
Best Laid Plans Gone Awry: Practices for Rule 10b5-1 Trading Plans

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Rule 10b5-1 trading plans are in the limelight due to investigations initiated by U.S. Attorney's Offices and the SEC into possible abuses by corporate executives of such plans. Now, more than ever, companies and their boards of directors should review and strengthen their insider trading policies concerning Rule 10b5-1 trading plans.

Rule 10b5-1 trading plans are no stranger to controversy. First introduced in 2000 by the Securities and Exchange Commission (SEC), Rule 10b5-1 trading plans permit a corporate insider to adopt a plan of acquisition or disposition of his or her company's stock when not in possession of material nonpublic information so that trades may be executed by a broker at predetermined times regardless of whether the insider then possesses material nonpublic information.

Now that investigations have been initiated by U.S. Attorney's Offices and the SEC into possible abuses by corporate executives of such plans, the private securities bar inevitably will follow suit and file litigation. Nevertheless, the plans continue to be an effective affirmative defense against allegations of insider trading. Companies and their boards of directors should review and strengthen their insider trading policies concerning Rule 10b5-1 trading plans. Such measures will raise the likelihood that the plan will be successful as a defense, the company's insider trading policy will be deemed rigorous by regulators and governmental entities and more favorable directors' and officers' (D&O) insurance policy terms and premiums will be available due to a reduced risk profile.

Renewed Interest in Rule 10b5-1 Trading Plans

In November and December of 2012, a series of articles in the *Wall Street Journal* reported on corporate executives' use of Rule 10b5-1 trading plans to sell shares of their own company stock.¹ The trades appeared to have drawn the scrutiny of news media and federal prosecutors and securities regulators due

¹ Susan Pulliam & Rob Barry, *Executives' Good Luck in Trading Own Stock*, Wall St. J., Nov. 27, 2012; Susan Pulliam, Jean Eaglesham, & Rob Barry, *Insider-Trading Probe Widens, U.S. Launches Criminal Investigation Into Stock Sales by Company Executives*, Wall St. J., Dec. 11, 2012; Jean Eaglesham & Rob Barry, *Trading Plans Under Fire, Despite 2007 Warning, Experts Say Loopholes Remain for Corporate Insiders*, Wall St. J., Dec. 14, 2012.

to their opportune timing, resulting in highly beneficial sales, just days before the companies' stock prices plunged. The articles suggest corporate executives may have achieved above-market returns using prearranged corporate-executive trading plans. According to the articles, the U.S. Attorney's Office for the Southern District of New York and the SEC opened investigations into alleged abuses of such trading plans.

In April 2013, the *Journal* ran another series of articles on Rule 10b5-1 trading plans, this time, shifting its focus to corporate directors' use of such plans to sell company shares for investment funds they run.² One article reported that federal prosecutors in the Eastern District of New York had launched a criminal investigation, expanding on the investigation previously opened by the SEC and the U.S. Attorney's Office in the Southern District of New York. The articles highlight the well-timed nature of a few corporate directors' trades, which allegedly spared their investment funds significant declines in the value of their holdings.

Rule 10b5-1 trading plans have long been the subject of debate.³ The recent wave of renewed interest by federal prosecutors and securities regulators in such plans suggests that companies and their directors review their insider trading policies to evaluate compliance and to consider best practices.

Rule 10b5-1 Trading Plans: The Basics

In 2000, the SEC adopted Rule 10b5-1 to clarify "what, if any, causal connection must be shown between the trader's possession of inside information and his or her trading." It provides that a trade is made "on the basis of" material nonpublic information "if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale."

The Rule provides officers, directors and other insiders an affirmative defense to allegations of insider trading when, **prior to becoming aware of material nonpublic information**, the person entered into a binding contract to purchase or sell the security, instructed another person to purchase or sell the security for the instructing person's account, or adopted a written plan for trading securities. The contract, instruction, or plan must (a) specify the amount and price of securities to be purchased or sold as well as the date on which the purchase or sale is to be made (or include a written formula for determining such information) and (b) not permit the insider to exert influence over how, when, or whether to trade after entering into the plan.

For example, three months before the first scheduled trade, a director could adopt a plan that called for her broker to sell 10,000 securities of Company A on March 15, July 15 and November 15 every year so long as the sale could be completed for a minimum of \$20 per share. If sales occurred on those dates, the director should be able to raise a Rule 10b5-1 affirmative defense against an allegation of insider trading with respect to those sales. However, if the director altered or deviated from the plan such as by selling 20,000 shares of Company A for \$15 per share on March 5, the resulting sale would not be considered to be made pursuant to the plan and the affirmative defense would be unavailable.

Tips for Your Company's Rule 10b5-1 Trading Plan Policy and Plan Guidelines



² Susan Pulliam & Rob Barry, *Directors Take Shelter in Trading Plans*, Wall St. J., Apr. 24, 2013; Susan Pulliam, Rob Barry, & Scott Patterson, *Insider-Trading Probe Trains Lens on Boards*, Wall St. J., Apr. 30, 2013.

³ See, e.g., Alan D. Jagolinzer, *Do Insiders Trade Strategically Within the SEC Rule 10b5-1 Safe Harbor?* (Stanford Univ. Graduate Sch. of Bus., Working Paper, Dec. 2006), available at http://www.thecorporatecounsel.net/HotTopics2007/materials/docs/FAQ/12_06_Jago.pdf.

In light of the current investigations underway concerning potential insider trading and Rule 10b5-1 trading plans, companies and their directors should strengthen their insider trading policies addressing these plans and consider adopting guidelines for trading plans. In particular, companies should consider the following in order to maximize the protections of Rule 10b5-1 when companies and individuals are faced with allegations of insider trading.

- **Oversight of Trading Plans as Part of Company's Compliance Program:** Qualified legal and compliance personnel should preapprove the insider's entry into a Rule 10b5-1 trading plan and review proposed modifications to established plans. This review is part of the company's obligation to maintain a robust compliance program to detect and deter improper conduct, including insider trading. The company should develop preapproved plan guidelines for use by insiders.
- **Institute a Waiting Period:** Rule 10b5-1 does not impose a waiting period from the time of the plan's adoption to the first trade executed under it. Nevertheless, requiring a reasonable waiting period of 30 to 90 days (the longer the better), or expressly providing that no trades may occur until the next open window, would be helpful in strengthening a Rule 10b5-1 defense and avoiding suspicion of a trade made under the plan.⁴
- **Restrict Timing for Adoption of Plans:** A Rule 10b5-1 trading plan must be adopted at a time when the insider was not aware of material nonpublic information. Companies should consider restricting the time for adoption of such plans to "open window" periods under the company's insider trading policy. Such a limitation would dispel the potential negative inference that may arise if a plan was adopted outside the company's trading window.⁵ Companies should prohibit modifications of plans once adopted.
- **Preapproval for Cancellation of Plans:** Rule 10b5-1 does not establish a minimum duration period for plans or otherwise address the timing for cancellation of a plan established thereunder. However, cancellation or modification (if not prohibited) of a plan could affect the availability of the Rule 10b5-1 defense.⁶ Companies should additionally consider whether to restrict plan terminations to open window periods. Therefore, companies' qualified legal and compliance personnel should review and preapprove any proposed cancellation.
- **Discourage Suspension or Cancellation of Plans:** If an insider suspends (if modifications are permitted) or cancels a plan after the first option exercise or stock sale, companies should consider requiring the insider to terminate all outstanding trading plans and agree not to enter into another prearranged trading plan for a specified period (for instance, six months) after such termination.
- **Require Plans to Be Put in Place for a Reasonable Period of Time:** Companies should consider establishing a minimum duration period for prearranged trading plans. Any such requirement should be subject to limited exceptions for legitimate exigencies. Although Rule 10b5-1 does not require plans to be in existence for a specific period of time, establishing a minimum duration period may ward off skepticism that the plan was established in bad faith.

4 *In re Novatel Wireless Sec. Litig.*, 830 F. Supp. 2d 996, 1025 (S.D. Cal. 2011) (denying defendants' motion for summary judgment, and finding "Souissi's use of 10b5-1 was particularly questionable because he sold 110,000 shares the day after entering his 10b5-1 plan, for proceeds of over \$2.2 million.").

5 *See, e.g., In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1068-69 (C.D. Cal. 2008) (finding defendant's "amendments of 10b5-1 plans at the height of the market does not support the inference that the sales were pre-scheduled and not suspicious").

6 SEC Exchange Act Rules, *Questions and Answers of General Applicability* (Feb. 13, 2012), available at <http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm> (Interpretation 120.18).

- **Discourage Multiple Plans:** The use of multiple, overlapping plans is not prohibited by the Rule. But the existence of overlapping plans may cast doubt on whether the plans were adopted in good faith, particularly where a second plan could affect trades of the same securities covered by the first plan.⁷ This concern should not apply where multiple plans are used to sell shares to pay withholding taxes on the vesting of separate grants of restricted stock, because these plans would cover separately identifiable shares.
- **Restriction on Significant Sales:** Large sales of securities may draw scrutiny and undermine the effectiveness of a Rule 10b5-1 affirmative defense. Companies should consider imposing a volume restriction on sales made under Rule 10b5-1 trading plans, taking into account any volume restrictions imposed by Rule 144.
- **Automatic Termination or Suspension of Plan Upon Occurrence of Specified Events:** The Rule 10b5-1 trading plan should provide for automatic termination upon the occurrence of personal events, such as death, bankruptcy and termination of employment, and corporate events, such as mergers, acquisitions or securities offerings. In addition, Rule 10b5-1 trading plans should be suspended or terminable by the company upon the occurrence of a corporate event that would cause a prearranged transaction to violate the law or to have an adverse effect on the company, the trading plan must be revoked.
- **Keep It Simple:** Companies should make sure Rule 10b5-1 trading plans provide adequate instructions for the broker to implement the plan, keeping in mind that a simple plan is best. The plan should clearly describe the number of shares to be sold or purchased on specified days. Avoid ambiguity and complexity.
- **Voluntary Disclosure:** The adoption, amendment or termination of a Rule 10b5-1 trading plan is not required to be publicly disclosed. Nevertheless, companies should consider voluntary disclosure as a good faith effort to be transparent and to ward off public scrutiny. Such disclosures should merely identify that a Rule 10b5-1 trading plan has been adopted or terminated by a particular corporate insider, and should not include the plan's details.
- **Form 4 Filings Should Indicate That Trades Were Made Pursuant to a Trading Plan:** The Rule 10b5-1 trading plan must state how the insider should notify the company of trades in a timely manner since insiders must file a Form 4 reporting all transactions in company stock within two business days. Where relevant, the Form 4 filing should indicate that the trades were made under a Rule 10b5-1 trading plan. Companies should consider the effect that frequent trades under a plan would have on Form 4 filings and encourage insiders to plan accordingly.

Conclusion

In light of the increased media attention paid to Rule 10b5-1 trading plans and the resulting regulatory and governmental investigations, it is not far-fetched to believe that the plaintiff's securities bar will not be too far behind. Carefully crafted Rule 10b5-1 trading plans can be an effective tool to rebut allegations of insider trading in securities fraud class actions as well as in regulatory or governmental investigations or proceedings. Adoption and maintenance of robust insider trading policies and drafting guidelines concerning such plans also are important to demonstrate to regulators and governmental entities that a company has taken all reasonable steps to put effective compliance measures in place to detect and deter

⁷ See *SEC v. Mozilo*, No. 09-3994, Docket No. 1 §§ 114-124 (C.D. Cal. filed June 4, 2009) (highlighting multiple trading plans entered into by defendant in three-month period).

insider trading. In addition, a company's adoption of rigorous insider trading programs and plan guidelines may be useful in demonstrating to prospective D&O insurers during the underwriting process that a company's risk profile is relatively low, resulting in more favorable coverage terms and lower premiums. For all these reasons, companies and their boards should review their current policies concerning trading plans and strengthen them if necessary to best defend themselves from potential litigation and investigations and best position themselves for favorable D&O insurance coverage opportunities.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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