CLIENT UPDATE

INSIDER TRADING PLANS IN SPOTLIGHT AGAIN

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The spotlight is shining once again on the use (and possible abuse) of Rule 10b5-1 trading plans by corporate executives. A recent front page article in the *Wall Street Journal* entitled "Executives' Good Luck in Trading Own Stock" reported that, based on the review of thousands of trades by corporate insiders, many executives appear to have done suspiciously well buying and selling their companies' stocks under so-called Rule 10b5-1 trading plans. The *Wall Street Journal* article, as well as the recent intense focus on insider trading matters generally, suggests that Rule 10b5-1 trading plans may be ripe for increased scrutiny by regulators, prosecutors and shareholders alike.

BACKGROUND

Company insiders have long been a primary focus of laws barring individuals from buying or selling securities on the basis of material non-public information. Engaging in such insider trading is a violation of the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Under Rule 10b5-1, as interpreted by the SEC, any trade made while in possession of material non-public information would be considered to have been made "on the basis" of that information and thus a violation of the prohibition on insider trading. This position has been adopted by a number of courts.

The position that "possession" and not "use" of material non-public information is sufficient to establish insider trading liability raises significant concerns for company insiders, who often are in possession of information that may be considered – or determined by the SEC or criminal prosecutors in hindsight – to be material non-public information. In recognition of the potential difficulties raised by the possession standard, the SEC added to Rule 10b5-1 an affirmative defense to insider trading allegations for insiders who often have much of their wealth tied up in company stock. Under Rule 10b5-1, an insider who is in possession of material non-public information concerning his or her company's securities may purchase or sell those securities so long as the transactions are executed under a plan adopted at a time when the insider did not possess material non-public information.

To provide an effective defense to insider trading, a Rule 10b5-1 plan must be binding and written and it must be adopted while the insider is not in possession of material non-public information. The trading plan must also (i) specify the amount of securities to be traded, the price of the trade and the date of the trade; (ii) specify a written formula for determining sales or purchases; or (iii) delegate sale and purchase decisions to another party. In practice, many Rule 10b5-1 trading plans specify that a predetermined number of shares or percentage of holdings will be sold either at certain times of each quarter or when the stock reaches a set price.

WALL STREET JOURNAL'S ANALYSIS

The *Wall Street Journal* examined records related to thousands of insider transactions entered into within five trading days prior to the release of material news. The *Wall Street Journal's* review revealed that a disproportionate number of insiders recorded significant gains, or avoided significant losses, when trading just prior to market moving news. In addition, the article asserts that several notable deficiencies in the general requirements surrounding Rule 10b5-1 plans result in a lack of information regarding the implementation, modification and cancellation of Rule 10b5-1 trading plans. Such systemic issues include that (i) trading plans are not required to be filed with the SEC or any other regulatory body; and (ii) there are no disclosure requirements relating to the trading plans. In addition and most significantly, although Rule 10b5-1 is clear that insiders may not possess material non-public information when they enter into a trading plan, the rule does not prevent insiders from cancelling an established plan at any time – including while in possession of such information. As the SEC's Division of Corporation Finance made clear shortly after the adoption of Rule 10b5-1, the act of terminating a plan while in possession of material non-public information is not a violation of the prohibition on insider trading because such a cancellation is not in connection with a purchase or sale

of a security. Plan cancellations occurring in close proximity to a planned sale or those which are followed closely in time by the adoption of a new plan do, however, risk undermining the effectiveness of the plan itself and the ability of the insider to rely on it in effecting purchases or sales. The SEC has warned that cancellation on the basis of material non-public information might "call[] 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 within the meaning of Rule 10b5-1(c)(1)(ii)."

IMPLICATIONS TO ISSUERS AND INSIDERS

It may be that the *Wall Street Journal* article prompts federal regulators to take a closer look into the practices surrounding Rule 10b5-1 plans. If so, we would expect regulators to focus on whether insiders were in possession of material non-public information at the time they adopted, modified or, potentially, even cancelled a plan. Similarly, we would expect regulators to focus on whether companies have policies and procedures designed to prevent changes to plans while insiders possess such information.

The negative media attention on Rule 10b5-1 trading plans is a good reminder to review those plans and the internal policies governing them with an eye towards ensuring that they are thoughtfully designed and carefully executed in order to protect against claims of impropriety in connection with trading under these plans. Best practices in this area include the following:

- Confirm, and document, that an insider is not in possession of material non-pubic information any time a plan is adopted or modified. In addition, consider initiating similar procedures with respect to plan terminations.
- Depending upon the nature and extent of any information asymmetry between an insider and the public marketplace, consider requiring a time lag between (i) the time an insider acts to adopt or modify a plan and the date that action takes effect; and (ii) the cancellation of an existing plan and adoption of a new plan. This should help avoid any inference that such action was taken in order to take advantage of material non-public information.
- Structuring a plan to effect a series of regularly scheduled trades would help to avoid an inference that an insider is attempting to exploit material non-public information.

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Please do not hesitate to contact us with any questions.

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