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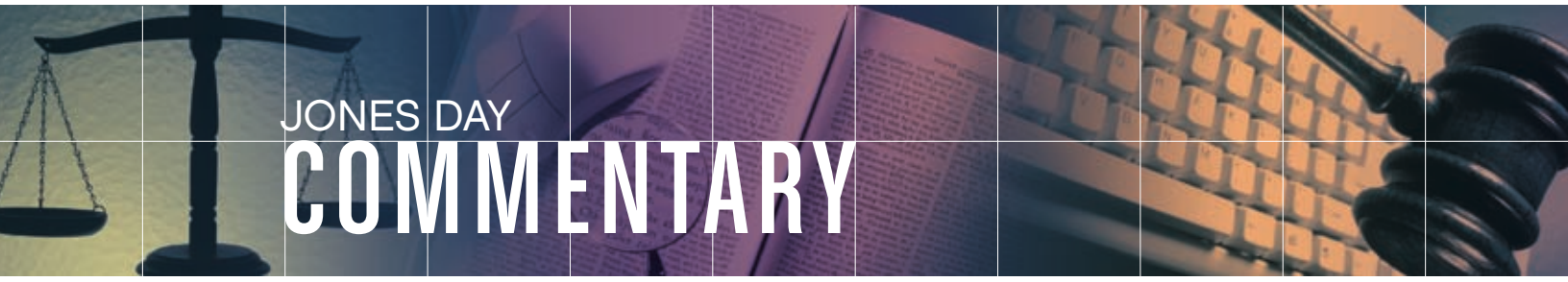

RULE 10b5-1 PLANS UNDER SCRUTINY: THE NEXT EXECUTIVE STOCK-TIMING STORY

A recent academic study suggests that returns on trades by public-company executives under so-called "10b5-1" prearranged trading plans beat the market by significantly more than executive trades made outside of such plans. Although the academic study's findings may be attributable to a variety of factors, the United States Securities and Exchange Commission (the "SEC") is taking a close look at public-company executives' potential abuse of these plans, which are designed to give executives a "safe harbor" against insider-trading charges for prearranged equity trades. In view of this increased scrutiny, we urge public companies to revisit the requirements of Rule 10b5-1 and evaluate the other practical considerations discussed below for plans that are either already in place or currently contemplated.

The SEC has recently turned its attention to a review of insider stock sales made under prearranged trading plans intended to comply with SEC Rule 10b5-1 ("10b5-1 plans").[1] Because of the SEC's enhanced scrutiny, we expect 10b5-1 plans to become a new enforcement target. The Director of the SEC's Division of Enforcement, Linda Chatman Thomsen, stated recently that studies "suggest that the Rule [10b5-1] is being abused," and added, "We are looking at this—hard."[2] Consequently, U.S. public companies and their executives should carefully monitor trading under 10b5-1 plans.

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1. See Dionne Searcey & Kara Scannell, *SEC Now Takes a Hard Look at Insiders' 'Regular' Sales*, Wall Street Journal, April 4, 2007, at C1; Jane Sasseen, *The SEC Is Eyeing Insider Stock Sales:* BusinessWeek *Has Learned It Is Examining Possible Abuses in Automatic Trading Plans*, BusinessWeek, March 19, 2007, http://businessweek.com/print/magazine/content/07_12/b4026059.htm.

2. Linda Chatman Thomsen, Director, Division of Enforcement, Securities and Exchange Commission, Remarks at the 2007 Corporate Counsel Institute (March 8, 2007), http://www.sec.gov/news/speech/2007/spch030807lct2.htm.

10b5-1 PLANS

Rule 10b5-1 under the Securities Exchange Act of 1934 (the "Exchange Act"), which became effective on October 23, 2000, establishes that a person can be liable for trading on material, nonpublic information ("inside information") if he or she was "aware" of the inside information when trading securities. Rule 10b5-1 also provides an affirmative defense to Section 10(b) insider-trading allegations when such trades are made pursuant to a preexisting, written trading plan.

Rule 10b5-1 was designed to help resolve an unsettled insider-trading issue that had resulted in conflicting decisions from the courts of appeals. The issue was whether purchasers or sellers of securities confronted insider-trading liability simply because their securities transaction occurred at a time when they possessed inside information about the issuer of the securities involved, even if they didn't rely upon or use the inside information as a basis of their trade. The uncertainty made it difficult for executives to manage their personal company stock holdings. As Director Thomsen put it in a recent speech before the 2007 Corporate Counsel Institute,

> Rule 10b5-1 allows corporate executives to make a plan, at a time when they are not in possession of inside information, to make prearranged trades at specified prices or dates in the future. The idea was to give executives "a safe harbor" to proceed with these prearranged trades without facing charges of insider trading. The Rule was intended to give executives regular opportunities to liquidate their stock holdings—to pay their kids' college tuition, for example—without risk of inadvertently facing an insider trading inquiry.[3]

However, the Rule's affirmative defense or "safe harbor" is available only if a 10b5-1 plan was entered into in good faith and not as part of a scheme to evade Section 10(b)'s and Rule 10b-5's insider-trading prohibition.[4]

To be effective, 10b5-1 plans must satisfy certain requirements. Among other things, a 10b5-1 plan must:

- Be established in good faith when the participant was not aware of inside information.
- Specify the number of securities to be traded and the price at which the securities are to be traded, or include a formula for making such determinations.
- Prohibit the participant from later exercising any influence over any person who exercises discretion as to how, when, or whether to effect the trades.[5]

Rule 10b5-1 contains what some perceive to be a "loophole" that permits plan participants to cancel a plan (and therefore a planned trade) even if the person was aware of inside information.[6] After Rule 10b5-1 was promulgated, the SEC staff stated that a person who cancels planned trades under a 10b5-1 plan is not engaging in insider trading even if the person was aware of inside information when canceling the plan. At the time, the SEC reasoned that there cannot be a basis for securities fraud under Rule 10b-5 without an actual transaction involving the trading of securities.[7]

THE STUDY AND ITS IMPLICATIONS

A December 2006 paper by Alan Jagolinzer studied more than 100,000 trades in 10b5-1 plans by more than 3,000 executives at almost 1,250 companies.[8] The statistical methodology

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3. *Id.*
4. See Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, 65 Fed. Reg. 51,715 (August 15, 2000).
5. *Id.* For a more detailed discussion of these requirements, see the Jones Day *Commentary, New SEC Rule Facilitates Insider Trades During Blackout Periods*, October 2000. http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4226.
6. Rule 10b5-1 also does not preclude participants from establishing multiple trading plans. Some believe this creates the possibility of strategic behavior by plan participants.
7. However, cancellation of a plan could call into question whether the plan was entered into in good faith. SEC Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Fourth Supplement, Rule 10b5-1, Question 15 (issued May 2001).
8. Alan D. Jagolinzer, *Do Insiders Trade Strategically within the SEC Rule 10b5-1 Safe Harbor?* (Stanford University Graduate School of Business, Working Paper, December 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=541502.

used in the study found that trades under such 10b5-1 plans beat the market by more than 6 percent during a period of six months, while executives at the same companies who traded without 10b5-1 plans beat the market by only 1.9 percent. The study asserts that statistically abnormal trade returns realized by executives selling company stock under Rule 10b5-1 plans may be explainable by (1) insiders' creation of trading plans before bad news becomes public, so they are able to sell before the news affects the market, (2) termination of plans (and therefore of planned sales) before stock prices decrease, or (3) manipulation of the content or timing of material disclosures after trades have already been planned.[9]

The paper also cited several instances where huge stock sales at stock-price highs followed terminations of 10b5-1 plans, and it observed that participants' sales systematically followed positive and preceded negative firm performance, generating abnormal forward-looking returns larger than those earned by nonparticipating colleagues.

Although several of the reports on trading-plan returns[10] point to increased trades after a rise in company stock prices, limit orders are common features of Rule 10b5-1 plans and generally provide for sales of shares in specified amounts as the stock price reaches certain price points. Such features are permitted under Rule 10b5-1 and can also be implemented by investors who are not insiders. As a result, it would not be surprising for regular, long-term trading under Rule 10b5-1 trading plans with price sale triggers to generate better returns than episodic trades.

Given that S&P 500 executives sold in excess of $8.5 billion in stock through 10b5-1 plans in 2006 (up from $5.3 billion in 2004),[11] SEC enforcement scrutiny of 10b5-1 plans could easily rival the scope of the SEC's ongoing stock-option backdating investigations. In a speech last month, Director Thomsen stated that

> . . . executives with plans sell more frequently and more strategically ahead of announcements of bad news. This raises the possibility that plans are being abused in various ways to facilitate trading based on inside information . . . . We want to make sure that people are not doing here what they were doing with stock options. If executives are in fact trading on inside information and using a plan for cover, they should expect the "safe harbor" to provide no defense.[12]

IMPLICATIONS FOR PUBLIC COMPANIES

As with the early reports about option backdating, it is too soon to predict how this increased scrutiny will affect insider sales. We expect the SEC may initiate rulemaking to require disclosure of 10b5-1 plans or impose additional conditions to these sales. If the SEC uncovers widespread abuse of 10b5-1 plans, it might amend the rule to, for instance, prohibit executives from engaging in securities transactions under plans until some minimum number of months after a plan has been finalized, or it may remove the rule's protection if certain other conditions are not satisfied.

Since the inception of Rule 10b5-1, prearranged trading plans have become commonplace. They are now often designed by brokerage firms and given to executives on a turnkey basis, without review by company counsel. Many such plans create complicated, although not prohibited, trade parameters, including formulas for trades and price hurdles.

In view of the SEC's new program to scrutinize these plans, it is more important than ever that any 10b5-1 plan or program

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9. A May 2006 study by Alexander Patrick Robbins of the University of Chicago involved an analysis of 81 NASDAQ-listed companies from 2004 to 2006. It concluded, among other things, that insiders make above-market profits using 10b5-1 plans and do not appear to arbitrarily or continually create such plans.
10. See Jane Sasseen et al., *Insiders With A Curious Edge: How Corporate Executives Seem to Be Violating the Spirit, if Not the Letter, of a Rule Meant to Prevent Insider Trading*, BusinessWeek, December 18, 2006, http://businessweek.com/print/magazine/content/06_51/b4014045.htm.
11. Searcey & Kara Scannell, *supra* note 1.
12. Thomsen, *supra* note 2.

adopted by an insider be reviewed not only for technical compliance with the Rule, but also to confirm that the particular trading plan will operate in a manner consistent with other legal requirements and that related planning issues have been considered.

Rule 10b5-1's requirements are specified in detail in our October 2000 *Commentary*.[13] That *Commentary* reviews situations that can cause a loss of an affirmative defense, important recordkeeping procedures to be followed, and the relationship of the Rule to other legal requirements. We would urge public companies to revisit these requirements in light of the types of 10b5-1 plans that are either currently in place or proposed to be implemented.

Among the more important considerations are the following:

Trade Terms. The most important element of a 10b5-1 plan is sufficiently specific parameters for the insider trade. These include the amount, price, and date of the securities trades, and a prohibition on changing these parameters, except for a complete termination of the plan. Because these features tend to be personal to the executive, they should be reviewed specifically to confirm that they meet the Rule's requirements.

Education. Each executive who implements a trading plan should understand the circumstances under which the affirmative defense provided by the Rule may be lost. The most important circumstance would be an alteration or deviation from the trading plan, unless the alteration or deviation was itself made pursuant to the conditions of the Rule (*i.e.*, constitutes the adoption of a new plan that qualifies under the technical requirements of the Rule). In addition, plans to exploit inside information by setting up noncompliant hedging trading programs would also be prohibited by the Rule.

Recordkeeping. Based on the Division of Enforcement's most recent statements, we expect the SEC to begin to require insiders to document that a particular 10b5-1 plan complied with the Rule and was adopted during a period when the executive was not in the possession of inside information. Accordingly, 10b5-1 plans should be adopted only with company oversight, and there should be a requirement that a 10b5-1 "record" be maintained by both the insider and by the company and in solid detail.

Relationship to Other Requirements. Myriad other legal requirements and planning issues are implicated by 10b5-1 plans. These include compliance with Rule 144, planning to ensure that Section 16(b) short-swing profit recovery will not be triggered, timely filing of Form 4s according to plan requirements, accommodation of the trading plan under the company's insider-trading policies (which may restrict trades outside of normal window periods), and a consideration of whether the prearranged trading program should be disclosed through a press release or on Form 8-K. In addition, any intervening equity offering may require accommodation or termination of the plan because of the effect of insider lockup agreements. Lastly, since the Rule was adopted, numerous special situations have come to light that require consideration when plans are implemented. These include the potential for application of the aggregation provisions of Rule 144 in situations where groups of executives are trading under similar plans, the interplay of trading under plans with Regulation M and Rule 10b-18, and insider involvement and decision making under these and other material programs of an issuer.

10b5-1 plans may also become an emerging area of risk for underwriters of directors' and officers' insurance. Underwriters are likely to scrutinize companies' 10b5-1 plan practices and executive trading more closely before issuing policies.

13. *Jones Day Commentary, supra* note 5.

Despite the SEC's recent remarks regarding the integrity of trading under 10b5-1 plans, the Rule remains a valuable and legitimate mechanism for the orderly sale by insiders of company stock, particularly by large holders whose personal wealth has become concentrated in employer securities. Without the use of these trading plans, insider trades generally can be effected only within narrow trading windows and in limited amounts. Trading plans have enabled insiders to sell larger amounts of securities over more extended periods of time when traditionally trades would have been restricted. Thus, executive trading plans, when properly designed and disclosed, may reduce market disruption and concern among institutional investors because of the orderly manner in which trades are made pursuant to the plans.

Public companies and executives should seek experienced counsel to advise them on the implementation and review of 10b5-1 plans, including assessing the various issues described above. Special considerations involving trusts, hedging transactions, margin accounts, contemporaneous trades, plan modifications, and 401(k) trades merit particular attention. Jones Day remains ready to assist with any and all of these issues, including offering training sessions for in-house counsel and presentations to executives interested in learning more about 10b5-1 plans and their requirements.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Gidon Caine
1.650.739.3952
gcaine@jonesday.com

Robert Clarkson
1.650.739.3996
rtclarkson@jonesday.com

Lyle Ganske
1.216.586.7264
lgganske@jonesday.com

Harold Gordon
1.212.326.3740
hkgordon@jonesday.com

Elizabeth Kitslaar
1.312.269.4114
ekitslaar@jonesday.com

Robert Profusek
1.212.326.3800
raprofusek@jonesday.com

Louis Rorimer
1.216.586.7224
lrorimer@jonesday.com

Manan Shah
1.212.326.3986
mdshah@jonesday.com

Philip Stamatakos
1.312.269.4097
pstamatakos@jonesday.com

Lizanne Thomas
1.404.581.8411
lthomas@jonesday.com