

Rule 10b5-1 Plans: What You Need to Know

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Rule 10b5-1 plans are back in the news. These plans are widely used by officers and directors of public companies to sell stock according to the parameters of the affirmative defense to illegal insider trading available under Rule 10b5-1, which was adopted by the SEC in 2000. Several recent *Wall Street Journal* articles suggest that some executives may have achieved above-market returns using the plans.¹ These articles are reported to have drawn the interest of federal prosecutors and the SEC enforcement staff.

Rule 10b5-1 plans are no strangers to controversy. An academic study published in December 2006 found that, on average, trades under 10b5-1 plans outperformed the market by about 6% after six months. The resulting scrutiny did not lead to a significant uptick in insider-trading prosecutions, but did cause many companies to revisit their executives' use of the plans. We suggested then that the potential for controversy was not by itself a reason to forego the benefits of employing 10b5-1 plans. We continue to believe that using properly designed plans is a good idea in many cases and can be at least as prudent as discretionary selling under normal insider-trading policies, with trading windows, blackouts and the like. Although regulators and the media may scrutinize trades made under 10b5-1 plans even when above board and done according to best practices, a well-thought-out and implemented 10b5-1 plan may help a company and its executives avoid or ultimately refute accusations of impropriety.

In light of the renewed focus on 10b5-1 plans, companies should review their 10b5-1 policies for conformity with current best practices. Below we provide an overview of 10b5-1 plans and some guidelines for their use.

Overview of 10b5-1 Plans

Under Rule 10b5-1, large stockholders, directors, officers and other insiders who regularly possess material nonpublic information (MNPI) but who nonetheless wish to buy or sell stock may establish an affirmative defense to an illegal insider trading charge by adopting a written plan to buy or sell at a time when they are not in possession of MNPI. (Companies themselves may also employ 10b5-1 plans for stock repurchases.) A 10b5-1 plan typically takes the form of a contract between the insider and his or her broker.

The plan must be entered into at a time when the insider has no MNPI about the company or its securities (even if no trades will occur until after the release of the MNPI). The plan must:

1. specify the amount, price (which may include a limit price) and specific dates of purchases or sales; or
2. include a formula or similar method for determining amount, price and date; or
3. give the broker the exclusive right to determine whether, how and when to make purchases and sales, as long as the broker does so without being aware of MNPI at the time the trades are made.

¹ See *Executives' Good Luck in Trading Own Stock*, November 27, 2012; *Insider-Trading Probe Widens, U.S. Launches Criminal Investigation Into Stock Sales by Company Executives*, December 10, 2012; and *Trading Plans Under Fire Despite 2007 Warning, Experts Say Loopholes Remain for Corporate Insiders*, December 14, 2012 (subscription required).

Under the first two alternatives, the 10b5-1 plan cannot give the broker any discretion as to trade dates. As a result, a plan that requests the broker to sell 1,000 shares per week would have to meet the requirements under the third alternative. On the other hand, under the second alternative, the date may be specified by indicating that trades should be made on any date on which the limit price is hit.

The affirmative defense is only available if the trade is in fact made pursuant to the preset terms of the 10b5-1 plan (unless the terms are revised at a time when the insider is not aware of any MNPI and could therefore enter into a new plan). Trades are deemed not to have been made pursuant to the plan if the insider later enters into or alters a corresponding or hedging transaction or position with respect to the securities covered by the plan (although hedging transactions could be part of the plan itself).

Guidelines for 10b5-1 Plans

Practice varies as to whether companies permit, encourage or require the use of 10b5-1 plans. As we noted above, we view properly designed and implemented plans to be at least as prudent as discretionary trading under normal insider trading policies. When handled correctly, 10b5-1 plans can be an effective way to deal with the public relations issues posed by sales by corporate insiders. In appropriate cases, the announcement of a 10b5-1 plan may help investors understand the reasons for insider sales in advance, and reduce the potential for misunderstanding when sales occur. While the SEC has not prescribed best practices for 10b5-1 plans, below are a set of practical guidelines to consider.

- **When can a plan be adopted or amended?** Because Rule 10b5-1 prohibits an insider from adopting or amending a plan while in possession of MNPI, allegations of insider trading despite the existence of a 10b5-1 plan are likely to focus on what was known at the time of plan adoption or amendment. We recommend that companies permit an executive to adopt or amend a 10b5-1 plan only when the executive can otherwise buy or sell securities under the company's insider trading policy, such as during an open window immediately after the announcement of quarterly earnings.
- **Should a plan impose a waiting period before trading can begin?** Because an insider cannot have MNPI when a plan is adopted or amended, Rule 10b5-1 does not require the plan to include a waiting period before trading can begin. And importantly, including a waiting period (even a lengthy delay) will not correct the fatal flaw of adopting or amending a plan while in possession of MNPI. Many companies, however, require 10b5-1 plans to include a waiting period as a matter of risk management, in order to decrease the likelihood of the scrutiny that can occur when an executive's trading activity suddenly commences before material news is announced. Practice varies as to length (anywhere from 10 days to the next open window), although the rationale for including a waiting period is usually stronger when the period is long enough to be able to say that any information currently in the insider's possession should either be stale or public by the time trading commences. This has no bearing on the effectiveness of a 10b5-1 plan, but a longer delay can, as a matter of optics, help an insider demonstrate that he or she was not motivated to make trades by nonpublic information available at the time of plan adoption or amendment.
- **Should adoption of a plan be announced publicly?** Generally speaking, there is no requirement to publicly disclose the adoption, amendment or termination of a 10b5-1 plan, although in some cases public announcement may be advisable due to the identity of the insider, the magnitude of the plan, or other special factors. That said, announcing the adoption of a 10b5-1 plan may be a useful way to head off future public relations issues, since announcing a plan's adoption prepares the market and should help investors understand the reasons for insider sales when trades are later reported. Because Rule 10b5-1 does not obviate the need for Section 16 insiders to file Forms 4 and 144, the market will often quickly learn of the 10b5-1 plan once trading commences. If a company decides to announce the adoption of a 10b5-1 plan, we do not generally recommend disclosing plan details, other than, perhaps, the aggregate number of

shares involved; this is to diminish the ability of market professionals to front-run the insider's transactions. It is unusual to announce the suspension or termination of a plan.

- **What else should we consider when amending or modifying a plan?** As we noted above, an insider may only modify or amend a 10b5-1 plan when he or she is not in possession of MNPI. Even if an insider is not in possession of MNPI at the time of amendment, a pattern of amending or modifying one's plan raises the question of whether the insider is using the plan as a legitimate tool to diversify his or her risk exposure and monetize assets, or as a way to opportunistically step in and out of the market. Because Rule 10b5-1 provides an affirmative defense but not a safe harbor, insiders and their companies should be aware that the effectiveness of the affirmative defense could be diminished by a pattern of plan amendments and modifications.
- **Can a plan be terminated or suspended?** Unlike amending a plan, a 10b5-1 plan may legally be terminated before its predetermined end date even though the insider is in possession of MNPI (although some brokers' forms prohibit this as a contractual matter). Because plan sales shortly before the announcement of bad news can generate unwanted attention, an insider may decide to terminate a plan in the face of an impending negative announcement, even though as a technical matter the affirmative defense would be expected to cover the sales. On the other hand, terminating a selling plan before an impending positive announcement may raise the suspicion that the insider is using Rule 10b5-1 as a way to opportunistically time the market, thereby risking the likelihood that his or her future use of the affirmative defense will be successful.

We generally suggest that plan terminations initiated by an insider take place during an open window, absent special circumstances and approval by the general counsel. It may also make sense for the general counsel to have the ability, but not the responsibility, to terminate the plan. Plans should also allow for mandatory suspension if legally required, for example due to Regulation M or tax reasons.

- **How long should a plan last?** In order to minimize the need for early termination, the term of the plan should be carefully weighed at the outset. An optimal plan term will be long enough to distance the insider, and any current knowledge that he or she may have, from a particular trade but short enough that it will not require termination should the insider's financial planning strategies change. A short "one-off" 10b5-1 plan can appear to be timed to take advantage of MNPI. On the other hand, the longer the plan term, the greater the likelihood that it will need to be modified or terminated. Most plans tend to have a term of six months to two years.
- **Should the company pre-clear or review an executive's plan?** A company's pre-approval or review of a specific or template 10b5-1 plan may provide assurance that the plan complies with best practices, and we think this is useful. Certain companies disallow the third type of plan (one that gives the broker the right to determine whether, how and when to make purchases) in order to avoid the evidentiary difficulty associated with proving that the executive did not communicate with the broker with respect to trades under the plan. While this is not required, we think this is a prudent option to consider.

At a minimum, most companies require pre-approval of an executive's entry into a 10b5-1 plan, if not pre-approval of the plan itself. Other limits that are sometimes considered are whether to set a maximum percentage of holdings that can be subject to a 10b5-1 plan, and rules for setting price floors.

These guidelines are general suggestions only, and a plan's design may vary based on particular facts and circumstances. We urge companies whose executives are contemplating entering into or modifying their plans to contact us to discuss the issues involved.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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