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Getting Back to Basics with Rule 10b5-1 Trading Plans

Posted by Brian Breheny, Skadden, Arps, Slate, Meagher & Flom LLP, on Friday April 19, 2013 at 12:34 pm

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In late 2012, *The Wall Street Journal* published a number of articles that analyzed the trading practices of certain public company executives, in many cases under trading plans that were entered into in accordance with the affirmative defense provisions adopted by the U.S. Securities and Exchange Commission (SEC) pursuant to Rule 10b5-1 under the Securities Exchange Act of 1934. [1] The trades examined in the *Journal* articles were called into question because they were sizable and were reported to have occurred shortly before company news updates. The articles also compared returns by executives who traded irregularly against those who followed a consistent pattern, and concluded that irregular trading resulted in greater gains. These articles have reignited interest in "best practices" for Rule 10b5-1 trading plans.

The Council of Institutional Investors (CII), a group of pension funds that oversees more than $3 trillion in assets, has picked up on the issue of potential misuse of Rule 10b5-1 trading plans and submitted a rulemaking petition to the SEC requesting interpretive guidance or amendments to Rule 10b5-1. [2] CII recommends that the SEC:

- limit the time period for adoption of Rule 10b5-1 trading plans to the issuer's open trading window;
- prohibit the adoption of multiple, overlapping trading plans;
- require a mandatory three-month or longer delay between plan adoption and the execution of the first trade pursuant to the plan; and
- limit the frequency of modifications and cancellations of trading plans.

The SEC has yet to announce whether it will take action in response to the petition.

We believe that CII's proposed changes to Rule 10b5-1 are unnecessary. In our experience, when adopting trading plans, executives and issuers generally follow certain established best practices that guard against perceived abuses. The CII proposal would impose additional limitations that would not necessarily prevent misuse but may well inhibit continued use of Rule 10b5-1 trading plans.

Rule 10b5-1

Rule 10b5-1 was adopted by the SEC in 2000 to provide affirmative defenses to the assertion that a purchase or sale of a security was made on the basis of material nonpublic information about the security or its issuer. The rule generally allows individuals or entities to enter into a prearranged plan for future stock trades. The plan must be entered into in good faith when the person or entity does not possess material nonpublic information about the subject security.

Rule 10b5-1 plans are most commonly used by executives of publicly traded issuers, or the issuers themselves, who are likely to have only limited windows in which they do not possess material nonpublic information. Rule 10b5-1 plans must include instructions with respect to the amount, price and date for the planned transactions (or give discretion to a broker to determine when to purchase or sell, provided the broker does not possess material nonpublic information). To benefit from the affirmative defense provided by Rule 10b5-1, the trades must be made in accordance with the plan instructions, without hedging transactions.

Best practices

There are a number of best practices regarding Rule 10b5-1 trading plans that have developed since the rule was adopted. Those practices include:

- entering into trading plans only during issuer open trading windows;
- avoiding frequent modifications or cancellations of trading plans;
- ensuring that any overlapping trading plans cover separate securities; and
- waiting a period of time before trading begins under the plan.

CII's request to the SEC for interpretive guidance or amendments to Rule 10b5-1 includes recommendations with respect to many of these established best practices. CII's request, however, also includes a call for a flat prohibition on adopting multiple, overlapping Rule 10b5-1 trading plans and a mandatory waiting period — preferably of three months or more — between the adoption of a Rule 10b5-1 trading plan and the execution of the first trade pursuant to such a plan.

CII's recommendation to prohibit multiple, overlapping plans could have potentially negative consequences for routine uses of Rule 10b5-1 trading plans that are entirely appropriate and, in fact, beneficial. For example, some issuers require their executives to use Rule 10b5-1 trading plans for all of their trades, which would include the sale of shares necessary to pay tax withholding obligations upon vesting of restricted stock. Executives at these issuers may regularly enter into a new Rule 10b5-1 trading plan with respect to each new restricted stock award, which could certainly result in the use of multiple plans that may overlap with respect to the time period and the type of securities covered, but which would never cover the same exact securities. In these circumstances, it is entirely reasonable for an executive to have multiple trading plans covering different stock awards.

A different type of overlapping plan — one that involves trades of the same exact securities — may be more problematic, but does not require new or amended rules in light of existing restrictions of Rule 10b5-1. For example, if an individual has a trading plan in place with respect to all of his or her holdings and subsequently puts another plan in place with a lower limit price instruction to sell the same securities, the individual could be viewed as altering the initial trading plan by subjecting the same securities to differing sale instructions during the same time period. Rule 10b5-1 specifically prohibits an individual from having any further influence over whether, when or how the transactions under a trading plan will occur. In this example, by entering into a second plan covering the same securities, the individual could be viewed as influencing the planned trades under the first plan. Because this potential issue is already addressed by Rule 10b5-1, we believe it is unnecessary to adopt further prohibitions in multiple, overlapping plans that could inhibit legitimate uses of Rule 10b5-1 trading plans.

We also believe that CII's proposal to require a mandatory waiting period of a minimum of three months is unnecessary and overly long. While some period of time (generally between 10 and 30 days) between the adoption of a trading plan and the first trade is generally recognized as a best practice to minimize the potential of an appearance issue, a mandatory 90-day waiting period could have a negative effect. An extended waiting period may diminish the utility of Rule 10b5-1 such that executives and issuers may be deterred from adopting them altogether. In addition, Rule 10b5-1 already requires that the individual or entity entering into the plan have no material nonpublic information. The SEC has been very clear that this requirement cannot be circumscribed by entering into a Rule 10b5-1 trading plan while in possession of material, nonpublic information and delaying trades until after that information will become public. [3] A lengthy waiting period premised on providing an opportunity for additional disclosure of material information prior to the first trades under the Rule 10b5-1 trading plan is inconsistent with this established SEC guidance.

Recommended actions

Properly handled, Rule 10b5-1 trading plans can be a valuable, appropriate and sound tool for trading by executives and issuers. With increased media scrutiny, however, interest in Rule 10b5-1 trading plans and practices by the plaintiff's bar and potentially the SEC is possible — whether in support of broader securities fraud claims or on a stand-alone basis.

Executives and issuers should continue to be mindful of the requirements of Rule 10b5-1 and follow generally recognized best practices. Executives and issuers also should consider adopting trading practices that may be more easily defended if challenged, such as spreading smaller trades over a longer period and establishing a consistent pattern of trading practices. Finally, executives and issuers should understand that their decisions with respect to company matters, such as the timing of disclosures, must be made without regard to and not influenced by the existence of a Rule 10b5-1 trading plan.

Endnotes:

[1] See Susan Pulliam and Rob Barry, "Dark Markets: Executives' Good Luck in Trading Own Stock," *Wall Street Journal*, Nov. 28, 2012; Susan Pulliam and Rob Barry, "Disclosure on Trades Is Sought," *Wall Street Journal*, Nov. 29, 2012; and Justin Lahart, "For Insiders, It's All in the Timing," *Wall Street Journal*, Nov. 29, 2012. The articles concluded that, statistically, corporate executives' stock trading during the five trading days before the company released material information resulted in gains in excess of 10% (or losses avoided in excess of 10%) at almost twice the rate of those executives who suffered losses of similar amounts. The articles also asserted that because of the "proliferation of trading plans" and "holes" in Rule 10b5-1, it has become more difficult for regulators to assess these trades and to detect insider trading. It has been reported that the SEC, Federal Bureau of Investigation and the U.S. Attorney for the Southern District of New York have launched investigations in the wake of the Journal reports.
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[2] CII, Letter to the Honorable Elisse B. Walter, Chairman of the SEC, Dec. 28, 2012, available here: http://www.sec.gov/rules/petitions/2013/petn4-658.pdf.
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[3] *See* Question 120.20, "Manipulative and Deceptive Devices and Contrivances: Rule 10b5-1," *SEC Division of Corporation Finance Staff Compliance and Disclosure Interpretations* (March 25, 2009), available here:

http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm.
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