

# BLACKOUT PERIODS - UNINTENDED CONSEQUENCES?

Your blackout policies may be negatively impacting your long-term incentive plans- here's how to mitigate that risk.

Under Canadian securities legislation, insiders (including all employees of a company) are restricted from trading in their company's securities when they are in possession of material non-public information (MNPI). Issuer imposed trading restrictions (often referred to as "blackouts") typically place further restrictions on an insider's ability to trade in the company's securities. While insider trading restrictions are essential for the proper functioning of the public markets, they place significant restrictions on the ability of senior executives to exercise or otherwise transact in the securities underlying their companies' equity incentive plans or their own personal holdings in these securities.

## IMPACT ON SENIOR EXECUTIVES AND CORPORATE DIRECTORS

Plunging commodity prices in recent years, coupled with corporate blackouts, have in many instances, resulted in corporate insiders seeing significant impairment of the value of their already-vested incentive securities alongside their companies' declining share prices. This wealth destruction is not limited to equity incentive plans; increasingly, company executives and directors are being asked by institutional shareholders and proxy advisors to hold increasing levels of securities in the issuers that they oversee. The typical CEO is now required to hold three to five times their annual salary in shares of the company, while the remainder of the senior executive team is required to hold a minimum amount equal to their respective salaries. Post-exercise and post-retirement hold periods for executives are now being requested by these same stakeholders. Add in the frequency and duration of blackout periods—especially for companies with a high growth/high acquisition strategy—and executive and corporate director shareholdings can become practically illiquid. As a considerable portion of most executives' personal net worth is tied up in the companies they oversee, this illiquidity can have detrimental consequences to the financial well-being of an executive.

## IMPACT TO ISSUERS

In addition to the individual considerations, the limited trading windows of executive equity incentives can negatively impact issuers, especially in cyclical commodity sectors. We have witnessed numerous cases where company executives are in blackout for several months at a time while commodity and share prices decline. This combination of events can lead to a large number of underwater stock options and can greatly reduce the value of other equity-based incentives such as Restricted Share Units (RSUs). Should the low price commodity cycle be protracted, as with the current downturn, the resulting abundance of underwater options may cause the following issues:

1. Reduced transactions in stock option and other equity-based incentives which, in turn, restrict the company's ability to grant new equity incentives as available room under the incentive plan is already filled with a glut of underwater incentives; and
2. Negative impact on the perception of a company's equity incentive plans under various proxy advisor analyses—either as an increased 'cost' of the plan under the Shareholder Value Transfer (SVT) model utilized by Institutional Shareholder Services (ISS) and/or as higher plan dilution, which is concerning to most institutional investors and proxy advisors. This higher cost and dilution can lead to AGAINST voting recommendations by proxy advisors and corresponding votes against a company's equity incentive plans by shareholders, should a company have to ask shareholders for plan (re)approval during these difficult times.

## MITIGATING THE RISK

A well-designed Automatic Securities Disposition Plan (ASDP) can help mitigate many of the foregoing issues.

ASDPs are plans that are entered into by the insider, or sponsored by the issuer, that, when entered into in advance of MNPI coming into existence, allow an insider to later sell securities of the issuer, while in possession of, or potentially in possession of, material non-public information (i.e. while in blackout).

ASDPs are structured to comply with exemptions to insider trading prohibitions (and associated liability) in Canadian securities laws—for example, subsection 175(2)(b) of the General Regulations of the Ontario Securities Act (the Act), which states that an insider will be exempted from insider trading prohibitions if *"the purchase or sale was made pursuant to participation in an automatic dividend reinvestment plan, share purchase plan or other similar automatic plan that was entered into by the person or company prior to the acquisition of knowledge of the material fact or material change"*.<sup>1</sup>

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<sup>1</sup> Note that most jurisdictions in Canada have similar provisions which allow for trades under 'other similar written automatic plans' (e.g. s.147(7)(c) in Alberta and s.57.4(s) in British Columbia).

## OVERVIEW OF ASDPs

ASDPs are structured around the Ontario Securities Commission (OSC) Staff Notice 55-701, which addresses several frequently asked questions from stakeholders regarding possible exemptions from insider trading under the Act. The Staff Notice is clear that the OSC will consider an ASDP to be an *other similar automatic plan* under 175(2)(b) if it is truly *automatic* and possesses the following criteria:

- The insider can demonstrate that he/she no longer has the ability to make decisions relating to trading in the securities in the plan (i.e. after they have been set initially) and cannot make "discrete investment decisions" during the term of the plan;
- At the time of entry into the plan, the insider is not in possession of any MNPI in relation to the issuer;
- At the time of entry into the plan, in the case of plans that have not been established by the issuer, the insider provides the broker with a certificate from the issuer confirming that the issuer is aware of the plan and certifying that, to the best of its knowledge, the insider is not in possession of material undisclosed information about the issuer. A formal certificate or other such documentation is important as a mere representation by the insider that they are not party to any MNPI is insufficient;
- Trading parameters (number of securities to be sold, number of options to be exercised, price floor for exercise/sale, timeline over which the sales and/or exercises will take place, etc.) and other instructions are set out in a written plan document at the time of the establishment of the plan;
- The plan contains meaningful restrictions on the ability of the insider to vary, suspend or terminate the plan so that the insider cannot profit from MNPI through a decision to vary, suspend or terminate the plan;
- The plan provides that the broker is not permitted to consult with the insider regarding any sales under the plan and that the insider cannot disclose to the broker any information concerning the issuer that might influence the execution of the plan; and
- The plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the insider trading prohibitions.

## OTHER CONSIDERATIONS

**PLAN DISCLOSURE** – The OSC Staff Notice notes that a disclosure obligation may exist depending on the particular circumstances of the ASDP and whether the plan would be sufficiently material to require public disclosure (best practice would be for full plan disclosure, regardless of materiality). Whether or not there is a legal requirement to disclose the ASDP, it may be advantageous from an investor relations standpoint to voluntarily disclose a plan's adoption in order to manage the market's perception of the sale of securities by insiders. Disclosure may also assist in mitigating the need for immediate disclosure under the System for Electronic Disclosure by Insiders (SEDI) (see below).

**WAITING PERIOD/NOTICE PERIOD** – The OSC Staff Notice does not expressly require a waiting period prior to commencement of trading under the ASDP; however, best practice is to include a waiting period of one to three months to help mitigate:

- any market perception that the insider was in possession of non-public information at the time the ASDP was established (for example, if the plan was disclosed immediately following a blackout period); and
- potential negative market reaction from the sale of securities from insiders.

Note that recent plans that have received exemptive relief to allow for annual SEDI reporting rather than immediate SEDI reporting had waiting periods of 90 days.

**PLAN DURATION** – While the Staff Notice does not specifically address the minimum or maximum term of an ASDP, a plan should likely be long enough to avoid any perception of impropriety/use of MNPI on behalf of the insider. Conversely, the plan should not be so long as to raise the possibility that plan amendment or termination is required by changing insider circumstances. Plans typically range from six to 24 months.

**INSIDER REPORTING** – An insider (or the broker on behalf of the insider) is required to file insider trading reports each time there is a disposition under the ASDP. We recommend that each report include a statement in the general remarks section of the insider report that the sale is pursuant to an ASDP. It is possible for an issuer or insider to apply for exemptive relief to reduce the reporting requirements for sales under an ASDP to an annual reporting schedule. Securities commissions may grant exemptive relief when they are satisfied that the ASDP is truly automatic and that annual SEDI reporting is in the public interest.

## SETTING UP AN ASDP FOR YOUR COMPANY

Lane Caputo Compensation, Burnet, Duckworth & Palmer LLP and Solium Capital have collaborated to provide a turnkey solution for the efficient and cost-effective development of an ASDP for our clients. Our approach ensures the appropriate compensation governance structure to underpin the ASDP, includes all plan documentation and securities legislation interpretation and a cloud-based solution to administer, track and report activity under the plan. To learn more about this solution, or for any questions surrounding the information presented in this article, please contact:



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