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THE SEC'S FOCUS ON INSIDER TRADING POLICIES AND PROCEDURES – WHAT YOUR COMPANY NEEDS TO DO NOW

During the past two years, the Securities and Exchange Commission has increased its focus on insider trading enforcement. Two recent steps by the SEC indicate that it is targeting not only the individuals who trade on inside information, but also companies themselves, for failing to maintain and enforce policies designed to prevent such trading.

In March 2008, the SEC issued a report of its investigation into an alleged violation of the insider trading laws by the Retirement Systems of Alabama (RSA). In the report, the SEC stated that the unlawful trading could have been prevented if RSA had had adequate policies and procedures in place to ensure compliance with the federal securities laws. The SEC also noted that most of the RSA personnel involved, including the CEO, did not have a clear understanding of the securities laws and the risks implicated by possessing material, non-public information. While RSA did have an in-house counsel, he was not responsible for securities law matters and was not consulted before trades were made, and there were no means available for its investment staff to seek advice regarding securities law compliance. Although the SEC declined to pursue an enforcement action against RSA, due primarily to its cooperation with the SEC's investigation and its taking of subsequent remedial actions, the SEC will likely be less lenient in similar cases in the future.

In May 2008, the SEC announced the settlement of an enforcement action against Chanin Capital LLC, a broker-dealer, for failing to maintain and enforce effective insider trading policies in violation of Section 15(f) of the Securities Exchange Act of 1934. Significantly, the SEC also charged Chanin's former chief compliance officer with aiding and abetting Chanin's Section 15(f) violation.

Although the RSA and Chanin cases involved an investment manager and a broker-dealer, they contain an important message for all public companies - the SEC is very serious about pursuing companies that have lax or nonexistent policies to prevent illegal insider trading.

What is the risk to my company if a director or employee engages in illegal insider trading and what can it do to reduce that risk?

Both the SEC and private plaintiffs can bring insider trading claims against a company where a person "controlled" by the company (typically, a director, officer or employee) engages in unlawful insider trading. A company has a defense to a private claim where it can show it acted in good faith and did not directly or indirectly induce the violation. The SEC will not prevail on its claim against a company unless the SEC shows that the company "knew or recklessly disregarded" the fact that the controlled party was likely to trade

unlawfully and "failed to take appropriate steps to prevent such act before it occurred."

In order to reduce the likelihood of unlawful insider trading and the liability risk to the company, every public company should have a written insider trading policy. The recent SEC enforcement cases involving RSA and Chanin Capital serve as reminders that companies should periodically review their insider trading policies to ensure that they are consistently followed and enforced.

What are some of the key points to consider when reviewing my company's insider trading policy?

- ***Keep it simple***. The policy should be straightforward and easy to understand.

- ***Everyone should be subject to it***. All directors, officers and employees of the company and its subsidiaries should be covered by the policy generally, which should plainly and clearly remind them that trading while in possession of material non-public information (or passing this information on to others) is prohibited and illegal.

- ***Window periods.*** In order to reduce the likelihood of trading while in possession of material non-public information, the policy should provide that, absent a pre-arranged trading plan properly established under SEC Rule 10b5-1 (discussed below), certain persons may only trade during designated periods, often referred to as "trading windows." Although the use of trading windows is not required and there is no specific guidance from the SEC on how to tailor them, most trading windows open on the second or third trading day after the release of quarterly earnings (allowing the market sufficient time to digest the information). The closing of the window varies from company to company, with some companies closing the window after two weeks and others keeping the window open for a longer period, perhaps until the end of the second month of the next quarter or until the financial results for the second month of the next quarter are released internally to senior management and the board. Of course, it may be necessary to close the window early or not open the window at all if a material undisclosed event is on the horizon (such as negotiations for a merger or acquisition transaction). You should consider whether the timing of your existing windows strikes the right balance between preventing illegal insider trading (or the appearance of such trading) and allowing insiders to purchase and sell company stock at reasonable intervals.

  The persons required to abide by the trading windows should not be limited to directors and executive officers and should include all employees who are regularly in a position of access to material non-public information (such as the CEO's secretary). Some companies may be small enough that it makes sense to require all employees to abide by the trading windows, while in others this may be an unnecessary burden (both on the individual employees and on the company in terms of enforcing the policy). The window requirement should not only apply to the insiders themselves, but also to all family members residing in their homes or who consult with the insider before trading and to all entities over which the insider has control (such as trusts, partnerships, corporations and other

entities which invest in the company's securities).

- ***Preclearance***. The insider trading policy should require all transactions in the company's stock by insiders (i.e., directors, executive officers and anyone else required to abide by the trading windows) to be pre-cleared by a designated insider trading compliance officer, even during an open window. This will further reduce the chances that trading will occur while a material event is on the horizon. For planned trades by directors and executive officers, this will also alert the insider trading compliance officer to the fact that a Form 4 will need to be filed with the SEC soon (by the second business day after the trade date). It will also give the insider trading compliance officer the opportunity to assess whether the director or executive officer has engaged in any "opposite way" transactions during the preceding six months, which could result in short-swing profit liability for the director or executive officer under Section 16(b) of the Securities Exchange Act of 1934 if the proposed trade is allowed to proceed.

- ***10b5-1 Plans***. SEC Rule 10b5-1 provides a defense from insider trading liability if a trade occurs pursuant to a pre-arranged trading plan that meets specified conditions. Under this rule, if a person enters into a binding contract, provides an instruction or adopts a written plan to purchase or sell securities that specifies the amount, price and date on which securities are to be purchased or sold, and these arrangements are established at a time when the person is not aware of material non-public information, then the person may claim a defense to insider trading liability if the transactions under the trading plan occur at a time when he or she has subsequently become aware of material non-public information. Arrangements under the rule may specify the amount, price and date through a formula or may specify trading parameters which another person has discretion to administer, but the insider must not exercise any subsequent discretion affecting the transactions, and if the insider's broker or any other person exercises discretion in implementing the trades, the insider must not influence his or her actions and he or she must not possess any material non-public information at the time of the trades.

  The SEC has recently announced that it intends to closely scrutinize 10b5-1 trading plans where it believes abusive practices may be taking place. Accordingly, companies and insiders need to be very careful with how these plans are structured and operated. If your company wishes to allow insiders to establish 10b5-1 trading plans, then your insider trading policy should specifically permit them, provided they have previously been approved by the company and are adopted during an open trading window. For additional information on the structuring and administration of these plans, please see our separately enclosed memorandum entitled "Rule 10b5-1 Trading Plans – Best Practices in Response to Increased SEC Scrutiny."

- ***Gifts***. Charitable and other non-profit organizations that receive gifts of public company securities typically sell those securities very soon after receiving them. If an insider makes such a gift, the sale of the gifted securities by the organization may be attributed to the

insider for purposes of the insider trading laws. The same applies with respect to any other gifts, whether to family members or other persons, where the insider has reason to believe the recipient is likely to sell the securities soon after receiving them. For this reason, we believe that a company's insider trading policy should state that gifts of company securities should not be made to charitable or other non-profit organizations, or to any other person who is believed to be likely to sell the securities soon after receiving them, at a time when the donor is aware of material non-public information about the company (and that insiders should only be permitted to make such gifts during an open trading window).

Another reason for imposing these restrictions is the potential for manipulation (or perceived manipulation) by the donor to gain a larger income tax deduction. Indeed, in March 2008, *The Wall Street Journal* reported on a recent study that raises questions about the propriety of charitable donations of stock by insiders. The study looked at 151 instances in which CEOs and chairmen made charitable donations of more than $1 million of their companies' stock. The study found that in nearly 60% of the cases, the stock price declined after the date of the gift. The insiders benefited from the timing of their gifts because a charitable deduction equals the price of the stock on the day of the donation. The implication is that some of the gifts were either backdated to when the stock price was higher or the insiders had negative non-public information when they donated their stock. As was the case with the stock option backdating scandals of recent years, media coverage of a particular practice can sometimes be a precursor to government investigations and shareholder suits.

- ***Other Restrictions.*** Other restrictions to consider include the following:

  - Short Sales. Short sales evidence an expectation on the part of the seller that the securities will decline in value, and therefore signal to the market that the seller has no confidence in the company. In addition, short sales may reduce the seller's incentive to improve the company's performance. Directors and officers are prohibited by law from engaging in short sales of their own company's securities. We believe that an insider trading policy should also prohibit short sales of the company's securities by all other employees.

  - Standing Orders. The problem with purchases or sales resulting from standing instructions to a broker is that there is no control over the timing of the transaction. The broker could execute a transaction when the insider is in possession of material inside information. We therefore believe that an insider trading policy should permit standing orders only for a brief period of time, except those used in connection with pre-approved Rule 10b5-1 trading plans.

  - Margin Accounts and Pledges. Securities held in a margin account may be sold by the broker without the customer's consent if the customer fails to meet a margin call. Similarly, securities pledged (or hypothecated) as collateral for a loan may be sold in foreclosure if the

borrower defaults on the loan. If a margin sale or foreclosure sale occurs at a time when the borrower is aware of material non-public information, insider trading liability could result. For this reason, some companies prohibit their insiders from pledging securities altogether. Other companies, wanting to give their insiders some flexibility, simply provide a statement in the insider trading policy reminding insiders that if they hold company securities in a margin account or otherwise pledge company securities as collateral for a loan, they should be aware that doing so carries with it the risk of insider trading liability if they fail to meet a margin call or if they default on the loan.

- Publicly Traded Options. A transaction in a publicly traded option is, in effect, a bet on the short-term movement of the underlying stock and therefore creates the appearance that the director or employee is trading based on inside information. Transactions in options also may focus the director's or employee's attention on short-term performance at the expense of the company's long-term objectives. For these reasons, many companies prohibit transactions in puts, calls or other derivative securities.

- Hedging Transactions. Certain forms of hedging or monetization transactions, such as zero-cost collars and forward sale contracts, allow a person to lock in much of the value of his or her stock holdings, often in exchange for all or part of the potential for upside appreciation in the stock. These transactions allow the director or employee to continue to own the covered securities, but without the full risks and rewards of ownership. When that occurs, the director or employee may no longer have the same objectives as the company's other security holders. For these reasons, some companies prohibit their directors and employees from engaging in any such transactions. Other companies, wishing to give their insiders more flexibility, instead require these transactions to be pre-approved by designated senior management personnel (such as the CFO).

- Post-Termination Transactions. Because a departing director or employee may be in possession of material non-public information at the time when his or her service terminates, the policy should provide that it continues to apply to post-termination transactions. The policy should state that if a director or employee is in possession of material non-public information when his or her service terminates, he or she may not trade in the company's securities until that information has become public or is no longer material. You should consider providing that if an insider's termination of service occurs outside of an open window period, he or she may not trade until the window next opens, absent approval from designated senior management personnel (who would be in a position to know whether a material event is on the horizon).

What should my company do now?

If your company does not currently have a written insider trading policy, it should adopt one as soon as possible. If it does

have one, the policy should be reviewed to consider whether any modifications would be appropriate, whether to address the above points or otherwise. In addition, because they are also subject to the reporting (Form 4) and short-swing profit liability provisions of Section 16 of the Securities Exchange Act of 1934, Rule 144 (for sales, see our separate memorandum entitled "SEC Adopts Major Amendments to Rules Governing Resales of Securities") and potential other restrictions on trading, all of which contain a number of traps for the unwary, directors and executive officers should be reminded of the basics from time to time. We have attached a suggested form of reminder memorandum to directors and executive officers, along with a one-page checklist they can review each time they wish to trade in the company's securities, to help ensure they have complied with all applicable requirements.

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For further information, please contact Craig M. Scheer at (202) 295-4525 or cscheer@sftlaw.com.

For over 30 years, Silver, Freedman & Taff, L.L.P. has represented financial institutions and other companies nationwide in connection with initial public offerings and other capital raising transactions, mergers and acquisitions, regulatory and enforcement issues, tax and compensation matters, and corporate governance matters. With attorneys who previously served with the federal banking and thrift regulators as well as the Securities and Exchange Commission, Silver, Freedman & Taff, L.L.P. provides a full array of legal services to financial institutions and other companies.

This document provides general information and should not be used or taken as legal advice. Such advice requires a detailed analysis of applicable requirements and an evaluation of precise factual information.

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SAMPLE MEMORANDUM

To: Directors and Executive Officers

From: Insider Trading Compliance Officer

Re: Transactions in Company Stock

Date: _________, 2008

This memorandum is intended to remind you of the basic things you should always consider prior to buying or selling Company stock or exercising Company stock options. A checklist of these items is attached.

Abide By Trading Windows and Don't Trade When You Have Non-Public Information that Might be Material

Under the Company's insider trading policy, unless you have entered into a pre-arranged trading plan under SEC Rule 10b5-1, you must limit your purchases and sales of the Company's stock to times when the trading window is open. The window generally opens on the third trading day after the announcement of quarterly or annual earnings and generally closes when financial results for two months of the subsequent quarter have been released internally. For example, if the Company issues its annual earnings release on January 23rd, the window would open on the third trading day after that day and close after the financial results for January and February have been released internally (usually during the second or third week of March). Of course, the window might have to close prematurely if material non-public information develops, such as negotiations for an acquisition. [Modify as appropriate based on timing of window periods]

Sometimes the window might be open for sales, but not purchases, or vice versa. For example, in a stock acquisition by the Company, the SEC's rules prohibit directors and executive officers from purchasing Company stock during the target's proxy solicitation period and any other period when the Company's stock price determines the exchange ratio. *Even if the trading window is open*, unless you have a pre-arranged 10b5-1 trading plan, you may not buy or sell Company stock if you are aware of material non-public information. When in doubt, don't trade.

Notify the Company's Section 16 Filing Coordinator, <u>Before</u> You Trade

Under Section 16(a) of the Securities Exchange Act of 1934, a Form 4 must be prepared and filed with the SEC no later than the second business day after you engage in a transaction in Company stock (i.e., the second business day after the trade date). Because of this extremely tight time frame and the time needed to prepare the form, the Company's insider trading policy requires you to notify __________, the Company's Section 16 filing coordinator, *before* you execute a transaction. You or your broker must report the trade date, the number of shares bought or sold and the purchase or sale price to Company's Section 16 filing coordinator promptly after the trade (preferably same day and no later than next day). Any late filings must be disclosed in the Company's annual proxy statement, with the insiders identified by name and number of late filings.

Avoid Short-Swing Profits! Before Trading, Look Back at all Transactions During the Preceding Six Months and Consider What Transactions You Might Want to Do During the Next Six Months

Under Section 16(b) of the Securities Exchange Act of 1934, generally speaking, if you have a purchase and sale, or a sale and purchase, which occur within six months of one another where the sale price is higher than the purchase price, you will be deemed to have realized a "short-swing profit" that you must pay back to the Company. (This is the case regardless of whether one of the transactions is pursuant to a Rule 10b5-1 pre-arranged trading plan.) For example, if on June 1st, you sold 10,000 shares at $35 and on September 1st you purchased 3,000 shares at $32, you would have a short-swing profit of $9,000 (3,000 shares x $3). Purchases and sales within six months of one another can be matched regardless of whether they involve your direct or indirect holdings (e.g., for immediate family members in your household).

Certain transactions are exempt from Section 16(b). These include, among others: grants and exercises of stock options, grants of restricted stock, acquisitions under the deferred compensation plan, ongoing acquisitions under the 401(k) plan (switching into Company stock from another plan fund, or vice versa, is treated differently, however, so contact the Company's Section 16 filing coordinator before doing so) and bona fide gifts and inheritances. While the exercise of an option is not treated as a purchase, **a sale of the underlying shares, as part of a broker-assisted cashless exercise, is treated as a sale, and would be matchable with another non-exempt purchase within the prior or subsequent six months.** Open market purchases and sales are almost *never* exempt.

Section 16(b) is extremely complicated and contains numerous traps for the unwary. This is another reason why, even during an open trading window, you should notify the Company's Section 16 filing coordinator before you trade. It is critical to determine *beforehand* whether you have had any transactions during the preceding six months which might be matchable with the one you are contemplating. It is also very important to consider any potentially matchable transactions which you might be planning to effect during the subsequent six months (i.e., a purchase to follow a sale, or vice versa).

When Selling, Be Sure That You and Your Broker Comply with Rule 144

When you sell Company stock, you will risk a potentially serious securities law violation if you and your broker do not follow SEC Rule 144. Rule 144 requires the following:

- that the Company be current in its annual and quarterly SEC filings;
- that the amount you are contemplating selling, when combined with all other amounts you and any others whose shareholdings are attributable to you (generally immediate family members in your household, trusts of which you are a trustee and/or 10% or greater beneficiary, estates of which you are executor and business entities of which you are a 10% or greater owner) have sold during the preceding three months, does not exceed the greater of (1) 1% of the Company's shares outstanding and (2) the average weekly trading volume of the Company's stock for the four preceding calendar weeks;

- that the sales be made in either ordinary brokerage transactions or directly with a market maker; and

- that a Form 144 be transmitted to the SEC and the NASDAQ Stock Market on the same day the sell order is placed with the broker if the number of shares sold at that time or during the preceding three months is greater than 5,000 or has an aggregate sale price in excess of $50,000. While most brokers normally will prepare and file the Form 144 on your behalf, it is your obligation to make sure the broker does so.

Some Things to Keep in Mind When Exercising Options

- You may exercise a stock option at any time, regardless of whether the window is open, if you pay the exercise price entirely in *cash*. Unless done pursuant to a 10b5-1 plan, however, you may not exercise an option outside of a window period if you are selling or otherwise disposing of any shares in connection with the exercise, except to the extent the Company withholds some of the option shares to satisfy its tax withholding obligations. Thus, a cashless exercise through a broker, or the surrender of already-owned shares in payment of the exercise price (a process known as "pyramiding"), may occur only during a window period, unless done pursuant to a 10b5-1 plan. ***You should keep this in mind and plan accordingly when your option expiration dates approach.***

- If you are selling some of the option shares, comply with Rule 144.

- The Sarbanes-Oxley Act prohibits a public company from directly or indirectly extending credit, or arranging for the extension of credit, in the form of a personal loan to any of its directors and executive officers. (Loans by a bank under Reg. O are exempt.) If taken literally, this arguably includes broker-assisted cashless exercises of options. While the SEC has offered no guidance on this, the general consensus among securities lawyers appears to be that if structured properly with very limited involvement by the company, broker-assisted cashless exercises should not be problematic.

- As noted above, while the exercise of an option is not treated as a purchase for purposes of Section 16(b), a sale of the underlying shares in connection with the exercise would be matchable with another non-exempt purchase within the prior or subsequent six months. Unlike a sale of the option shares, however, a surrender of already owned shares to pay the exercise price (pyramiding) is exempt from Section 16(b) (that is, not matchable with a purchase during the preceding or subsequent six months). Check the terms of your option agreement to see if pyramiding is available.

- If you exercise an incentive stock option through a cashless exercise with a broker, you will lose the favorable federal income tax treatment and owe tax immediately on the difference between the market price and the exercise price to the extent of the number of shares the broker sells. To avoid this, you might consider using cash (whether on hand or borrowed from a broker or other unaffiliated third party) or already owned shares of Company stock to pay the exercise price. The tax consequences of pyramiding are complex, however, so you should consult the Company and your personal tax advisor prior to doing so.

INSIDER STOCK TRANSACTION CHECKLIST

☐ Is the trading window open? If not, then you may not trade unless the transaction is pursuant to a 10b5-1 pre-arranged trading plan.

☐ If the window is open, is it limited to just purchases or just sales? If yes, then you may only engage in transactions of the type permitted.

☐ Even if the window is open, are you aware of material, non-public information? If yes, then you may not trade unless you have a 10b5-1 plan. If you have any doubt, don't trade. Contact _______ if you are unsure.

☐ If it is a time when you are able to trade, and the transaction is not pursuant to a 10b5-1 plan, have you notified _______ [the Company's Section 16 filing coordinator]? If not, then don't trade until you have done so.

☐ If you are selling, have you had any purchases during the last six months, or if you are purchasing, have you had any sales during the last six months? If so, would the purchase price be less than the sale price? If so, you would have a short-swing profit and should not proceed with the proposed transaction unless the prior and/or proposed transaction is exempt from Section 16(b).

☐ Are you planning any opposite-way transactions during the next six months, i.e., purchase after a sale or vice versa? If so and if neither transaction is exempt from Section 16(b), you might want to refrain from the currently contemplated transaction, especially if the planned subsequent transaction is more important to you (as you won't know for sure until the time of that subsequent transaction whether you will have a short-swing profit).

☐ If you are selling, make sure the conditions of Rule 144 have been met (i.e, Company current in annual and quarterly SEC filings, 3-month volume limit not exceeded, broker has prepared and will file Form 144).

☐ If you are engaging in a cashless exercise of stock options with a broker, have you purchased any stock during the last six months at a lower price than the price at which the option shares will be sold? If so, you should use a different means of exercise (e.g., cash or pyramiding, if available). You should also consider using a different exercise method if you contemplate a non-exempt purchase during the next six months that is more important to you (as you won't know until the time of that purchase whether you will have a short-swing profit), or if you are exercising incentive stock options and do not wish to lose the favorable tax treatment to the extent of the number of shares sold.