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"Plan B" for Rule 10b5-1 Plans?

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Companies and their executives who utilize "Rule 10b5-1 Plans" to reduce the risks from insider trading claims when trading in company securities should evaluate plan use given recent increased scrutiny by the media and securities regulators. Since the adoption by the Securities and Exchange Commission (SEC) of Rule 10b5-1 (the Rule) in 2000, executives and directors at public companies have widely used plans to take advantage of the affirmative defense to insider trading suits created by the Rule. Plans can be particularly helpful as class action securities plaintiffs suing companies and insiders, in order to establish a key element of their case, often point to executive trading occurring in close proximity with the timing of company disclosures at issue in the case.

The Wall Street Journal recently conducted an investigation examining such plans and published a series of articles within the past several months calling into question certain plan practices by some participants. The investigation found that of roughly 20,000 executives or trades sampled, around 1,500 of them recorded gains (or avoided losses) of 10 percent in the week following the trade, compared to only 800 who posted a loss of 10 percent. Executives who traded irregularly recorded average gains (or avoided losses) of over 20 percent in the week following their trade, a result that executives who traded on a more regular pattern were much less likely to achieve.

The FBI and SEC in turn opened investigations concerning seven executives whose trades the Wall Street Journal highlighted as suspicious, while the U.S. District Attorney's office for the Southern District of New York subpoenaed five of those seven executives. The Wall Street Journal also reported that the SEC will be conducting broad computerized surveys akin to the Journal's investigation. The Council of Institutional Investors has publicly requested new Rule guidelines or revisions for 10b5-1 Plans, while various shareholders have proposed to companies the adoption of what they consider to be best practices concerning plan use.

Under the current Rule, plans must be in writing and specify, or set forth a formula for determining, the number of securities to be traded, the trade price and the trade date. Typically, this is implemented as a contract with a securities broker. Alternatively, the plan can grant a broker sole discretion over how, when, and whether to trade, but this is used less frequently. The plan can only be adopted when the executive is not aware of material nonpublic information, and the executive is acting in good faith and not as part of a plan or scheme to evade the prohibitions of the Rule. The executive cannot deviate from the plan and cannot engage in offsetting hedging transactions in connection with sales or purchases made under the plan.

In general, plans work well for executives who have a long-term stock strategy, such as diversification, or for planning for a known event, such as college funding. They are not suitable for every executive, particularly those who prefer to have flexibility and control over their trading or who want to make a one-time trade.

Some of the current issues being discussed regarding plans, either as Rule changes or as "best practices" implementation, include:

◆ ***Establishing a sufficient waiting period prior to trading under a plan***. The Rule does not currently mandate a waiting period between plan adoption and implementing trades. A sufficient waiting period is important to establish good faith.

◆ ***Further limiting the executive's ability to make amendments to or cancel a plan***. Although the current Rule bars an executive from amending a plan while possessing material nonpublic information, the Rule does not expressly prohibit the executive from cancelling a plan at any time, including while he or she possesses material nonpublic information. Frequent amendments or cancellations, however, place doubt on whether an executive implemented a plan in good faith.

◆ ***Limiting the adoption of multiple or overlapping plans***. Although an executive's use of multiple plans may be justified under certain circumstances, having more than one plan may raise questions as to motivation.

◆ ***Company involvement and tracking of plans***. The Rule does not require executives to provide the plan to the company. However, having the plans furnished to the company can further demonstrate good faith, and the company's ready access to the plans is very useful when in the midst of addressing the securities law implications of a significant company development or crisis.

◆ ***Public Disclosure of Plans***. Company disclosure of plans in a Form 8-K or other filings also may be helpful to support a good faith determination. It also may be beneficial from an investor relations standpoint to avoid stock analyst and investor alarm over insider sales when the inevitable subsequent Form 4 filings occur.

While identification and evaluation of "best practices" is very appropriate, companies should be wary of "one size fits all" approaches. Rule 10b5-1 Plans should be viewed in the context of, and as a part of, a company's overall insider trading policies. Moreover, companies should keep in mind that executives may be reticent to use plans if the requirements imposed for use are overly burdensome and restrictive. Careful thought should be given to establish those policies which best advance for a particular company and its executives the goals and purposes of having these plans.

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