs

Sarbanes-Oxley also makes it unlawful for directors and executive officers of a public company to acquire or transfer equity securities of the company during a "black-out period." Generally, the trading prohibition applies to any "reporting company" that files periodic reports with the SEC under the Securites Exchange Act of 1934 ("Exchange Act") and to certain foreign companies, if U.S. employees may purchase or hold the company's equity securities under an individual account plan. Key features of the statutory trading prohibition and the SEC rules implementing it are summarized below.

Definition of "Black-out Period"

"Black-out period" is defined differently for purposes of the insider trading prohibition. A black-out period is a period lasting more than three consecutive business days during which the ability of not fewer than 50 percent of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell, or otherwise acquire or transfer any equity security of the issuer is temporarily suspended. The final rules provide that the term "individual account plan," as defined in ERISA § 3(34), encompasses a variety of plans – e.g., 401(k), profit-sharing, stock bonus and money purchase pension plans – and also includes nonqualified deferred compensation, or "top hat," plans that contain the elements of an individual account plan. Any individual account plan maintained by an issuer would be included in the calculation of whether a black-out period occurs if the plan permits participants or beneficiaries to invest in the issuer's equity securities, provides for a match of employee contributions with equity securities of the issuer, or has an open brokerage window that allows employees to invest in the equity securities of the issuer (whether or not the plan actually holds the issuer's equity securities).

In addition, for purposes of making the 50 percent calculation, the final SEC rules provide that:

- the controlled group rules of Code § § 414(b), (c), (m), and (o) apply;
- the 50 percent calculation applies only with respect to participants and beneficiaries located within the U.S. and its territories and possessions;
- an individual account plan maintained outside of the United States primarily for the benefit of nonresident aliens is not to be considered; and
- an individual account plan maintained exclusively for directors is not to be considered.

A company may utilize plan census data as of any date within the 12-month period preceding the beginning of the black-out period in question, provided there has not been a significant change in the number of participants and beneficiaries in the plan. A company may also aggregate participant and beneficiary totals without regard to overlapping plan participation. The black-out trading prohibition applies to directors and executive officers of a foreign private issuer only if the 50 percent threshold is triggered and the affected U.S. participants and beneficiaries either (a) comprise 15 percent of the total number of employees of the issuer and its consolidated subsidiaries, or (b) total 50,000.

Exceptions to Definition of Black-out Period

Exceptions from the definition of black-out period are similar to exceptions under the DOL rules, including exceptions for:

- a regularly scheduled period in which the participants and beneficiaries may not purchase, sell, or otherwise acquire or transfer equity securities, if the period is (a) incorporated into the plan and (b) timely disclosed to employees; or
- any suspension that is imposed solely in connection with persons becoming participants or beneficiaries, or ceasing to be participants or beneficiaries, in the plan by reason of a corporate merger, acquisition, divestiture or similar transaction involving the plan or plan sponsor, provided that the persons becoming participants are not permitted to participate in the same class of equity securities after the transaction as before the transaction.

The final rules clarify that the requirement that a regularly scheduled suspension period be incorporated into the plan may be satisfied by including a description of the suspension period, including the plan transactions to be suspended and the frequency and duration of the suspension, in the documents or instruments under which the plan operates, including an ERISA § 404(c) notice, a summary plan description or any other plan communication. In the case of a merger or similar transaction, the rules clarify that a suspension would not trigger the prohibition on trading if the principal purpose of the suspension is to enable individuals to become participants or beneficiaries, or to terminate plan participation, even though the black-out period also is used to effect other incidental administrative actions.

Definition of "Executive Officer"

The rules define the term "executive officer" in the same manner as the term "officer" is defined under § 16 of the Exchange Act (Rule 16a-1(f)).[4] Rule 16a-1(f) defines an officer generally as the president, principal financial officer, principal accounting officer or controller, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), and any other officer or other person who performs a policy-making function, including for a subsidiary or parent. The rules provide special definitions of "director" and "executive officer" with respect to foreign private issuers.

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[4] The SEC rules implementing the trading prohibition employ a number of concepts and definitions developed under Section 16 of the Exchange Act, which contains the short-swing profit liability and insider reporting rules.

After Sarbanes-Oxley was enacted, it was widely expected that the definition of "executive officer" would track the definition of the same term in Exchange Act Rule 3b-7 (a definition that could exclude an issuer's principal financial officer and controller). The SEC release explains that the Section 16 definition of "officer" is more appropriate in part because it will allow companies to coordinate the application of the black-out trading prohibition with their other insider trading programs. In addition, the Exchange Act definitions of "officer" and "executive officer" are very similar, and use of the Rule 16a-1(f) definition should not have a material effect on the number of persons subject to the black-out trading rules.

Transactions Subject to Black-out Trading Prohibition

A director or executive officer is prohibited from directly or indirectly purchasing, selling, or otherwise acquiring or transferring any equity security of the issuer during a black-out period, if the equity security was acquired in connection with the director or executive officer's service or employment as a director or executive officer. The rules interpret the phrase "acquired in connection with service or employment" broadly to include equity securities acquired by a director or executive officer in any of the following circumstances:

- at the time he or she was a director or executive officer under any compensatory plan, contract, or arrangement, including, but not limited to, plans relating to option, pension, retirement, deferred compensation, bonus, incentive, or profit-sharing plans;
- solely or primarily as a result of his or her status as a director or executive officer, even if acquired through an arms-length commercial transaction;
- to satisfy the issuer's minimum ownership guidelines, including so-called "directors' qualifying shares;" or
- before the individual became a director or executive officer if the equity security was acquired as an "inducement" to service or employment with the issuer or as a result of a merger or other acquisition involving the issuer.

An acquisition of equity securities in one of the four situations listed above by a related person or entity may also result in the securities being treated as “acquired in connection with service or employment,” if the director or executive officer is deemed to have an indirect pecuniary interest in the equity securities acquired. This attribution rule would cover an acquisition by immediate family members sharing the same household, or by a partnership, corporation, limited liability company or trust. (The attribution rule also applies with respect to the prohibition on any purchase, sale, or other acquisition of an equity security during the black-out period.)

The SEC rules clarify that equity securities acquired by an individual before he or she became a director or executive officer generally are not subject to the prohibition on trading during black-outs – the inducement and merger provisions being notable exceptions – but that equity securities acquired in connection with an individual's service or employment as a director or executive officer before the company became a public company would be subject to the prohibition on trading.

The SEC rules provide that equity securities sold or transferred during a black-out period will be presumed to have been acquired in connection with service or employment as a director or executive officer to the extent the individual holds any such securities. This presumption can be rebutted by an individual if he can establish that the securities are not covered securities by specifically identifying their origin and demonstrating that this identification is consistent for all purposes related to the transaction (such as tax reporting and applicable disclosure and reporting requirements).

Definition of "Equity Security"

The black-out trading prohibition applies to any "equity security of the issuer" other than an "exempt security." For this purpose, "equity securities" generally include stock or similar securities (such as American Depository Receipts ("ADRs")), a future on a security, any security convertible into an equity security, warrants or rights to subscribe to a security. (This term is defined by reference to Exchange Act § 3(a)(11)). "Exempt securities" are defined by reference to Exchange Act § 3(a)(12), and include, for example, interests in tax-qualified pension plans offered by an employer. Consistent with the approach taken under § 16 of the Exchange Act, the phrase "equity security of the issuer" is defined to include any equity security or derivative security relating to an issuer, whether or not issued by the issuer.

Exempt Transactions

Sarbanes-Oxley specifically authorized the SEC to provide any appropriate exceptions from the black-out trading prohibition, and the SEC rules exempt the following transactions:

- acquisitions pursuant to broad-based, nondiscriminatory dividend or interest reinvestment plans;

- purchases or sales pursuant to an advance election under a contract, instruction or written plan that satisfies the affirmative defense conditions of Exchange Act Rule 10b5-1(c), provided that the advance election was made before the individual was aware of the impending black-out;
- purchases or sales pursuant to certain "tax-conditioned" plans – "qualified plans," "excess benefit plans," or "stock purchase plans" as defined in Exchange Act Rule 16b-3(b) – other than "discretionary transactions" (e.g., transfers between investment options or volitional withdrawals involving the issuer's equity securities);
- 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 provides for grants or awards to occur automatically and specifies the terms and conditions of the grants or awards;
- exercises, conversions or terminations of derivative securities that a director or executive officer did not write or acquire during the black-out period in question or while aware of the actual or approximate beginning or ending dates of the black-out period, and where (i) the derivative security may be exercised, converted or terminated only on a fixed date, with no discretionary provision for earlier exercise, conversion or termination, or (ii) the derivative security is exercised, converted or terminated by a counterparty and the director or executive officer does not exercise any influence on the counterparty with respect to whether or when to exercise, convert or terminate the derivative security;
- acquisitions or dispositions of equity securities involving a bona fide gift or a 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.

It is worth noting that the exemption for purchases or sales pursuant to "tax-conditioned plans" does not exempt transactions under most nonqualified deferred compensation plans, as these plans typically do not meet the applicable definition of a "tax-conditioned plan." Thus, periodic "investments" of amounts deferred by executive officers and directors into a company stock fund under a nonqualified plan would not be permitted during a black-out.

Notice to Directors and Executive Officers

In any case in which a director or executive officer is subject to the black-out trading prohibition, the issuer must provide a notice to the director or executive officer and to the SEC. Notice may be in any graphic form that is reasonably accessible to the intended recipient, including electronically, and is required to include:

- the reasons for the black-out period;
- a description of the plan transactions to be suspended;
- a description of the class of equity securities subject to the black-out period;
- the actual or expected beginning and ending dates of the black-out period; and
- the name, address and telephone number of the person designated to respond to inquiries about the black-out period or, in the absence of such a designation, the issuer's human resource director.

The notice is required to be provided to directors and executive officers within five business days after the issuer receives notice of the black-out period from the plan administrator (as required under the DOL rules discussed above). If the issuer does not receive a notice from the plan administrator, the notice must be provided at least 15 calendar days in advance of the start of the black-out period.

An exception to the 15-day notice requirement applies if the inability to provide advance notice is due to events that were unforeseeable or to circumstances that were beyond the reasonable control of the issuer, and an authorized representative of the issuer so determines in writing. If the exception applies, the issuer is required to provide the notice and written determination to all affected directors and executive officers as soon as reasonably practicable before the black-out period commences. As under the DOL rules, expected beginning and ending dates may be described by a calendar week rather than a specific date. If there is a subsequent change in the beginning or ending date of the black-out period, the issuer is required to provide (as soon as reasonably practicable) an updated notice identifying the changes and the reasons for the changes.

Importantly, an issuer's failure to provide notice to directors and officers is not an affirmative defense to an SEC enforcement action or a private action to recover profits brought against the officer or director. However, failure to provide the notice could result in an enforcement action against the issuer for causing the director or executive officer's violation.

Notice to the SEC

The notice to the SEC is required to be provided on Form 8-K – the form generally used to report the occurrence of material events or corporate changes that would be important to investors. The Form must be filed by the deadline for providing the notice to executive officers and directors and must indicate the date on which the company received the notice required under the DOL black-out notice rules. Until the SEC announces that its EDGAR system is ready to accept such Form 8-K filings, however, the information required to be provided in the notice should be included in the first Form 10-Q filed by the company after the black-out period begins.

Remedies for Violations

The rules describe two distinct remedies for violations of the black-out trading prohibition. First, because a violation would be a violation of the Exchange Act, directors or executive officers who violate the prohibition also would be subject to all remedies available to the SEC to redress violations under the Exchange Act, including civil injunctive actions and penalties, and possibly criminal liability.

Second, a private right of action to recover profits is provided under Sarbanes-Oxley. Specifically, any profit realized by a director or executive officer from a prohibited transaction inures to and is recoverable by the issuer, regardless of the intention of the individual in entering into the transaction. The owner of any equity security of the issuer, including a plan participant or beneficiary, may bring an action to recover the profits on behalf of the issuer if the issuer fails to bring an action within 60 days after the date of a request by the owner or fails diligently to prosecute the action. No suits may be brought more than two years after the date on which the profits were realized. The final rules provide guidelines for determining whether an officer or director has realized a profit.

Conclusion

Substantial penalties may be imposed on those who do not comply with the black-out notice requirement or the insider trading prohibition under Sarbanes-Oxley. As a result, compliance is critically important when a black-out in transactions under a participant-directed plan is contemplated. Plan sponsors and third party administrators may want to review various contracts in light of issues raised in connection with a possible black-out. For example, parties may wish to review administrative services contracts regarding recordkeeper or third party administrator responsibility to notify affected participants, officers and directors of a potential black-out (and vice versa).