United States
Morrison & Foerster
New York

Insider trading

Just when you thought you had read almost everything that could possibly be written on the subject of stock options, Stanford University professor Alan Jagolinzer published a study that suggests that Rule 10b5-1 trading plans could be abused in a number of ways to "facilitate trading based on inside information". The Enforcement Division of the Securities and Exchange Commission has indicated that it expects to focus closely on the use and operation of 10b5-1 plans.

The SEC adopted Rule 10b5-1 in 2000 to "clarify and strengthen" insider trading laws. Rule 10b5-1 establishes that trading by an insider while they are aware of material non-public information will give rise to insider trading liability – abolishing the distinction that had previously been argued in insider trading cases between *use* and *possession* of inside information. The rule provides company insiders and the company with affirmative defences to insider trading claims for sales made under documented, pre-existing plans or commitments and sales by broker-dealers and others made on their behalf. To qualify for the safe harbour, an insider must have entered into a binding commitment or adopted a written plan before becoming aware of material non-public information. The plan must not permit the insider to exercise any further influence over how, when, or whether to effect purchases or sales. The defence to liability would be lost if the plan or instruction were altered or hedged in any way at any time.

The recent study showed that executives who traded pursuant to 10b5-1 plans fared better than the market. The study did not attribute the enhanced performance to any wrongdoing on the part of these executives. But in this era of internal investigation and regulatory scrutiny, commentators question whether insiders are manipulating the disclosure of material information to impact the trading dates in their plans; whether insiders are timing the entry into, the amendment of, or the suspension of their plans based on their possession of inside information; or whether insiders base the duration and nature of their trading activities on their superior knowledge of upcoming company announcements.

Given the SEC's determination to look closely at the area, we can expect that there will be a series of formal inquiries into the use of these programmes. Public companies should revisit their guidance to executives relating to 10b5-1 plans; consider their disclosure practices relating to executive 10b5-1 plans; and assess their compliance and recordkeeping practices in relation to 10b5-1 plans. The professor has spoken, the SEC has listened, and the beat goes on...