INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

Volume 29 Number 11, November 2015

INSIDER TRADING

Proactive Planning: A Guide to Rule 10b5-1 Plans

Given the SEC's increased focus on insider trading by executives and the complicated determinations needed to decide if an executive or director has material non-public information, it is anticipated that the use of Rule 10b5-1 plans will continue to grow. Companies and their executives carefully should consider the benefits, and the shortfalls, of these plans.

By Stuart Gelfond and Arielle L. Katzman

Stock is routinely an important part of public company compensation, but insider trading restrictions (*e.g.*, blackout periods and exposure to material non-public information (MNPI)), can pose a significant challenge to selling corporate stock. Rule 10b5-1 of the Securities and Exchange Commission (SEC) presents a valuable solution to such a dilemma, but there are nuances that need to be understood. Internal and external legal counsel should be familiar with the terms and application of the rule, which covers more situations than the common scenario.

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Benefits of Rule 10b5-1 Plans

Rule 10b5-1 plans provide an affirmative defense for companies and those presumed to be "insiders" (*i.e.*, directors and officers) transacting in the relevant company's securities. These plans have become relatively commonplace, but from time to time, they have attracted attention, usually in response to media coverage of enforcement action by the SEC or reports of suspicious activity. The instances of public scrutiny have demonstrated the unraveling of perceived abusive plan practices such as establishing multiple plans, making excessive modifications to plans or limiting plan duration. Recently, the SEC has increased its enforcement activity for violations of Section 16 reporting obligations, which demonstrates a renewed focus on insider trading activity,[1] a landscape that Rule 10b5-1 plans also occupy.

Rule 10b5-1 plans are passive investment schemes (plan holders relinquish direct control over transactions), which provide a mechanism for companies and corporate insiders to purchase and sell securities of such company when they have MNPI, by providing an affirmative defense to insider trading. Although attention generally is focused on the selling aspect, the plans also can cover purchases of securities. Furthermore, the protections of Rule 10b5-1 are not limited to publicly-traded stocks. Private equity funds and other investment managers can benefit from Rule

10b5-1, such as by using a Rule 10b5-1 plan to make future acquisitions or dispositions of company equity or debt without violating insider trading restrictions.[2] Distressed debt investors also may use Rule 10b5-1 plans to make future acquisitions or dispositions of company debt.

Companies can also benefit from having their insiders adopt their own plans.

Rule 10b5-1 plans benefit both companies and their insiders by offering greater clarity and certainty on how participants can plan and structure securities transactions to avoid incurring liability. They enable insiders to diversify their investment opportunities without being circumscribed by restricted trading windows or threats of liability. Establishing a plan eliminates the need to evaluate the materiality of any nonpublic information that insiders may possess at each instance a transaction is contemplated; rather, the materiality determination only needs to be made at the time of plan enactment. But it is important to note that the time of entering into the plan is not the only relevant moment as subsequent actions can impact the strength of the affirmative defense, as discussed later in this article. In addition to benefitting directly when companies are the plan participants, companies can also benefit from having their insiders adopt their own plans. When insiders adopt Rule 10b5-1 plans, companies have a reduced responsibility in scrutinizing insider transactions and they can avoid entanglement with insider trading controversies (because less controversies would be expected when insiders execute trades under properly implemented plans). By supporting the adoption of Rule 10b5-1 plans, companies can also align with the investment objectives of their insiders. However, some companies may disfavor its management's adoption of Rule 10b5-1 plans because they could decrease management's alignment with the company by facilitating disposal of company interests, particularly during difficult times.

In order to understand how the plans function, it is also helpful to identify when they are *not needed* as an affirmative defense. Trading when not aware of MNPI is always permissible; however it might be easier to make the case that one was not aware of MNPI when a plan was established (versus at the time of executing a transaction). Insider trading is always judged in hindsight. Events that do not appear to be material at a particular instance may result in stock price fluctuations. Moreover, stock price may vary for other reasons but proving the exact cause of the price variation can be complicated. Additionally, the 10b5-1 plan affirmative defense is only necessary in response to a charge of trading on MNPI. Thus, the failure to establish a viable 10b5-1 plan does not independently constitute an actionable claim; however, once a claim is brought, the plan holder bears the legal burden of establishing that trades pursuant to a Rule 10b5-1 plan are protected. Furthermore, Rule 10b5-1 plans are not appropriate for all situations. For example, they would not advance the investment objectives of investors desiring tight control over finances or seeking to execute transactions on a short timeline.

Rule 10b5-1

Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and the associated Rule 10b-5 prohibit the employment of manipulative and deceptive devices in the trading of securities. Rule 10b5-1 states that the manipulative and deceptive devices prohibited under Section 10(b) and Rule 10b-5 include purchases and sales of securities made "on the basis of" MNPI about a security or issuer in breach of a duty of trust or confidence that is owed to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the MNPI. Furthermore, Rule 10b5-1 specifies that a purchase or sale of a security is made on the basis of MNPI when the person making the purchase or sale was "aware" of MNPI *at the time* the purchase or sale was made. Thus, the SEC contends that "possession," not "use," of MNPI is sufficient to establish

liability in insider trading cases. This interpretation is significant since corporate insiders are exposed to a high volume of arguably non-public information, but it can be difficult to determine which subset of information satisfies a materiality threshold. Although the rule broadens the scope of illegal trades, it provides relief in the form of an affirmative defense of a Rule 10b5-1 plan, which is available to any person and any entity, including companies with respect to their own securities.

Individuals and Entities

A purchase or sale of securities is not deemed to be made on the basis of MNPI if the person making the purchase or sale can demonstrate that before becoming aware of any MNPI, the person, in good faith and not as part of a scheme to evade the prohibitions of Rule 10b5-1:

- (1) entered into a binding contract to purchase or sell the security; (2) instructed another person to purchase or sell the security for the instructing person's account; or (3) adopted a written plan for trading securities;
- with respect to the purchase or sale, such contract, instruction or plan either must (1) expressly specify the amount, price and date; (2) include a written formula or algorithm, or computer program, to determine the amount, price and date of securities to be purchased or sold; or (3) not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales, provided that any other person exercising such influence must not be aware of MNPI when doing so; and
- the person must demonstrate that the purchase or sale that occurred was pursuant to the prior contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

The 10b5-1 affirmative defense is available even if actual trades made pursuant to the plan are executed at a time when the plan holder is aware of MNPI that would otherwise subject that person to liability.

Entities (*e.g.*, Issuers and Investment Banks)

Non-natural persons will not be liable for insider trading if they can demonstrate that the individual(s) making an investment decision on behalf of the entity was not aware of MNPI, and that the entity had implemented reasonable policies and procedures to prevent insider trading. As noted in the SEC release, "most entities to whom this affirmative defense would be relevant—*i.e.*, broker-dealers and investment advisers—already have procedures in place, because of existing statutory requirements." Thus, entities should be able to establish this defense if properly documented.

Subsequent Regulatory and Corporate Developments

In 2009, the SEC pronounced additional guidance on Rule 10b5-1 and it brought various well-publicized insider trading enforcement actions including an action against Countrywide Financial CEO Angelo Mozilo.[3] In the *Mozilo* action, which involved allegations that Mozilo used his Rule 10b5-1 plans to trade illegally on inside information, the SEC obtained the highest settlement against a public company senior executive in its history at the time of settlement.[4]

Insider trading enforcement actions also have spurred policies originating from companies rather than at the regulatory level. For example, subsequent to recent public scrutiny, some companies have strengthened their insider trading policies regarding Rule 10b5-1 plans pertaining to their securities by (1) mandating longer "cooling-off periods" between the establishment of an

executive's 10b5-1 plan and transaction execution under the plan, (2) discouraging executives from making changes to such plans before big news events that could impact the stock, or (3) encouraging employees to forego adoption of Rule 10b5-1 plans and limit trading to open windows between potentially market-moving news events.[5] Furthermore, influential groups have encouraged the SEC to provide additional guidance.[6] However, these restrictions and additional SEC regulations will not necessarily prevent misuse and could hinder the usefulness of Rule 10b5-1 plans.

Coordination with Other Securities Laws

Rule 10b5-1 provides specific guidance in the insider trading realm, but it does not operate in a vacuum and co-exists with other securities laws, which remain applicable. For example Rule 10b5-1 does not alter the elements of a case under Rule 10b-5/Section 10(b) (*e.g.*, scienter is still required). Additionally, transactions pursuant to a Rule 10b5-1 plan must still comply with (1) the volume limitations of Rule 144 (if shares are not otherwise freely tradable and Rule 144 applies), (2) short swing profit rules and filings of ownership forms under Section 16(a) of the Exchange Act (*i.e.*, filing a Form 4 in connection with each transaction), and (3) filing Schedules 13D or 13G where appropriate.

Implementing a Rule 10b5-1 Plan

Any person or entity can establish a Rule 10b5-1 plan to sell or buy securities at a time when the person or entity is not aware of MNPI, so long as the plan is not part of a plan or scheme to evade the insider trading prohibitions of the rule. Although Rule 10b5-1 plans are of greatest benefit to those presumed to have insider information on a regular basis, such as directors and officers of a company[7] (who are frequently in possession of MNPI), non-insiders also can set up such plans (*e.g.*, a secretary or intern who is likely to encounter material, nonpublic information). Even if companies do not require their insiders to establish plans, corporate insider trading policies may still govern their terms if voluntarily adopted by insiders.[8] Corporate oversight may be useful in assuring that plans follow best practices and are institutionally consistent.

While plans are most commonly associated with individuals (such as directors and officers), entities can establish plans; for example, a company might conduct a share repurchase program pursuant to a Rule 10b5-1 plan. This would require satisfaction of additional conditions for companies whose share repurchase plans are designed to be compliant with Rule 10b-18 under the Exchange Act, which provides a safe harbor from violations of laws against market manipulation for issuer repurchases that satisfy manner, timing, price, and volume conditions. Some companies may decide to not use the 10b5-1 vehicle for company repurchases because they prefer to not put share repurchase programs on auto-pilot.

Formal SEC policy outlines broad guidance and the SEC has taken a facts and circumstances approach in evaluating whether Rule 10b5-1 plans comply with the rule. Below are some best practices for internal and external counsel to consider when reviewing Rule 10b5-1 plans to bolster their compliance. Many of these suggestions also apply to Rule 10b5-1 plans at the company level.

Establish Only One 10b5-1 Plan

The existence of multiple plans raises suspicions and is suggestive of impermissible hedging. A single plan can incorporate multiple strategies and achieve the same desired outcome. For plans designed to sell securities, arrangements for funding such purchases should be determined upon establishment of a plan since funding a plan when sales are effected may be viewed as implementing a new plan, which would require re-evaluating the existence of MNPI.

Optimal Time of Adoption

To decrease the appearance of possession of MNPI, an ideal time to adopt a plan is during

an issuer's open trading window, particularly shortly after a company announces its quarterly or annual results or files its Form 10-Q or Form 10-K.

Public Disclosure

Although public disclosure of Rule 10b5-1 plans is not required, issuers should consider publicly disclosing (*e.g.*, through a Form 8-K) the establishment, but not complete details, of plans for themselves as corporate entities (*e.g.*, in connection with a stock repurchase plan) and for their insiders.[9] Disclosure can strengthen the good faith defense but also distort the plan participant's intentions regarding sales pursuant to the plan. Once publicly announced, consideration should be given to disclosing changes to the plan or termination. Additionally, executive officers, directors, and 10 percent shareholders are required to file Section 16 ownership forms in connection with changes in ownership of relevant securities, and such filings may indicate that the transaction is pursuant to a Rule 10b5-1 plan. A Form 144, which is filed when a director, executive or affiliate sells the relevant security, specifically requires disclosure that a transaction is pursuant to a Rule 10b5-1 plan. Investors may react less negatively to the disclosure of particular transactions if the establishment of a plan was initially disclosed.

Establish a Waiting Period

Companies may want to require a period of time to separate the establishment of a Rule 10b5-1 plan and the execution of trades pursuant to the plan. Although the absence of possession of MNPI at the time of plan adoption is the threshold question, rapid transaction executions subsequent to plan adoption may create an appearance of impropriety and call into question whether a plan adopter had MNPI at the time of plan adoption. Brokers administering plans frequently impose a seasoning period as part of their own trading practices, but companies also adopt these policies. A fourteen day period is often used, but many companies have increased the waiting period to about one month. Some companies may even prefer that trades pursuant to the plan do not commence until the next open trading window. The SEC has taken the position that delaying the commencement of sales until the release of MNPI does not legitimize a plan if the plan was adopted while in possession of MNPI.[10] One way to deal with this guidance is to conduct trades outside of the plan (since it is permissible to freely trade when information is public), but plan holders would not have the benefit of the affirmative defense and also should exercise caution in trading the same security under and outside of a Rule 10b5-1 plan.

Duration

There is no regulatory timeframe for plan duration. Plans that are too short may be seen as questionable in hindsight, but plans that are too long will limit flexibility. Longer plans can be cautiously terminated as discussed below. Plans typically have terms ranging from six months to two years.

Breadth

Rule 10b5-1 plans should include only securities of companies where the participant is likely to acquire MNPI. In addition to the securities of one's employer, this may include securities of key suppliers and customers. For investment firms, this may include securities of multiple portfolio companies.

Avoid Multiple Modifications, Suspension and Termination

Modifications, suspension and termination actions are technically all permitted but may weaken the good faith defense. A change is permissible if the participant does not have MNPI at such time. Plans that are sufficiently broad may not require frequent modifications absent changes in personal circumstances of the plan

participant. Although termination (even when the plan participant is aware of MNPI) does not a priori invalidate the defense, it could affect the availability of the defense for prior plan transactions if it calls into question whether the plan was entered into in good faith and not as part of a plan or scheme to evade the insider trading rules.[11] Thus, it may be permissible for a CFO to terminate a plan if such insider has knowledge of an impending announcement of disappointing earnings, but serial terminations should be avoided. Plans also can provide for automatic termination in connection with particular events (therefore, the participant would not exercise any discretion as prescribed by the rule). Once terminated, a cooling off period should be considered prior to the entry into a new plan. Additionally, cancellation of a transaction likely will be deemed an alteration or deviation from the plan, which will terminate the plan.[12]

Employ a Third-Party Administrator

Typically, an administering broker will execute trades and some companies will require employees to use a "captive" broker. Many of the major investment banks have groups that administer Rule 10b5-1 plans, which have their own policies designed to enhance plan validity. Transfer of discretion is a required element of the rule, but participants can minimize third-party discretion through sufficient specificity in plan design. For example, trades can be linked to particular dates or more qualitative triggers. Other than issuing a notice of execution, participants should not communicate with administering brokers subsequent to implementation of a plan. It is critically important for plan administrators to timely communicate transactions under the plan to ensure continued compliance with other regulations (*e.g.*, Section 16 and Rule 144). Plan administrators must not be aware of MNPI if/when they are exercising influence over how, when or whether to effect trades under a plan. Transfer of a plan to a replacement broker is permissible if the initial broker becomes defunct.

Limit Discretion on Margin Account

In connection with a margin account, a participant should not retain any discretion to substitute or provide additional collateral, or to repay the loan before the pledged securities may be sold because these actions may constitute impermissible subsequent influence over transactions.

Coordinate with Trading Outside of the Plan

Although trading outside of a Rule 10b5-1 plan is permissible, it can weaken plan validity. If the insider is subject to Rule 144 volume limitations, the sales of securities outside the plan could effectively reduce the number of shares that can be sold under the plan, which could be deemed to be an impermissible modification of the plan. Allocation of the Rule 144(e) volume limit between plan and non-plan sales during the operation of a plan should be set in advance via a formula. In some instances, it may be appropriate (even if not required) to pre-clear trades outside of a plan with outside counsel, the company or the plan administrator.

Strengthen Insider Trading Policies

Companies have an interest in ensuring that insiders adopt compliant plans. Insiders should familiarize themselves with corporate insider trading policies, which may have specific provisions on Rule 10b5-1 plans (*e.g.*, parameters on establishing, modifying and terminating them, exemption of Rule 10b5-1 plans from the restrictions on trade imposed by blackout periods, etc). Corporate policies can require pre-clearance of plans to verify compliance with Rule 10b5-1 (at inception and any subsequent alterations) and commencement of trading thereunder; this practice is especially advisable for senior officers. Such review may also involve consultation with outside counsel.

A structured corporate framework can achieve uniformity of plans (*e.g.*, by requiring use of a

particular broker and its form), but can offer more flexibility, support and less deterrence to insiders looking to establish plans than policies handed down by the SEC. Corporate involvement and coordination is prudent given that Rule 10b5-1 plans may interact with other corporate policies such as blackout periods, public disclosures, stock ownership guidelines, exercise of stock options, and 401(k) plans. Companies can benefit from greater involvement reputationally (because they have demonstrated a commitment to strong corporate governance) and in the form of more favorable D&O insurance premiums (because such corporate policies reduce risk exposure). Furthermore, it is expected that the SEC would look favorably upon directors and officers abiding by company policies on Rule 10b5-1 plans.

Ensure Lock-Up Agreements Contain Exceptions for Plans

Insiders and companies that sign lock-up agreements in connection with public and private securities offerings should confirm that lock-up agreements (1) carve-out the establishment of a Rule 10b5-1 plan during the lock-up period and (2) do not apply to securities traded under existing Rule 10b5-1 plans.

Satisfy ALL Requirements

The suggestion to satisfy ALL requirements may seem obvious, but compliant Rule 10b5-1 plans must contain specific elements. To summarize the requirements detailed above, one must establish an arrangement in advance of trades when unaware of MNPI, such arrangement must contain sufficient detail or a formula and the participant must not exercise any discretion over transactions pursuant to such plan. Although not dispositive, it may be beneficial for a plan to contain representations regarding compliance with Rule 10b5-1's criteria (for example, affirmations that (1) the plan has been entered into at a time when the investor is not in possession of inside information, and (2) the plan is entered into in good faith and without intent to manipulate or deceive). Companies with robust policies also may provide broker's with an acknowledgement that the plan does not violate corporate insider trading policies.

A combination of the above considerations will factor into the analysis for determining the availability of the 10b5-1 affirmative defense. For example, in the SEC's case against Angelo Mozilo, not only was he charged with possessing insider information at the time that he entered the plans, but also the SEC buttressed its claim by noting that he implemented four plans in three months, modified one of the plans, and started trading immediately under some of the plans.

It should be noted that the above suggestions do not capture certain questionable practices that violate the spirit, but not the letter, of the law. Technically permissible, but dubious practices, usually become visible when correlated with financial windfalls for plan holders and have drawn attention to the use of plans and their viability. In this regard, an investigation by the *Wall Street Journal* in 2013 identified a practice of some *non-executive* directors using Rule 10b5-1 plans to sell heavily in a short period of time instead of selling a fraction of their shares at regular intervals. Although Rule 105b-1 permits both trading patterns, some practitioners would argue that regulators envisioned the plans as a way for executives to diversify their holdings through steady trades; massive sales, resulting in tremendous profitability, may seem more suspect. Additionally, when trades under plans precede the release of material news and avert losses or amplify gains, plans invite greater scrutiny as they suggest that plan holders may have been in possession of MNPI at the time of plan implementation. This negative attention could produce a reputational stigma for both companies and their insiders.

Conclusion

Implementing Rule 10b5-1 plans through well-developed corporate policies that evaluate the considerations and best practices listed above

assist in achieving compliance with the spirit and letter of the rule. Given the SEC's increased focus on insider trading by executives and the complicated determinations needed to decide if an executive or director has MNPI, it is anticipated that the use of Rule 10b5-1 plans will continue to grow. Companies and their executives carefully should consider the benefits, and the shortfalls, of these plans.

Notes

1. "SEC Announces Charges Against Corporate Insiders for Violating Laws Requiring Prompt Reporting of Transactions and Holdings," September 10, 2014, *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542904678.*

2. For example, a private equity fund may seek to rely on Rule 10b5-1 where principals of such fund serve on the board (or the private equity fund is otherwise exposed to insider information) of a public company in which a fund invests.

3. *SEC v. Mozilo,* No. 09CV03994 (C.D.Cal. filed June 4, 2009). Notably, the SEC's action against Mozilo was not its first well-publicized 10b5-1 plan investigation. Previously, in 2004, the SEC brought an action against former Enron CEO Kenneth Lay, who was charged (among other things) with fraudulently amending his trading plans to sell more than $20 million worth of Enron shares when he was in possession of MNPI concerning Enron's deteriorating financial condition. *See* Litigation Release No. 18776, "SEC Charges Kenneth L. Lay, Enron's Former Chairman and Chief Executive Officer, with Fraud and Insider Trading" (July 8, 2004).

4. "Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive," October 15, 2010, *http://www.sec.gov/news/press/2010/2010-197.htm.*

5. For further discussion, *see* "Firms Set Curbs on Trading," *Wall Street Journal,* July 28, 2013.

6. In 2012 (with a follow-up request in 2013), the Council of Institutional Investors (CII), a group of pension funds that oversees more than $3 trillion in assets, called upon the SEC to provide interpretive guidance or amendments to Rule 10b5-1.

7. Rule 10b5-1 clearly indicates that its scope is not limited to executives of companies. Recent coverage has noted a new "exotic" practice, whereby investment funds use the plans to trade stock of companies where their principals sit as directors. "Directors Take Shelter in Trading Plans," *Wall Street Journal*, April 24, 2013.

8. A recent survey (June 2013) of about 30 companies by TheCorporateCounsel.net found that no participating companies required insiders to establish 10b5-1 plans. Nevertheless, when insiders opt to establish plans, approximately 91 percent of companies said they review and approve their insider's trading plans.

9. Approximately 79 percent of companies indicated they did not have a policy on public disclosure of 10b5-1 (*e.g.*, by press release and/or a Form 8-K). *Id.*

10. SEC CD&I 120.20.

11. SEC CD&I 120.17 and 120.18.

12. SEC CD&I 120.19.