

ALERT

CORPORATE / SECURITIES

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Rule 10b5-1 and the "Safe Harbor" for Trading by Insiders

Introduction

In 2000, the Securities and Exchange Commission (the "SEC") adopted Rule 10b5-1 which provides insiders of an issuer additional flexibility in trading the issuer's securities. Rule 10b5-1 broadens the scope of Rule 10b-5 of the Securities Exchange Act of 1934 by providing that a person will be deemed to have traded on the basis of material, non-public information if he or she was "aware" of the material, non-public information at the time of the trade.

However, the new rule also provides insiders with an affirmative defense from liability for the purchase or sale of securities even if they are aware of material, non-public information at the time of the purchase or the sale.

To date, many issuers and insiders have not taken advantage of the Rule 10b5-1 safe harbor.

Rule 10b5-1

Under Rule 10b5-1, an insider will be deemed to have traded on the basis of material, non-public information if he or she was aware of the material, non-public information at the time of the trade. However, the SEC created an important exception from this presumption which, under certain circumstances, allows insiders to trade in issuer securities while in possession of material, non-public information. This affirmative defense should provide appropriate flexibility to insiders who would like to plan securities transactions in advance at a time when they are not aware of material, non-public information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material, non-public information.

Excluded from the application of the Rule 10b5-1 presumption are transactions in which the insider can demonstrate that:

- before becoming aware of the material, non-public information, the insider had either
 - entered into a binding contract to purchase or sell the security,
 - provided instructions to another person to execute the trade for the insider's account, or
 - adopted a written plan for trading securities; and

- the contract, instruction or plan referred to above either:
 - specified the amount of securities to be purchased or sold, and the price at, and date on, which the securities were to be purchased or sold,
 - included a written formula, algorithm or computer program for determining the amount of securities to be purchased or sold, and the price at, and date on, which the securities were to be purchased or sold, or
 - did not permit the insider to exercise any subsequent influence over how, when or whether to effect purchases or sales, provided that any other person who did exercise such influence pursuant to the contract, instruction or plan must not have been aware of the material, non-public information; and
- the purchase or sale that occurred must have occurred pursuant to the aforementioned contract, instruction or plan without subsequent interference or influence from the insider; and
- the contract, instruction or plan must have been entered into in good faith and not as part of a scheme to evade the provisions of Rule 10b5-1.

For purposes of the rule, "amount" means either a specified number of shares or a specified dollar value of securities, "price" means market price on a particular date or a limit price or a particular dollar price, and "date" means either the specific day of the year on which a market order is to be executed, or a day or days of the year on which a limit order is in force.

Practical Implications

For Insiders

We believe that Rule 10b5-1 can be a useful tool for insiders to pre-plan transactions involving issuer securities so that they may avoid insider trading liability under Rule 10b-5. By following the procedures established by Rule 10b5-1, insiders are able to engage in purchases and sales of issuer securities at a time when they are in possession of material, non-public information. For example, at a time when an insider does not possess material, non-public information, the insider could instruct his or her financial advisor to sell

a specified number of shares of the issuer's stock held by the advisor for the account of the insider on a specified future date or dates (such as monthly or quarterly) and at a specified price or at a price tied to the performance of the issuer's stock, a peer group index or other indices. The example provided by the SEC involves a formula plan pursuant to which an insider exercises options and sells the underlying shares one month before each date on which the insider's child's school tuition is due, with the amount of the sale being tied to the cost of the tuition payment. Alternatively, the insider could simply delegate all of the discretion to determine amounts, prices and dates to another person who is not aware of material, non-public information at the time the person exercises such discretion. The rule will also allow insiders to participate in issuer benefit plans, such as employee stock purchase plans, with the certainty that their participation will not lead to Rule 10b-5 violations. Finally, compliance with the rule will minimize the risk of insider trading violations by insiders.

For Issuers

Rule 10b5-1 also benefits issuers. For example, the rule also can be used by issuers in connection with stock repurchase programs. An issuer can adopt a repurchase plan that specifies the amounts (or a formula for determining amounts), prices and dates on which to repurchase securities. As in the case of an insider, an issuer also could delegate the discretion to determine such amounts, prices and dates to an independent third party having no access to material, non-public information concerning the issuer. The safe harbor also boosts morale of insiders who now have some additional liquidity with respect to their equity compensation. Use of the safe harbor reduces the risk of adverse publicity and shareholder lawsuits because insider sales of securities will now likely be made on a more regular basis and in smaller volumes.

Suggested Action Items for Issuers

To facilitate the ability of insiders to take advantage of Rule 10b5-1 for purchases and sales of issuer securities, we would advise that every issuer review and modify its insider trading policy, which likely prohibits any transactions in issuer securities outside of the issuer's trading window. When making these modifications, we suggest that the following provisions be included:

- **Issuer Approval of Trading Plan** – The trading plan should be submitted to the issuer for approval prior to its first use. After approval of the trading plan, the insider will not need to obtain approval for the actual transactions effected under the trading plan.
- **Limit Approval of Trading Plans to Trading Window** – Because the trading plan cannot be established if the insider has material, non-public information, we would suggest that trading plans be approved only during the issuer's trading window. In addition, we would suggest that the first transaction pursuant to a trading plan not occur until at least one month after the trading plan becomes effective.
- **Limits on Modifications of Trading Plan** – Rule 10b5-1 allows for modifications to a trading plan made in good faith when the insider

does not possess material, non-public information. However, repeated modifications to a Rule 10b5-1 plan are highly inadvisable. Early termination of a plan likewise involves a significant degree of risk. We suggest that approval of modifications to trading plans can only be granted during the issuer's trading window and such approval should be limited to twice during any 12 month period, absent extraordinary circumstances.

However, automatic suspension and cancellation provisions included in the trading plan itself allow trades to be halted or to take place at a later time without consideration of whether the insider may be in possession of material, non-public information. Therefore, we recommend that any trading plan contain both automatic suspension and cancellation provisions. Typical triggers for cancellation and suspension include:

- the death of the insider,
- any sale which would violate Section 16, Rule 144, or any other federal or state law or regulation,
- a vote by the issuer's board of directors to suspend all trading,
- the commencement of a public offering by the issuer, or
- any merger, acquisition or reorganization in which the issuer's stock would be exchanged or converted.

Insiders should consider making a public announcement regarding the implementation of trading plans by insiders. A public announcement will prepare the investment community so that the trading by insiders does not come as a surprise.

In addition, issuers should be aware that transactions effected in accordance with Rule 10b5-1 plans are not exempt from the operation of Sections 13 and 16 of the Securities Exchange Act of 1934 or Rule 144 of the Securities Act of 1933. Accordingly, Rule 10b5-1 plan transactions must still comply with the requirements of these rules, which may require the filing of a Schedule 13D, a Schedule 13G, Forms 3, 4 and 5 or a Form 144. Of particular importance, Rule 10b5-1 plan transactions should be monitored to ensure that, when taken together with all other transactions by the insider, they do not result in short-swing trading liability under the provisions of Section 16(b).

If you have any questions about this *Alert* or any other related corporate/securities matter, please contact:

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