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- Key events timeline
- Grading the SEC's performance
- The next big blowup?
- Top legal decisions
- Directors to watch



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10b5-1 trading plans: The next big blowup?

If recent history is any guide, both regulators and plaintiffs' attorneys alike may soon be on the case. Consider implementing some safeguards so that you're not dragged into a potential future scandal. **BY PRIYA CHERIAN HUSKINS**

COULD ABUSES OF 10b5-1 trading plans become the next corporate governance scandal? New research from Stanford University School of Business Prof. Alan Jagolinzer calls into question the legality of trades being made under certain 10b5-1 trading plans. Moreover, perhaps as a result of this research, Linda Chatman Thomsen, the head of enforcement at the Securities and Exchange Commission, noted in a speech on March 8, 2007, that the SEC is now looking into the issue.

Considering that academic research precipitated the recent stock options backdating scandal, a similar pattern may emerge with respect to Rule 10b5-1 trading plans. Accordingly, public companies should review their 10b5-1 trading plans in light of Jagolinzer's research. To help you calibrate and address the risk, this article provides some background on 10b5-1 trading plans, then discusses the professor's research, and finally offers recommendations for best practices related to 10b5-1 trading plans.

Background

Numerous public company directors and officers — “insiders” — systematically sell stock of the companies that they serve through 10b5-1 trading plans. When properly implemented, these plans help insiders avoid three undesirable outcomes:

1. Never selling shares of company stock because of almost constant possession of material nonpublic information, and thus failing to sufficiently diversify their own personal portfolios.
2. Selling their shares and then being subject to charges of violating the criminal laws that prohibit trading on the basis of material non-public information.
3. Providing fodder for the civil securities class

action plaintiff bar if the price of their company's stock happens to fall sharply after the insider sales of stock. In theory, because sales are scheduled well in advance of their execution date and the plans are put into place at a time when the insider holds no material, nonpublic information, 10b5-1 trading plans prevent insiders from using material, nonpublic information to time the sale of their shares. (For a fuller explanation of Rule 10b5-1 trading plans, see sidebar, “What is a 10b5-1 Trading Plan?”)

The popularity of 10b5-1 trading plans

Given the affirmative defense against insider trading afforded to executives who follow the prescriptions of Rule 10b5-1, the popularity of 10b5-1 trading plans is unsurprising. In addition to enabling sales of stock by insiders, 10b5-1 trading plans may afford protection to defendants in securities class action lawsuits.

To understand the protection afforded in a securities class action, consider the typical allegations raised in a shareholder suit: The shareholder plaintiffs accuse the defendant insiders of violating Section 10(b) of the



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Securities and Exchange Act of 1934 and Rule 10b-5, with the thrust of the allegations being that company insiders committed fraud on the market, usually through false disclosure or failure to make necessary disclosures so as to support the price of a company's stock.

To prevail in their quest to find an insider liable of a 10b-5 violation, one element that the shareholder plaintiffs must establish is that the defendant insiders acted with intent to commit fraud. The shareholder plaintiffs' job is made easier when they can point to sales of stock made by the insiders at allegedly artificial prices — sales allegedly timed to personally enrich the defendant insiders. The fact that sales made by an insider were instead made pursuant to a pre-established 10b5-1 plan may rebut the bad intent that a trade by an insider may otherwise imply.

What is a 10b5-1 trading plan?

Many insiders face a dilemma. By virtue of stock option plans and other equity incentive plans, insiders often hold such large amounts of stock in their own companies that their personal investment portfolios are inadequately diversified. As a result, as part of the prudent management of their own finances, these insiders may justifiably want to sell company stock.

Yet, because of their corporate positions, these insiders often possess material, nonpublic information that prevents them from doing just that. After all, if they were to trade on such information, they would open themselves up to criminal and civil charges of illegal insider trading and market manipulation.

Recognizing this dilemma, the SEC promulgated Rule 10b5-1. The fundamental principle underlying Rule 10b5-1 is that an insider is not truly engaged in manipulating the market — even if the insider possesses material, nonpublic information at the time of a trade — provided that the trade occurs automatically according to a predetermined plan established before the insider ever possessed the material inside information.

Putting this principle into practice, Rule 10b5-1 provides an affirmative defense against insider trading liability to anyone in possession of material, nonpublic information if, before becoming aware of the information, the person:

- entered into a binding contract to purchase or sell securities;

- provided instructions to another person to purchase or sell securities; or,
- adopted a written plan for trading securities.

Furthermore, the person must act in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1.

In general, if a trade is conducted pursuant to a written plan, Rule 10b5-1(c) provides that the plan:

- must specify the number of and price at which securities to be purchased or sold as well as the date on which the securities are to be purchased or sold;

- must include an algorithm for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities are to be purchased or sold;

- must not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales.

In short, the insider must be able to demonstrate that material nonpublic information was not a factor in the trading decision.

Even though Rule 10b5-1 provides an affirmative defense to claims of insider trading, the SEC has the right to challenge the defense under the general “good faith” provision if the SEC suspects an abuse by an insider. For this reason, insiders must ensure that they can demonstrate good faith in addition to the technical elements of Rule 10b5-1.

— Priya Cherian Huskins

Possible evidence of abuse

Jagolinzer's research examines the return on trades made through 10b5-1 trading plans. His analysis of the data suggests that some insiders are using 10b5-1 trading plans so “strategically” that the insider trading laws may be being broken.

The preliminary results of the study suggest that the timing of trades under 10b5-1 plans is not always left to chance. Based on the data compiled by the study, insiders participating in 10b5-1 plans beat the market by 6 percent over six months, while those who did not participate in such plans beat the market only by 1.9 percent. These statistically significant results are indeed surprising if 10b5-1 plans are being employed in a way that does not take advantage of material insider information.

The higher return enjoyed by some 10b5-1 trading plan participants may be related to the finding that a substantial proportion of randomly selected 10b5-1 trading plan initiations take place in a way that does not seem random. Specifically, Jagolinzer found that many of the trade initiations seemed to take place ahead of negative news — i.e., before the price was about to drop — rather than in advance of positive news releases.

To understand how insiders can time the market in a supposedly automatic plan, remember that, even though 10b5-1 plans are predetermined and automatic in many ways, insiders typically retain some flexibility under the plans. For example, insiders can often terminate a plan on relatively short notice. Jagolinzer's research observes that early 10b5-1 plan terminations are not implemented randomly, but rather tend to precede declines in stock prices. Thus it may be the case that some insiders are terminating their 10b5-1 trading plans when they know bad news is coming that will temporarily depress the stock price before a scheduled sale. Indeed, as a technical matter, it is not illegal for an insider to terminate a 10b5-1 trading plan, even if the insider is in possession of material nonpublic inside information at the time of the plan termination.

In addition, it may be the case that some plans are being implemented at a time when insiders are arguably aware that good news may be forthcoming before the date of the first scheduled sale. Another possible explanation could be that insiders are manipulating the timing of public disclosure of material in-

formation to correspond favorably to trading dates in their 10b5-1 trading plans. Although these sorts of explanations are admittedly no more than conjecture at this point in time, these types of minor adjustments may explain the results of Jagolinzer's research.

Plan recommendations

Although the professor's research is still under peer review and the findings may not ultimately point to illegal activity, the research should serve as a wake-up call. If recent history is any guide, both regulators and plaintiffs' attorneys alike may now become much more attuned to 10b5-1 plans. Public companies should consequently examine the terms and conditions of their 10b5-1 trading plans.

To avoid even the appearance of impropriety, consider implementing the following practices:

- *Public Disclosure.* Promptly disclose the implementation of 10b5-1 trading plans on Form 8-K. Although not required by the SEC, such disclosure guarantees that the public is put on notice of a 10b5-1 plan's existence.

- *Minimum 30-Day Gap Between Disclosure and Trading.* Mandate that at least 30 days elapse between the public disclosure of the implementation of a new 10b5-1 plan and the first trade made under the plan. In the alternative, a 90-day period would be even more conservative. This will minimize any appearance of market timing.

- *Reporting Plan Sales on Form 4s.* Ensure that all 10b5-1 plan sales are promptly disclosed on Form 4. In addition, insiders should note on the Form 4s that the sales are being made pursuant to 10b5-1 trading plan.

- *Limited Modifications to 10b5-1 Plans.* There should only be minimal, if any, modifications to a 10b5-1 trading plan once adopted. If changes are made to a plan, there should be a significant lag period of at least 30 days between the adoption of the plan modifications and the first trade made pursuant to the modified plan.

- *Minimal Terminations.* Suspensions and terminations of the 10b5-1 plans should be allowed infrequently — very infrequently. If an insider is uncomfortable with this restriction, that insider might instead consider implementing shorter duration plans such as just six or nine months, but always

with significant lag periods of at least 30 days between the adoption of the new plan and the first trade made pursuant to that plan.

- *Small Sales Over Time.* Rather than just a few large sales, consider designing 10b5-1 plans to cause a number of smaller sales over time. Such a pattern will minimize inferences of exploitation of material nonpublic information.

- *Isolation of Trading Plan Broker.* Have the 10b5-1 plan administered by a broker who is not the insider's broker for the insider's other securities. As a result of isolating the broker, the insider will have many fewer reasons to communicate with the plan broker. With less need for information exchange, it is less likely that the insider will be able to convey information — advertently or inadvertently — that might help the plan broker improve the returns from the 10b5-1 plan. At the very least, isolation of the plan broker will curtail the appearance that the insider is somehow systematically conveying material nonpublic information to the broker. Furthermore, the insider should set up communication protocols with the plan broker — for example, only in writing — that would help rebut any implication that the insider is feeding material nonpublic

information to a broker that may have discretion over the execution of a particular trade.

- *No Other Trading.* Insiders who have 10b5-1 trading plans should only trade the company's stock pursuant to those plans. Not only will trades made outside of the currently-existing plan not benefit from the protection afforded by 10b5-1 plans but such trades may call into question the claim that the 10b5-1 plan is truly a part of a preplanned diversification strategy.

Mandate that at least 30 days elapse between the public disclosure of the implementation of a new 10b5-1 plan and the first trade made under the plan.

Out in front on the issue

Given the advantages 10b5-1 plans offer to insiders and their companies — allowing insiders to achieve liquidity in their company's stock at a much reduced risk of being accused of illegal insider trading — it would be premature to abandon the use of these plans. Nevertheless, in light of the academic research being reviewed by the SEC and others, it is never too soon for public companies to review the manner in which these plans are used by their insiders. ■

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