

Rule 10b5-1 plans: Put them to work

If properly designed, disclosed, and followed, 10b5-1 plans can accomplish virtually any executive's investment goals, without being limited by insider-trading policies. So why aren't more executives using them? **BY DARRYL P. RAINS AND PETER H. DAY**

INSIDER TRADING RESTRICTIONS are a constant headache for companies and their executives. Executives who receive a significant portion of their compensation in the form of options, restricted stock, or stock grants have a continual need to sell stock. Yet SEC regulations, company insider trading policies, and fears of allegations of insider trading keep many executives from properly diversifying their holdings.

Rule 10b5-1 trading plans are an ideal solution to this problem. Properly drafted Rule 10b5-1 plans allow executives the flexibility to sell stock without regard to limitations imposed by companies' insider trading policies and without violating SEC insider trading regulations. They also provide an affirmative defense to allegations of insider trading.

So why aren't more executives adopting Rule 10b5-1 trading plans? We think there are three main reasons. First, some executives still don't really understand Rule 10b5-1 plans. They don't fully appreciate how the plans work or the benefits they can provide. Second, many executives fear Rule 10b5-1 plans might deprive them of desired flexibility, forcing them to sell stock at the wrong time or at an unfavorable

price. And third, executives fear that sales made under these plans might generate negative publicity or send the wrong message to shareholders.

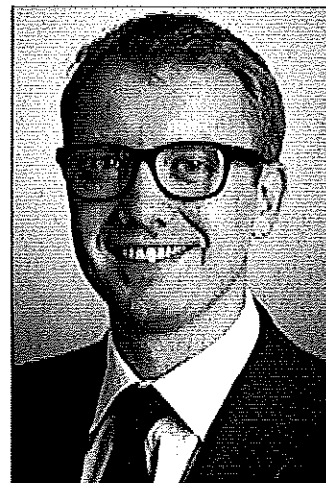
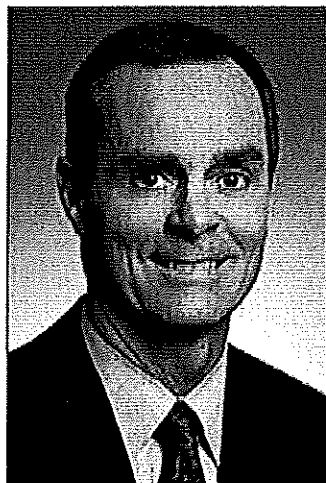
This article addresses all three concerns. We think properly prepared Rule 10b5-1 trading plans can allow executives to diversify their holdings in a flexible and advantageous manner without negative consequences. We encourage executives to use Rule 10b5-1 plans, and we encourage companies to adopt insider-trading policies that explicitly authorize such plans.

How Rule 10b5-1 plans work

Rule 10b5-1 creates an affirmative defense to charges of insider trading by allowing executives to create a plan for future sales of stock. A Rule 10b5-1 plan protects a seller, so long as the plan is adopted at a time when the seller does not have inside information, from insider trading liability, even if he comes into possession of material nonpublic information before a sale actually occurs.

To be effective, Rule 10b5-1 plans must be in

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writing and must meet three requirements. They must state the:

- **Number of shares to be sold.** The number can be specified as a number, as a percentage of the executive's holdings, or as the number of shares needed to produce a specific dollar amount of proceeds.

Rule 10b5-1 even allows the number of shares to be generated by an algorithm or computer program. Rule 10b5-1 plans can provide for multiple transactions. A different number of shares can be designated for each sale.

- **Prices at which the shares will be sold.** The exercise price can be set at specific dollar price, a limit order price, or as the prevailing market price. Again, prices can also be determined by an algorithm or computer model, and multiple transactions at

different prices can be ordered.

- **Timing of the sales.** Timing can be designated as a specific date or as the date on which a specific event occurs.

The benefits of Rule 10b5-1 plans

Rule 10b5-1 plans are easy to implement and use. Most brokerage firms have preprinted blank Rule 10b5-1 plans available for use by their customers, and many stockbrokers, especially those who specialize in high-net-worth individuals, are eager to assist. Once a plan is in place, a broker can and should execute the plan's instructions without further assistance from the executive.

Rule 10b5-1 plans, if properly prepared, can help executives comply with SEC trading regulations, such as sections 13 and 16(b). They can also allow executives to trade outside company "trading windows." Many companies have insider-trading policies specifically permitting transactions made pursuant to Rule 10b5-1 plans to occur outside trading windows and without compliance with other limitations, such as preclearance requirements. This is a huge benefit for executives, who often find they are prohibited from making trades in their company's stock as many as nine months of the year. Rule 10b5-1 plans also create a built-in protection against allegations of insider trading. Transactions made pursuant to Rule 10b5-1 plans can thus be made while executives possess inside information regarding unannounced mergers or acquisitions, upcoming financial results, new products, and the like.

The main restriction on Rule 10b5-1 plans is that, to be valid, they must be adopted before ex-

ecutives possess material nonpublic information. Executives must also refrain from attempting to influence how, when, or whether transactions occur once they have adopted a plan. Some brokerage houses have specialized Rule 10b5-1 trading desks that enforce a "wall of separation" between the executive and the persons responsible for executing the plan's instructions.

Rule 10b5-1 also has a general "good faith" provision that gives the SEC the right to challenge the affirmative defense created by Rule 10b5-1 if it suspects abuse.

Most challenges, to date, have centered on allegations that executives possessed material nonpublic information either at the time their plans were adopted or were amended. But the SEC has also challenged executives' "good faith" when plans were adopted or modified at suspicious times — such as at a stock price high — or called for sales that differed dramatically from an executive's prior sales pattern. For this reason, we suggest executives refrain from modifying or canceling plans once they are in place (although modifications are permitted by Rule 10b5-1 and may be appropriate in rare cases).

We also recommend that plans be adopted at least 60 days before becoming effective, that they be used only to diversify, over time, a reasonable portion of executives' holdings, and that they not coincide with company-initiated actions that may move a stock's price (like stock repurchase plans or acquisitions).

It's also a good idea to include a termination clause in 10b5-1 plans that will suspend trading upon, among other things, a merger or acquisition, a change in employment status, a divorce, ill health, or a personal bankruptcy.

The flexibility of Rule 10b5-1 plans

While Rule 10b5-1 plans might give very straightforward instructions ("sell 1,000 shares at the market price on the 15th of every month for the next two years"), they can also provide for very sophisticated trades tailored to accommodate individualized financial situations and goals. We recommend the following strategies for maximizing the flexibility of Rule 10b5-1 plans:

- **Short duration.** Rule 10b5-1 plans can be of any duration. So one frequent objection to Rule 10b5-1 plans — that they lock executives into trading strategies that may become outmoded over time — can easily be overcome. One approach might be to adopt a new plan annually (say every October) that will last for one calendar year. This approach also reduces the temptation to modify or amend an existing plan. We discourage executives from

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making any changes to an existing plan, terminating one prematurely, or adopting multiple overlapping plans, as the SEC and plaintiffs' lawyers have attacked these strategies.

- **Small percentage of holdings.** Some executives mistakenly believe that Rule 10b5-1 plans must cover all their holdings. Not so. We recommend executives make only a small part of their holdings — perhaps 25 percent to 50 percent — subject to Rule 10b5-1 instructions.

- **Minimum price “floors.”** No one wants to sell stock at a low price. One easy way to prevent this is to include a minimum price floor. Multiple price floors, which increase over specified periods of time, can also be used.

- **Multiple price targets.** Executives seeking to maximize their returns could create a matrix of future price targets. This strategy addresses a common concern of executives — that sales executed according to 10b5-1 plans occur at prices that, in hindsight, feel too low. Executives can manage this risk by providing for sales of certain numbers of shares at easily achievable price targets, and additional sales in the (less likely) event that more aggressive price targets are achieved.

- **Indices, price gaps, and industry moves.** Some executives base trading decisions on how their company's stock performs relative to various market or industry indices, or relative to certain selected competitors. Rule 10b5-1 is flexible enough to accommodate these types of strategies. Plans can provide, for example, for sales when a particular market indicator rises 10 percent in a two-month span, or when one company's stock outperforms a benchmark index (or a competitor's stock) by 10 percent over a specified period.

- **Personal financial milestones.** Executives' stock sales are often driven by personal financial considerations, including home purchases or remodels, college tuition payments, and the like. All of these can be built into custom-tailored Rule 10b5-1 plans. For example, a plan could provide for a sale 15 days before a college tuition payment for an executive's child is due, with the number of shares to be sold linked to the estimated tuition amount.

Publicity regarding Rule 10b5-1 plan sales

Executives are rightly concerned about the impact their stock sales might have on investors. They worry that future sales could lead to criticism (or even lawsuits) by shareholders. We rec-

ommend that executives take three steps to minimize the risk of adverse publicity from trades made under their Rule 10b5-1 trading plans:

- **Publicly disclose new plans.** Shareholders dislike surprises. The best way to prevent surprises is for executives to make public disclosures every time new Rule 10b5-1 plans are adopted. Investors are less likely to react negatively if they know in advance about these plans. Some CEOs have issued press releases to disclose the adoption of new Rule 10b5-1 plans, but we prefer using Form 8-Ks. There is no need to provide the details of the plan.

- **Delay transactions until after public disclosure.** We recommend that Rule 10b5-1 plans have an effective date at least 60 days after the plan is publicly disclosed to shareholders. This minimizes the risk of adverse publicity and also should help combat any “good faith” challenge to the plan by the SEC. After all, the plans are only effective if they are adopted while the executives do not possess inside information. The seller's defense on this issue is strengthened if some time passes before the first sales are made.

- **Report sales made under 10b5-1 plans on Form 4s.** Executives must disclose all sales on Form 4s. We recommend that Form 4s specifically note when sales are made pursuant to Rule 10b5-1 plans. That way, investors or analysts monitoring stock sales by insiders will know the sales were made according to previously established trading plans, and do not represent a current investment decision by an executive. Make sure, though, that the Form 4s accurately disclose the details of the sales, as the SEC has criticized allegedly false or misleading Form 4s.

Investment goals accomplished

Rule 10b5-1 trading plans can help corporate executives diversify their holdings of company securities in an orderly and regular fashion. If properly designed, disclosed, and followed, 10b5-1 plans can accomplish virtually any executive's investment goals, without being limited by insider trading policies, and create an affirmative defense to insider trading. ■

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