



## SEC Expands Probe into Rule 10b5-1 Plans — Firms Should Prepare to Show Compliance

March 4, 2013

Recent press stories have revived speculation that corporate insiders may be abusing rule 10b5-1 trading plans to reap unfair profits from inside knowledge of their companies.<sup>1</sup> The SEC is reported to have expanded its probe beyond trades highlighted by the press to cover a larger range of executive trading activity.<sup>2</sup> Other regulators have launched their own investigations, and investor groups have joined the conversation.<sup>3</sup>

In light of this widespread and intensifying scrutiny, companies and executives should consider techniques that make it easier to demonstrate compliance with the requirements of rule 10b5-1, such as:

- having the first trade under a 10b5-1 plan take place after some reasonable “seasoning period” has passed from the time of adoption of the plan,
- having each executive use only one 10b5-1 plan at a time, and
- minimizing terminations and amendments of 10b5-1 plans.

The current controversy centers on trading by executives under 10b5-1 plans that, in hindsight, appears “well-timed.” Much like in the stock option pricing controversy from a few years ago, the press and some analysts have employed a retrospective statistical analysis of 10b5-1 plan trades to argue that insiders using the plans seem to be doing surprisingly well.

Of course, superior performance of pre-planned trades, by itself, doesn’t necessarily mean that insiders are illicitly benefitting from inside information. Rule 10b5-1 requires that an insider must commit to a trading plan at a time when the insider possesses no material nonpublic information.

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<sup>1</sup> See, for example, recent articles in *The Wall Street Journal*, such as “Executives’ Good Luck In Trading Own Stock” (Nov. 28, 2012, page A1) and “Insider-Trading Probe Widens” (Dec. 11, 2012, page A1), and in *The New York Times*, such as “The Fine Line Between Legal, and Illegal, Insider Trading” (Dec. 10, 2012).

<sup>2</sup> See article in *The Wall Street Journal*, “SEC Expands Probe on Executive Trades” (Feb. 5, 2013, page C3).

<sup>3</sup> The Council of Institutional Investors, a nonprofit association of pension funds, other employee benefit funds, endowments and foundations, sent a letter on December 28, 2012 to Elisse B. Walter, Chairman of the SEC, urging the SEC to address misuse of 10b5-1 plans. The letter is available on the SEC’s website at: <http://www.sec.gov/rules/petitions/2013/petn4-658.pdf>

For example, consider a common sort of 10b5-1 plan, in which an insider commits to periodic sales of company stock in specified amounts if the share price exceeds a certain threshold. If the insider makes no trades outside the plan, the insider effectively has pre-committed to “sell high,” and it is no surprise that in a broad survey of the performance of all investors—many of whom trade at prices that follow the market up and down—some executives’ trading plans would generate superior performance.

Insiders tend to closely monitor industry news and have a sophisticated understanding of their industry as well. The resulting mosaic of specialized knowledge can be a legally permissible basis for trading, for deciding to set up a 10b5-1 plan and for setting the price and other trading criteria within a plan. This is another reason why superior performance of trading under 10b5-1 plans, by itself, should not necessarily be regarded suspicious or even surprising.

As we have seen with the stock option pricing controversies, however, “statistically anomalous” patterns of returns pique regulators’ interest, especially where senior executives are the ones who benefit. Recent press attention also has highlighted specific practices that, depending on the context, may jeopardize the protection of rule 10b5-1.

This heightened scrutiny will increase the importance of companies adopting well-crafted 10b5-1 policies that are designed both to prevent trades based on inside information and to avoid the appearance of impropriety—even when applying 20/20 hindsight.

## **RULE 10b5-1 BASICS**

[Rule 10b5-1](#) is ancillary to the SEC’s venerable [Rule 10b-5](#), which prohibits insider trading and other types of fraudulent and deceitful behavior in connection with buying or selling securities. Rule 10b5-1, adopted in 2000, broadens the reach of this concept by imposing a presumption *in favor of* liability. If a person is “aware of” material nonpublic information when buying or selling a security, that person is presumed to be trading on the basis of that inside information, in violation of law.

This presumption raises a practical problem for company insiders, because insiders such as directors and executives receive material nonpublic information on a recurring basis. They are privy to how quarterly results are trending, for example. Recognizing this, most public companies, as a prophylactic measure, impose quarterly “blackout” periods in which trading is prohibited by directors and executives, and often by lower-level employees with access to sensitive information.

The SEC itself recognized that this presumption was broad and, in a regulatory “quid pro quo,” included an affirmative defense to liability in rule 10b5-1. The affirmative defense provides that trades may be executed on behalf of companies and insiders, even when they are in possession of material nonpublic information, if the company or the insider committed to the trade at a time when they did not have material nonpublic information. The rule outlines several acceptable types of arrangement, of which the most commonly used is a “10b5-1 plan.”

In a 10b5-1 plan, the insider, at a time when he or she lacks material nonpublic information, adopts a written plan for trading securities that commits to future trades, either by stating an

amount, date and price, or by committing to trade according to a formula or algorithm, or by handing off trading discretion to an independent party. The key idea is, once the plan is put in place, the insider has no further discretion over future trades. Trading under 10b5-1 plans is usually administered by a broker, so the insider normally is separated from the process

Given insiders' justifiable need for liquidity and their periodic possession of material nonpublic information, 10b5-1 plans are a widely used tool in corporate securities law compliance.

## PRACTICAL POINTS TO CONSIDER

The current public controversy suggests that, in the future, the benefits of rule 10b5-1 may not be as strong in practical terms for such plans that do not appear to be part of a long-term liquidity strategy.

Below are some practices and plan features that can mitigate the risk of public criticism, regulatory scrutiny or insider-trading liability. Each situation is unique, and it may be reasonable under the circumstances for various companies and executives to take different approaches to any of these factors.

- *Consider publicly identifying trades made under a plan.* There is no specific obligation to disclose 10b5-1 plans, but many insiders choose to do so, usually in the Form 4 each insider must file shortly after a trade, noting that the trade was made pursuant to a 10b5-1 plan. This prompt disclosure can preempt investor concern that a well timed but proper trade was made on the basis of inside information. In some of the recent examples highlighted by the press, investor criticism might have been muted if it had been apparent (such as through a Form 4 filing) that controversial trades had been made under a long-standing 10b5-1 plan.
  - Although the Form 4 disclosure may help, it is sometimes missed by the press or others and typically is quite brief. Also, it is unusual to disclose in the Form 4 much beyond the fact that the trade occurred under a 10b5-1 plan. While adding a bit more detail, such as the date of entry into the plan, may be helpful, the decision whether to provide more detailed disclosure about a plan is a context-specific question.
  - Prospective disclosure about the particular formulas or pricing thresholds to be used in a plan can disrupt execution of the plan itself and inadvertently send a "message" to the market that was not intended. Also, disclosing the entry into a plan raises the question of whether an amendment or termination must also be disclosed – disclosing one but not the other can be seen as manipulative.
- *Consider a "seasoning period."* Having a company policy on "seasoning" a 10b5-1 plan—requiring some period of time to elapse (say, a quarter, or even a month) between adopting the plan and the first trade—can be critical in demonstrating compliance. There is no specific legal requirement for a seasoning period, but if trades begin very shortly after a plan is adopted, it can raise doubt about whether the insider really had no

inside information when adopting the plan. This risk is magnified if the initial trades under the plan are larger than the insider's historical trading volume. Trades under well-seasoned plans are much easier to defend and are consistent with the intent of 10b5-1 plans—to provide insiders with periodic liquidity over the longer term rather than facilitating opportunistic trading.

- Nearly all brokers that administer 10b5-1 trading require some seasoning, often at least two weeks. In our experience, many companies defer to these requirements and do not impose longer seasoning periods. In the current environment, companies will want to consider adopting their own policies regarding seasoning periods.
- *A single plan is best.* Ideally, each insider should have in place only one 10b5-1 plan at a time and, while a plan is in place, no trades should be made outside the plan. Otherwise, there is a risk that the plans will be reviewed in the aggregate, along with any trades outside the plans, and that different trades will be seen as effectively hedging each other, which would defeat the protection of rule 10b5-1.
- *Terminations and amendments increase risk.* Plans should be amended and terminated judiciously; typically only when necessary to address unforeseen events, such as a change in the insider's personal financial circumstances. It is problematic when terminations and amendments appear to be tied to changes in the insider's knowledge about company or industry prospects.
  - The SEC considers amendment or partial termination of a plan to be the same as entering into a new plan. Later trades under the amended plan will satisfy rule 10b5-1 only if the insider did not have material non-public information at the time of amendment.
  - Technically, termination of a plan itself is not prohibited by rule 10b5-1, but plans should not be terminated lightly. Termination raises questions about whether the plan was entered into in good faith, and it creates a risk that earlier trades under the plan will not have the benefit of rule 10b5-1. Further, if an insider has multiple plans active at once, termination of one plan can look like it is effectively an "amendment" of his or her remaining plans.
- *Mitigate overlap between plan sales and company stock repurchases.* It is not unusual for a company that undertakes a share repurchase program to also have executives with 10b5-1 plans in place. If trades under the company program and the executive plans occur in close proximity, investors may perceive contradictory messages about the company's prospects and raise concerns about management conflicts. Thoughtful planning around who will be involved in buyback decisions, the timing of those trades, the structure of the repurchase plan and the potential for any overlap with insider plans is a task that often falls to in-house counsel. In reviewing those situations, counsel may want to consider, among other things, the trading formulas/triggers being used by

senior executives in order to analyze the potential for real conflicts, as well the appearance of conflicts.

Companies can address the points above by imposing generally applicable corporate policies, requiring pre-approval of 10b5-1 plans and their amendment and termination, informally encouraging prudent practices, or some combination of these techniques. The ongoing scrutiny from regulators and the press illustrates why these matters are worth addressing. Using rule 10b5-1 to avoid insider-trading liability is good, but avoiding investigations and undue investor criticism in the first place is better.

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