SIMPSON THACHER MEMORANDUM

Trading Plan Storm Clouds Move to the Boardroom

May 30, 2013

The revived scrutiny of Rule 10b5-1 trading plans that began late last year has now expanded to the trading activities of corporate board members and affiliated large investors. Some recent press coverage has asserted that directors' and investors' use of 10b5-1 trading plans is "exotic" or beyond the intended scope of the rule—despite the fact that Rule 10b5-1 does not limit its use to corporate executives. Indeed, Rule 10b5-1 has consistently been used by directors and institutional investors since its adoption over a decade ago.

Nevertheless, with regulators and prosecutors continuing to take interest, corporate directors, investment funds and other insiders should consider best practices, such as those discussed below and in our March 4 memo, in order to reduce the risk that scrutiny will result in liability or reputational damage.

Legal compliance is necessary, but as the topic of 10b5-1 plans appears to be growing more charged, optics also grow more significant. A recurring feature in the recent public discussion is a focus on whether insiders have superior trading outcomes to other investors. This reflects longstanding interest in whether markets are fair to ordinary investors without inside connections to companies. The press coverage illustrates that—fairly or not—there is a common tendency to judge fairness in hindsight, apart from compliance with settled law.

Background

Front-page articles in the *Wall Street Journal* in April[1] discussed sales of stock under Rule 10b5-1 trading plans by some directors and investment funds. Rule 10b5-1 provides an affirmative defense to insider trading liability under Rule 10b-5. The affirmative defense provides that trades executed on behalf of a person who is in possession of material nonpublic information ("MNPI") at the time of the trade, will be deemed not to have been made on the basis of such information if the person can demonstrate that they committed to the trade before becoming aware of the information.

It is important to note that Rule 10b5-1 compliance does not remove a particular set of trades from scrutiny—it simply shifts the focus from whether the insider had MNPI at the time of the trade to whether the insider had such information at the time the insider became *committed* to the trade. This ability to "time-shift" the MNPI inquiry depends, most commonly, on the

[1] See articles by Susan Pulliam and Rob Barry, "Directors Take Shelter in Trading Plans" (April 25, 2013) and Susan Pulliam, Rob Barry and Scott Patterson, "Insider-Trading Probe Trains Lens on Boards," (April 30, 2013).

insider having created the commitment to trade under a "10b5-1 plan" in accordance with the requirements of the rule.

In a compliant 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 that, once the plan is put in place, the insider has no further discretion or influence over future trades. Trading under 10b5-1 plans is usually administered by a broker, so the insider is isolated from the process.

Putting Recent Press in Perspective

In broad terms, the recent *Wall Street Journal* articles are a continuation of prior coverage of the use of 10b5-1 plans by corporate executives. The articles highlight certain trades under 10b5-1 plans that look fortuitous in hindsight, along with commentary that seems intended to suggest that such trades are unfair and possibly illegal. As our March 4 memo explained, superior performance of trades under a 10b5-1 plan can have a number of perfectly legitimate explanations, such as the fact that insiders tend to closely monitor industry news and have a sophisticated understanding of their industry. Because under Rule 10b5-1 a person must commit to a trading plan at a time when the person possesses no material nonpublic information, superior performance of trades under 10b5-1 plans doesn't necessarily mean that insiders are illicitly benefitting from inside information. But the speculative element of the most recent articles, whether appropriate or not, is nothing new for stories of this type.

What is new—and both surprising and troubling—is the suggestion that it is inappropriate for non-executive directors and investment funds to use 10b5-1 trading plans. The *Journal*'s April 25th article said that 10b5-1 plans were intended for use by executives and quoted an SEC spokesman for the assertion that the use of 10b5-1 plans by directors is an "exotic permutation." This will come as news to the many directors and investment funds that have used 10b5-1 plans since the adoption of Rule 10b5-1 in 2000.

In fact, the language of Rule 10b5-1 itself—which defines the affirmative defense—contains nothing that limits 10b5-1 plans to executives. The affirmative defense is available to any "person." The SEC's adopting release for the rule does not suggest that the affirmative defense is limited to executives; nor does the SEC's proposing release; nor does the SEC's press release related to the proposal of the rule; nor does the SEC's set of compliance and disclosure interpretations related to the rule.

In fact, the affirmative defense in Rule 10b5-1 only makes sense if it applies equally to directors, investment funds and others. That is because Rule 10b5-1 also broadened insider trading liability by imposing a presumption in favor of liability—if any person (not just an executive) 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. This was the primary innovation of Rule 10b5-1, and the SEC added the affirmative defense for 10b5-1 plans in recognition that this new absolute standard of awareness could be overbroad. Logically, the affirmative defense

of Rule 10b5-1 must be *available* to everyone because the rule's presumption in favor of liability *applies* to everyone. Equally logically, if a person can show they committed irrevocably to a trade at a time they did not possess MNPI, that person should not be deemed to have been trading on the basis of events that may become material after adoption of the plan but before execution of the trade in question.

Practical Implications

SEC rules cannot be amended by quotes in a newspaper, so in legal terms the affirmative defense for trades under 10b5-1 plans remains as available as it has ever been for anyone—executive, director, investment fund or the issuer itself. However, as a practical matter, the most recent press coverage and the corresponding interest by regulators mean that issuers and insiders should expect that scrutiny of 10b5-1 plans will continue to increase, along with the public debate over their transparency and fairness.

In order to be prepared to demonstrate compliance with Rule 10b5-1, insiders should consider the techniques discussed in our March 4 memo, such as:

- making sure that the person or institution on whose behalf the plan is adopted has no material nonpublic information at the time of adoption of the plan—otherwise, the affirmative defense of 10b5-1 simply will not be available,
- 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 insider use only one 10b5-1 plan at a time, and
- minimizing terminations and amendments of 10b5-1 plans.

Also, while trades under 10b5-1 plans can be made in the period shortly before a company's earnings release, companies and their insiders may want to consider whether to avoid trades during such periods, in order to reduce the risk of public criticism.

Investment Funds *Can* Use 10b5-1 Plans, But When Should They?

In general, limited partners of an investment fund want the benefit of the investment manager's judgment about when to liquidate an investment—it is that judgment that limited partners are paying for. As a result, 10b5-1 plans, by pre-programming future trades, may not be well-suited for investment funds in most circumstances. If the stock price runs up after substantial sales under a 10b5-1 plan, fund investors may question why the investment manager didn't wait to sell until the stock price was higher. Each situation is unique, but some circumstances lend themselves to the use of 10b5-1 plans more easily than others.

- Using a 10b5-1 plan may be more apt where a fund has known future liquidity obligations—such as redemptions of LP interests or debt repayments—that would come due outside a company's "open window" periods or are large enough that it is deemed prudent to space out sales of stock.

- Using a 10b5-1 plan may also make sense where an investment fund doesn't have optimal registration rights and owns enough stock that staggering sales of stock is useful. This situation sometimes arises for minority investors who have a director on the board, but could arise in other situations as well.
- 10b5-1 plans that by their terms provide for sales over a long period could put an investment fund in an awkward position—if the stock price increases over time, fund investors could complain that the fund sold too soon; if the stock price decreases, the opposite complaint could arise. 10b5-1 plans with shorter durations can reduce the risk of this sort of complaint. Yet plans with shorter durations are potentially more vulnerable being scrutinized—in that the less time that passes between adoption of a plan and the first trade, the harder it may be to establish that any intervening material events were not known or heavily foreshadowed to the insider at the time of adoption.

If investment managers choose to use 10b5-1 plans, they should consider the following:

- ***No material nonpublic information.*** When an investment fund adopts a 10b5-1 plan, the fund should confirm that none of the personnel of its manager have material nonpublic information about the issuer, a process that should be undertaken with the advice of counsel.
- ***Recognize that 10b5-1 plans are not a panacea.*** Trades that look fortuitous in hindsight will likely generate interest and scrutiny. Trades under 10b5-1 plans are easiest to defend when it is clear that the MNPI in question only became evident after the trading plan was put in place. For example, purchases ahead of an announcement of adding a key customer may be easy to defend if the record is clear the customer had not been approached or targeted at the time the plan to purchase had been firmly implemented. By contrast, sales that occur prior to the announcement of an off quarter may be more difficult to defend if the decline was due to factors that were highly uncertain but nascent at the time the plan to sell was put in place. One way to mitigate the risk of being second guessed is to allow more time to pass between committing to a plan and the first trades under the plan, especially when the factors likely to be scrutinized are subjective.
- ***Insulate trader from material nonpublic information.*** It is possible, under Rule 10b5-1(c)(2), for an institution like an investment fund to sell company shares even when a company director who works for the fund's manager has material nonpublic information, as long as the fund follows reasonable policies and procedures to keep the material nonpublic information away from those who actually decide to sell.
    - However, using this approach may invite criticism or scrutiny from the public, who may not understand the protective procedures followed behind the scenes.
    - This approach can also invite criticism from fund investors, who may prefer that the fund make trading decisions with the benefit of the knowledge of the investment manager who sits on the company's board.

- This approach also may not be optimal for many funds, as it limits some of the benefits of sharing expertise and knowledge among the personnel of an investment manager.
- As a result, this approach may be more appropriate as one way to regulate the sharing of information among affiliated investment funds that are intended to operate with some degree of independence from each other.

Special Public Relations Considerations

Special public relations considerations also apply to the use of 10b5-1 plans by directors and affiliated investment funds:

- ***Investment funds sell securities differently than executives do.*** The April 25th *Journal* article drew an unfavorable contrast between the sometimes large sales by investment funds under 10b5-1 plans and the practice common among executives to sell smaller amounts at regular intervals, implying that some investment funds may be inappropriately selling off large stakes.
  - However, there are good reasons why an investment fund might choose—or need—to sell large amounts of stock under a 10b5-1 plan. First, investment funds need to sell large amounts of stock because they typically *buy* large amounts of stock—it is their business to buy and sell securities. Second, many hedge funds permit their investors to have their interests in the funds redeemed, which can mean that the funds must liquidate a portion of their investments in order to get cash to satisfy their redemption obligations. Similarly, many private equity funds have contractually limited lives, and must liquidate their investments within a particular time frame. Third, an investment fund has fiduciary duties to its own investors to maximize the value of the fund's investments, which includes selling investments when that is deemed advantageous.
  - Much of the press seems not to fully understand the legitimate motivations for investment funds to sell stock at large scale. Investment funds that use 10b5-1 plans should be prepared for such misunderstandings.
- ***Few in the general public understand Form 4s.*** Form 4s are very short SEC forms that report sales of securities by insiders—or by entities that insiders are affiliated with—using a mandatory SEC coding system that can be opaque to the uninitiated—*i.e.*, to everyone other than securities lawyers. If a director has a pecuniary interest in shares held by an affiliated investment fund (which is often the case), sales by the investment fund must be reported on a Form 4 filed by the director individually.
  - Very often, this leads to public misunderstandings as to whether the sale was made by the investment fund or by the director himself or herself. This distinction can be important if the fund is following policies and procedures under Rule 10b5-1(c)(2) (discussed above) to insulate the fund employees who actually decide to sell from receiving material nonpublic information.

- Adding clarifying disclosure in a Form 4 can help dispel misunderstandings as to whether a director or an investment fund is actually making a trade, but Form 4s seem to be misunderstood even by sophisticated financial journalists. Investment funds and affiliated directors should be prepared for such misunderstandings.

Conclusion

The revived public focus on 10b5-1 trading plans over the past few months appears likely to continue. Public companies and insiders should be mindful of compliance with insider trading laws as well as the risk that adverse publicity may follow even legally compliant trading activity.

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