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Rule 10b5-1 Trading Plans in the Current Environment:

The Importance of Doing it Right

By Craig M. Scheer

Rule 10b5-1 under the Securities Exchange Act of 1934 allows officers, directors and other insiders of public companies to purchase and sell their company's stock while they are in possession of material non-public information, provided that the transaction is made pursuant to a trading plan previously established at a time when the insider was not aware of material non-public information. Critics have long viewed the rule as creating an opportunity for abuse, claiming that some insiders may in fact be aware of material non-public information at the time plans are established and that the rule can be used to provide cover for improper trades. The critics' voices have grown much louder recently, due to a series of *Wall Street Journal* articles published in late 2012 that highlighted suspiciously fortuitous trading patterns under Rule 10b5-1 plans adopted by insiders at certain companies. Several of these insiders are now reportedly being investigated by the Securities and Exchange Commission (SEC) and federal prosecutors.

Although Rule 10b5-1 trading plans may be in the enforcement spotlight, when properly designed and administered, they remain a generally safe and effective way for insiders to purchase and sell securities without concern for insider trading liability. Set forth below is a brief background of Rule 10b5-1, followed by suggestions on the implementation and administration of trading plans in the current environment.

Background

Rule 10b5-1 was adopted by the SEC in 2000 (the adopting release is available at www.sec.gov/rules/final/33-7881.htm) in order to address the previously unsettled issue in insider trading law of whether insider trading liability requires proof that the insider "used" material non-public information in connection with a purchase or sale of a security, or whether the insider need only have "knowingly possessed" such information at the time of the transaction. Rule 10b5-1 addresses this issue by providing that "a purchase or sale . . . is 'on the basis of' material non-public information . . . if the person making the purchase or sale was aware of the . . . information when the person made the purchase or sale." In other words, knowing possession may be sufficient for insider trading liability to be found.

Rule 10b5-1 also established an affirmative defense which, if the following three conditions are satisfied, will result in the insider being deemed not to have traded "on the basis of" material non-public information, even if the insider was aware of material non-public information at the time of the purchase or sale:

- First, *before* becoming aware of material non-public information, the insider must enter into a binding contract to purchase or sell the security, instruct another person to purchase or sell the security for the insider, or adopt a written trading plan. For the sake of simplicity, a contract, instruction, or plan is referred to in this article as a "plan."
- Second, the plan must:
  - » specify the amount of securities to be purchased or sold, and the price(s) at which and the date(s) on which the securities are to be purchased or sold;
  - » include a written formula or algorithm, or computer program, for determining the amounts, prices, and trade dates; or
  - » not permit the insider to exercise any subsequent influence over how, when, or whether to effect purchases or sales, and any other person who does exercise such influence (such as the insider's broker) must not be aware of the material non-public information when doing so.
- Third, the purchase or sale in question must actually occur pursuant to the plan and not deviate from it.

The plan must have been entered into in good faith and not as part of a plan or scheme to evade the insider trading laws.

Suggestions on Adoption and Administration of Trading Plans

Confirm that the company's insider trading policy permits Rule 10b5-1 trading plans and obtain any necessary company approvals. Before a Rule 10b5-1 trading plan is established for a company's insider, it must first be confirmed that the company's insider trading policy permits Rule 10b5-1 trading plans. The insider also must obtain any approvals of the plan required under the insider trading policy, such as a sign-off by the company's general counsel.

Assess whether the contemplated trades are right for a Rule 10b5-1 trading plan. If the insider wants to purchase or sell relatively small amounts of shares at regular intervals over an extended period of time, then a Rule 10b5-1 trading plan would likely make sense. Such trading under a Rule 10b5-1 trading plan does not usually arouse suspicion that the insider was aware of material non-public information at the time the plan was adopted. Rule 10b5-1 trading plans also can be useful where the insider knows well in advance that he or she will need to sell shares at a particular time or times in order to generate cash – for example, to pay a child's college tuition prior to the start of a semester or to pay the exercise price and taxes for expiring stock options by selling a portion of the option shares.

If the insider wants to make a single trade or a small number of trades over a short period of time, it generally would be better to do so during an open trading window under the company's insider trading policy. Most companies open the trading window shortly after the public release of earnings and close it near or at the end of each quarter. Sometimes the window must close prematurely or not be opened at all even after the public release of earnings, if another potentially material event is on the horizon (such as a possible merger or acquisition). In addition, if the insider is aware of material non-public information (even if the issuer's trading window is not closed), the insider would be prohibited from purchasing or selling securities until such information is publicly disclosed or no longer relevant.

Put it in writing. Although Rule 10b5-1 technically permits trades to occur pursuant to oral contracts or instructions, best practice would be to put all such plans in writing.

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 clearly understand how the formula is intended to operate. Avoid adopting plans that are extremely complex or that cannot be easily understood by a third party reviewing the plan after the fact, as the SEC or a federal prosecutor could claim that the complexities or ambiguities of the plan do 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 an additional safeguard, it may be prudent for an insider to specify that an independent third party, rather than the insider's regular broker (for example, a separate department within the brokerage firm) handle all trades under the Rule 10b5-1 trading plan, and that the broker establish and maintain a separate account for plan transactions. If the insider's regular broker is used, extensive communications by the insider with the broker, even those relating to other securities holdings in the insider's account, 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 Rule 10b5-1 trading plans during an open trading window under the company's insider trading policy. This will help to establish that the insider was not aware of material non-public information at the time the plan was adopted. In addition, the plan should contain a reasonable "cooling off" period after adoption (perhaps 30–60 days) during which trades will not occur. The occurrence of purchases or sales shortly after the adoption of a plan could raise questions as to whether the insider was aware of material non-public information when the plan was adopted.

Amending plans. The SEC has indicated that a trading 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 for purposes of Rule 10b5-1. As with the initial adoption of a plan, modifications to a plan should only be made during an open trading window under the company's insider trading policy and the effectiveness of the modification should be delayed for a reasonable period of time. Insiders should also avoid frequent modifications, as these may lead the SEC or a federal prosecutor to question whether the plan was entered into in good faith and not as part of a plan or scheme to evade the insider trading laws.

Terminating plans. Early termination of a plan by the insider is permissible, even, according to the SEC, when the insider is in possession of material non-public information. The SEC has cautioned, however, that early termination at a time when the insider is aware of material non-public information can result in a loss of the Rule 10b5-1 affirmative defense for prior transactions if the termination calls into question whether the insider originally entered into the plan in good faith and not as part of a scheme to evade the insider trading laws. Repeat adoptions and early terminations of Rule 10b5-1 trading plans will likely raise doubts as to the good faith of the insider and therefore should be avoided. For this reason, the plan should provide for termination upon the occurrence of any one or more of several specified events, such as the purchase or sale of a maximum number of shares, the completion of a merger or similar transaction, the death or disability of the insider and the occurrence of a specified date

(typically one to two years after adoption). Be sure that the plan broker is aware of these provisions so that trading does not occur beyond the expiration date, which would leave the insider without the protections of Rule 10b5-1.

Discourage trading outside of adopted plans. Rule 10b5-1 does not prohibit a person who establishes a trading plan under the rule from trading outside of the plan, though it does prohibit non-plan, corresponding, or hedging transactions or positions with respect to the company's stock. Non-plan trading will not be covered by the rule's affirmative defense, however, and must not occur at a time when the insider is aware of material non-public information. Once a trading plan is in place, non-plan trading should be kept to a minimum or avoided altogether, as parallel trading could be viewed with suspicion. For example, in the case of a Rule 10b5-1 trading plan to sell securities, the SEC or a federal prosecutor challenging non-plan sales by the insider might argue that because the insider already had a trading plan, presumably to diversify the insider's investment portfolio, the insider was seeking to take advantage of material non-public information in making the non-plan sales.

Avoid multiple plans. While Rule 10b5-1 does not prohibit an insider from having multiple trading plans with the same company, doing so could be problematic. At a minimum, it may create confusion and cause administrative headaches for the insider, the insider's broker(s) and the company. Of greater concern is that maintaining multiple plans with different trading schedules and pricing parameters may lead to accusations that the insider is engaged in manipulative behavior and trying somehow to evade the requirements of Rule 10b5-1.

Allow for necessary suspensions. A Rule 10b5-1 trading plan should allow for the suspension of trading activity during periods when the insider should not be trading, such as any specific blackout periods under the SEC's rules (for example, Regulation M, which generally prohibits a company's directors and executive officers from purchasing the company's securities during specified time periods when the company is making a public offering of securities) and lockup periods that may be imposed by underwriters in connection with offerings of the company's securities, which generally prohibit insiders from selling company securities soon after the completion of an offering. (Underwriters sometimes agree to exempt previously established Rule 10b5-1 trading plans from lockup agreements.)

Determine how much to disclose regarding plans. Under current SEC rules, neither the insider nor the insider's company is required to make any public disclosures of a Rule 10b5-1 trading plan. If the insider is subject to Section 16 of the Securities Exchange Act of 1934, then at a minimum the Form 4 filed to report the insider's trade (due within two business days after the trade date) should indicate by footnote that the transaction occurred pursuant to a Rule 10b5-1 trading plan established prior to the trade date. An announcement by the company of the plan shortly after the plan's adoption also might quell suspicions over the timing of plan trades. Any such announcement should disclose the date the plan was adopted and the number of shares involved. Disclosing additional details, such as the plan trading schedule and pricing parameters, generally should be avoided. If a company chooses to announce an insider's Rule 10b5-1 trading plan, then any modifications to the plan relating to information previously disclosed (for example, the number of shares to be purchased or sold) also should be disclosed, as should a decision by the insider to terminate his or her plan early.

Changes Afoot?

While companies currently have the flexibility to disclose as much or as little as they want to with respect to their insiders' Rule 10b5-1 trading plans, the resurgence of criticism surrounding Rule 10b5-1 may soon change this. There is now a push by some in the investment community for the SEC to impose specific disclosure requirements for Rule 10b5-1 trading plans, as well as other restrictions on how trading plans are administered. For example, on December 28, 2012, the Council of Institutional Investors (CII), a pension fund trade association, wrote to the SEC (available at www.sec.gov/rules/petitions/2013/petn4-658.pdf) urging the adoption of interpretive guidance or amendments to Rule 10b5-1 that would permit Rule 10b5-1 trading plans to be adopted only during open trading windows under a company's insider trading policy, prohibit multiple, overlapping Rule 10b5-1 trading plans, prohibit trades from occurring for at least three months after the adoption of a Rule 10b5-1 trading plan, and prohibit frequent modifications or terminations of Rule 10b5-1 trading plans. CII also is calling for a requirement to immediately disclose the adoption, modification, or termination of any Rule 10b5-1 trading plan and for the imposition of direct responsibility for the oversight of Rule 10b5-1 trading plans on boards of directors.

Regardless of whether any of the proposed reforms to Rule 10b5-1 are implemented, the SEC and federal prosecutors remain as interested as ever in combating illegal insider trading. When used improperly, Rule 10b5-1 trading plans can increase an insider's liability risk, such as where trades occur too soon after the adoption of a plan, where plans are repeatedly adopted and terminated or where the insider supplements a plan with non-plan trades, each of which may suggest that the insider attempted to take advantage of material non-public information. But when structured and administered properly, Rule 10b5-1 trading plans can provide a safe and effective way for insiders to trade.

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