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RULE 10b5-1 TRADING PLANS – BEST PRACTICES IN RESPONSE TO INCREASED SEC SCRUTINY

Rule 10b5-1 under the Securities Exchange Act of 1934, adopted by the Securities and Exchange Commission in 2000, basically allows officers and directors of public companies to purchase and sell their company's stock, even while in possession of material non-public information, provided that the transaction is made pursuant to a trading plan that specifies the amount, price and date on which securities are to be purchased or sold and is established at a time when the officer or director was not aware of material non-public information.

Although Rule 10b5-1 is intended to establish a safe harbor against insider trading liability, trading plans under the rule have recently come under increased scrutiny. The heightened attention to these plans started with a December 2006 academic study that reviewed approximately 117,000 10b5-1 plan transactions over a five-year period. The study found that, on average, these transactions outperformed the market by approximately 6% six months after the trades were executed, suggesting that the timing of a good number of these transactions reflect the use of material non-public information. A similar-type academic study touched off the stock option backdating scandals of the past two years. More recently, the SEC has on a number of occasions suggested that 10b5-1 plans could become a new enforcement focus area, and executives at Countrywide Financial and other companies have come under scrutiny for sales made after amendments to their 10b5-1 plans.

In light of these recent developments, should my company allow directors and executive officers to use 10b5-1 trading plans?

We believe that to ban these plans outright would be an overreaction. When properly designed and administered, a Rule 10b5-1 trading plan should provide a director or executive officer with a safe and effective way of purchasing or selling company securities without concern for insider trading liability.

Should my company encourage or even require directors and executive officers to use 10b5-1 trading plans when buying or selling company securities?

We think that a requirement that all trades occur pursuant to 10b5-1 plans is unnecessarily restrictive and not desirable. It really depends on what the insider's plans are for buying or selling. If he or she would like to purchase or sell a relatively small amount of shares at regular intervals over an extended period of time, then a 10b5-1 plan would make perfect sense. Indeed, trading that is part of a clear pattern like this is not likely to arouse suspicion. On the other hand, if the plan is to simply make a single trade, then the safer course would be to trade during an open window under the company's insider trading policy when the insider is not aware of material non-public information.

What steps should be taken to help ensure that a 10b5-1 plan can withstand scrutiny by the SEC or a plaintiff's lawyer?

- ***Put it in writing.*** Although Rule 10b5-1 technically does not require a trading plan to be in writing, it would be ill-advised not to do so.

- ***Keep it simple***. The method of determining the number of shares to be purchased or sold can be as simple or as complex as desired. Of paramount importance is that both the insider and the executing broker each clearly understand how the formula is intended to operate. We caution against adopting plans that are very complex and that cannot be easily understood by a third party looking at the plan after the fact, as the SEC or a plaintiff's attorney challenging a complex plan could use the complexities to argue that the plan does not satisfy the requirements of Rule 10b5-1.

- ***No subsequent influence over trades***. Any subsequent influence by the insider over a decision to purchase or sell securities could eliminate the protections of the rule. The trading plan itself should specifically prohibit the insider from exerting such influence. While not required by Rule 10b5-1, as additional safeguards, we recommend having an independent third party, instead of the insider's regular broker (for example, a separate department within the brokerage firm) handle all trades under the 10b5-1 trading plan, and establishing and maintaining a separate account for plan transactions. If the insider's regular broker is used, this will likely lead to more contacts with the broker (perhaps to discuss other securities holdings in the insider's account) and could raise questions as to whether the insider exerted subsequent influence over the execution of the plan transactions.

- ***Waiting period before first trade.*** Insiders should only be permitted to adopt 10b5-1 trading plans during an open window under the company's insider trading policy. We also recommend imposing a "cooling off" period of at least 30-60 days after the plan is adopted during which trades will not be made. Large purchases and/or sales during a limited period of time, especially soon after the adoption of a plan, could raise questions as to whether the insider was motivated by material non-public information.

- ***Amending and terminating plans.*** The SEC has indicated that a plan may be modified so long as the modification is made in good faith and at a time when the insider is not aware of material non-public information. The altered plan is deemed to be a new plan. We caution against repeat modifications of a plan, as such changes could raise the question whether the plan was entered into in good faith and not as part of a scheme to violate the insider trading laws. As with the initial adoption of a trading plan, we recommend delaying the effectiveness of any modification for at least 30-60 days. In addition, we recommend that persons subject to the window period provisions of the company's insider trading policy be permitted to modify 10b5-1 trading plans only during open trading windows.

  Early termination of a plan by the insider is permissible, even, according to the SEC, when the person is in possession of material nonpublic information. The SEC has cautioned, however, that early termination by an

insider at a time when he or she is aware of material non-public information can result in a loss of the Rule 10b5-1 defense for prior transactions if the termination calls into question whether the person originally entered into the plan in good faith and not as part of a scheme to violate the insider trading laws. Repeat adoptions and early terminations of 10b5-1 trading plans by a director or officer will likely raise doubts as to the good faith of the insider in establishing the plans and therefore should be avoided. For this reason, we recommend that the plan by its terms provide for termination on the occurrence of any one or more of several specified events (such as the sale of a maximum number of shares, the occurrence of a merger or similar transaction after which the company will cease to exist, the death of the trading person and the occurrence of a specified date). Many plans provide for termination within one year to two years after their adoption (unless terminated earlier upon the occurrence of a specified event).

- ***Allow for necessary suspensions.*** A plan also should have automatic suspension provisions to allow trades to be halted during periods of time when the insider should not be trading, such as specific black-out periods imposed by the SEC's rules and lock-up periods that may be imposed by an underwriter in connection with a secondary securities offering. A lock-up period might also be imposed under the terms of a voting agreement which directors and officers might be asked to sign in connection with a merger transaction (for example, no sales prior to the shareholders' vote on the merger).

- ***Discourage trading outside of adopted plans.*** Rule 10b5-1 does not prohibit a person who establishes a trading plan under the rule from conducting transactions outside of the plan, though it does prohibit non-plan, corresponding hedging positions with respect to the company's stock. Non-plan transactions will not be covered by the rule's defense, however, and must not be effected at time when the person is aware of material non-public information. We caution against non-plan transactions once a plan is in place, for several reasons. The parallel trading could be viewed with greater suspicion during an investigation if a trading plan is already in place. A prosecutor, the SEC or a plaintiff's attorney might argue that because the insider already arranged for a 10b5-1 trading plan to diversify his or her holdings, trades outside the plan can only be justified for reasons other than portfolio diversification. Additionally, any non-plan sales would be aggregated with plan sales for purposes of Rule 144 (discussed below), which provides that the amount of securities sold by an insider during a three-month period cannot exceed the greater of 1% of the total shares outstanding or the average trading volume of the stock during the preceding four calendar weeks.

What other provisions of the federal securities laws and SEC rules are implicated under 10b5-1 trading plans?

Directors and executive officers must comply with the Section 16 (Form 4) reporting requirements when purchasing or selling securities, and the conditions and notice filing requirements of SEC Rule 144 when selling securities. The plan should provide for prompt notification of trades by the broker to the director or executive

officer and the company's Section 16 filing coordinator to ensure timely Form 4 filings. We recommend disclosing in the Form 4 in a footnote that the transaction was effected pursuant to a 10b5-1 trading plan, indicating the date on which the plan was adopted. The plan should also provide for the giving of a power of attorney by the insider to the broker to execute and file all necessary Form 144s and an agreement by the broker to conduct all sales in compliance with the manner of sale requirements of Rule 144.

How can directors and officers use 10b5-1 plans in conjunction with stock options and other equity compensation plans?

The SEC has specifically recognized that a Rule 10b5-1 plan can be used for exercises of employee stock options and sales of the stock acquired upon exercise. (Although the *exercise* of an employee stock option while aware of material nonpublic information generally will not result in insider trading liability, any sale of stock in connection with the exercise could result in liability.) A 10b5-1 plan may be particularly useful where a director or officer has stock options scheduled to expire relatively soon and the trading window might not be open at the time of the exercise and sale. A 10b5-1 plan may also be useful where an insider knows that he or she will need to sell shares on a specific date or dates in order to pay taxes upon the vesting of restricted stock.

Should my company use a Rule 10b5-1 plan for stock repurchases?

Like any other person, a company is prohibited from purchasing its own stock while in possession of material non-public information. The SEC has said that companies may use 10b5-1 plans to repurchase stock at times when they would otherwise be prohibited from doing so under the insider trading laws. Before adopting a 10b5-1 trading plan to implement a repurchase program, a company should consider the implications of having such a plan in place. Perhaps the most significant factor to consider is that the company will, to a certain degree, relinquish control over when its repurchases are actually made. Although the company could always terminate the plan early if it subsequently determined that it did not want to continue the repurchases, such a termination, if made while the company was in possession of material nonpublic information, could call into question whether the plan was established in good faith and possibly render the Rule 10b5-1 defense unavailable for prior repurchases under the plan. At the same time, a 10b5-1 trading plan could be helpful in implementing a repurchase program, especially if the Company finds implementation difficult due to limited availability of trading windows.

Should the adoption of a 10b5-1 plan be publicly announced?

While the SEC once proposed requiring 10b5-1 trading plans to be reported on Form 8-K, it has not yet done so. An increasing number of companies are electing to publicly announce the adoption of trading plans by their directors and executive officers (as well as by the company itself, for repurchase plans). The announcements generally give the number of shares covered but provide few other details. In an October 2007 speech, the Director of the SEC's Division of Enforcement said that the SEC is "looking at the disclosures surrounding 10b5-1 plans . . . and asymmetrical disclosure around plans – that is, disclosure of entry into a 10b5-1 plan, without timely disclosure of related plan modifications and terminations." The message seems to be that if a company chooses to announce the adoption of a 10b5-1 plan, the disclosure

had better be transparent and consistent throughout the duration of the plan term.

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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.