SEC RULE 10B5-1 AND INSIDER TRADING LIABILITY

SIMPSON THACHER & BARTLETT LLP

OCTOBER 17, 2000

The Securities and Exchange Commission (the "SEC") recently adopted Rule 10b5-1 (the "Rule") in a release dated August 10, 2000 (the "Release").[1] The Rule addresses:

- whether insider trading liability depends on a trader's "use" or "knowing possession" of material nonpublic information; and
- the circumstances through which an insider in possession of material nonpublic information may trade shares through a pre-existing plan, contract or instruction.

We provided an overview of Rule 10b5-1 in our recent memorandum discussing Regulation Fair Disclosure ("FD"). Rule 10b5-1, which was adopted simultaneously with Regulation FD, has been the subject of a great deal of recent discussion.[2] In response to several inquiries that we have received from clients, this memorandum summarizes the new rule and sets forth the criteria that must be followed to establish the new affirmative defenses under Rule 10b5-1.

EXECUTIVE SUMMARY

The new Rule:

- Provides that insider trading liability arises when a person trades while "aware" of material nonpublic information. Courts previously split on the issue of whether insider trading liability required a showing of "use" of material nonpublic information, as opposed to mere awareness.

1. The Rule is based on the version proposed in the SEC release dated December 20, 1999 (the "Proposing Release") and has been modified as a result of comments received by the SEC. The Rule takes effect on October 23, 2000.

2. *See e.g.*, Geanne Rosenberg, *Management: Insiders Get a Sturdy Tool to Rake in Stock Gains,* N.Y. Times, September 27, 2000 at C1. The New York Times article describes the Rule and its potential implications for companies and their senior management. The Article, however, may mischaracterize or overstate the implications of the new Rule in several important respects.

- Establishes an affirmative defense to insider trading liability for individuals and entities where the insider can demonstrate that before becoming aware of material nonpublic information, the insider adopted, in good faith, a plan, contract or instruction to purchase or sell securities which:
  - specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
  - included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
  - did not permit the person to exercise any subsequent influence over how, when or whether to effect purchases or sales.
- Establishes an additional affirmative defense to insider trading liability for corporate entities (including issuers) where the entity can demonstrate that:
  - the person making the investment decision on behalf of the entity was not aware of material nonpublic information at the time of the purchase or sale; and
  - the entity has implemented reasonable policies and procedures to ensure that individuals making investment decisions do not violate the insider trading laws.

RULE 10B5-1

GENERAL

The SEC adopted Rule 10b5-1 to clarify what it means to trade "on the basis of" material nonpublic information.[3] The Rule adopts the "knowing possession" standard and provides that

3. The Supreme Court has long held that a corporate insider violates Rule 10b-5 when the insider makes a trade "on the basis of" material nonpublic information. This is often referred to as the "traditional" or "classic" theory of insider trading liability. *See Chiarella v. United States*, 445 U.S. 228 (1980). The Supreme Court has also recently approved of the "misappropriation theory" of insider trading liability which holds that a corporate "outsider" violates Rule 10b-5 if he or she "misappropriates" material nonpublic information in breach of a duty of trust or confidence. *See United States v. O'Hagan*, 521 U.S. 642 (1997).

a person trades on the basis of material nonpublic information if he or she is "aware" of such information at the time of the purchase or sale. The SEC indicated that it believes that a trader aware of inside information inevitably makes use of that information when making a trade.

Importantly, the new Rule creates an affirmative defense to insider trading liability where the trader can demonstrate that a transaction was entered into pursuant to a previously adopted contract, instruction or plan for selling securities. It has been suggested in recent news articles and elsewhere that as more low-level employees acquire company stock, employers should consider setting up "an S.E.C.-approved selling plan." The SEC does not "approve" individual selling plans; Rule 10b5-1 merely permits a trader to assert a selling plan as an affirmative defense.

In addition, it has been suggested that there is a "loophole" in the new Rule that permits corporate insiders to *cancel* a purchase or sale with impunity. This so-called "loophole" is merely a function of the requirement of the securities laws that only "purchases or sales" subject a trader to liability. Importantly, it should be noted that traders should be cautious in repeatedly canceling a trading plan and reinstating it when market conditions approve. Such a practice may run afoul of two requirements of Rule 10b5-1: (a) that the trading plan must be entered into in good faith and (b) that a transaction must occur "pursuant to" a trading plan.

Finally, a few commenters have suggested that the new Rule exceeds the SEC's regulatory authority and that the Rule is adopted to reverse several federal court of appeals decisions. The new Rule has not been approved by any court and the boundaries of what the Rule permits may be decided in the courts at some time in the future. However, we note that the SEC has broad rule-making authority under § 10(b) of the Securities Exchange Act of 1934 to adopt such rules and regulations as the SEC deems "necessary or appropriate in the public interest or for the protection of investors." Accordingly, it is reasonable to assume that courts will find that Rule 10b5-1 is within the scope of the SEC's rule-making authority.

TRADING "ON THE BASIS OF" MATERIAL NONPUBLIC INFORMATION

Rule 10b5-1 addresses the unsettled issue in insider trading law of whether it must be shown that a defendant "used" inside information he or she possessed in trading or it is enough to show that the defendant was in "knowing possession" of the information when he or she traded. Under the Rule, if a trader "was aware of" material nonpublic information when he or she made the trade, he or she has violated Rule 10b-5.

Prior to adoption of the Rule, courts were divided over the "use" v. "knowing possession" issue. The Second Circuit suggested that "knowing possession" of material nonpublic information is a sufficient predicate for insider trading liability.[4] In contrast, the Ninth Circuit held that, at least in a criminal case, the prosecution must demonstrate that the

4. *See United States v. Teicher*, 987 F.2d 112 (2d Cir. 1993).

accused "used" material nonpublic information while trading.[5] The Eleventh Circuit chose a middle ground, requiring that "use" of material nonpublic information be demonstrated but holding that proof of "knowing possession" provides a strong inference of "use" sufficient to make out a prima facie case.[6]

The new Rule clarifies that, in the opinion of the SEC, a person trades "on the basis" of material nonpublic information if that person was "aware" of the information at the time the purchase or sale is made. Although the Rule adopts this expansive theory of insider trading liability, the new Rule creates affirmative defenses against liability that are designed to cover situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision.

AFFIRMATIVE DEFENSES

The affirmative defenses set forth in Rule 10b5-1, in effect, require that a person or entity demonstrate that material nonpublic information was not a factor in the trading decision. The SEC considered and rejected a proposal to recast the defense as a safe harbor and, accordingly, the burden of proof is on the party asserting the defense.

Pre-existing Contract, Instruction or Plan

The primary affirmative defense is set forth in Rule 10b5-1(c), which requires that the trader demonstrate three elements. *First,* the trader must demonstrate that prior to becoming aware of the material nonpublic information, he or she had:

- entered into a binding contract to purchase or sell the security;
- provided instructions to another to execute the trade for the trader's account; or
- adopted a written plan for trading securities.

Second, the trader must show that the contract, instruction or plan either:

- expressly specified the amount, price, and date;
- provided a written formula or algorithm, or computer program, for determining amounts, prices and dates; or

5. *See United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998).

6. *See Securities Exchange Commission v. Adler*, 137 F.3d 1325 (11th Cir. 1998).

- did not permit the trader, or anyone else in possession of material nonpublic information, to exercise any subsequent influence over purchases and sales.

Third, the trader must demonstrate that the purchase or sale was executed pursuant to the contract, instruction or plan. A purchase or sale is not "pursuant to" the contract, instruction or plan if, among other things, the person who entered into the contract, instruction or plan:

- altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price or timing of the purchase or sale); or

- entered into or altered a corresponding or hedging transaction or position with respect to those securities.

In addition, the defense is only available if the contract, instruction or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1.

Additional Affirmative Defense for Corporate Entities

An additional affirmative defense is available to any "person other than a natural person". Non-natural persons must demonstrate two discrete elements to establish this defense. The entity must demonstrate that:

- the person making the investment decision on behalf of the entity was not aware of material nonpublic information; and

- the entity had implemented reasonable policies and procedures, taking into consideration the nature of the entity's business, to ensure that individuals making investment decisions would not violate the insider trading laws. Such policies and procedures may include those that restrict any purchase or sale of any security as to which the entity possesses material nonpublic information or those that prevent such individuals from becoming aware of such information.

Examples of the Affirmative Defenses

In the Release, the SEC sets forth several examples of applications of the affirmative defenses. These examples are illustrative, and ultimately only those situations in which a person can demonstrate that the material nonpublic information was not a factor in the investment decision are covered. The SEC's examples are:

- An issuer operating a repurchase program is not required to specify with precision the amounts, prices, and dates on which it will repurchase securities. Instead, an issuer could adopt a written plan, when it is not aware

of material nonpublic information, that uses a formula to determine amounts, prices and dates. In the alternative, the issuer could delegate the discretion to determine amounts, prices and dates to another person not aware of material nonpublic information — provided that the plan does not permit the issuer to (and the issuer in fact did not) exercise any subsequent influence over purchases or sales.

- An employee may adopt a plan for exercising stock options and selling the underlying shares. Prior to becoming aware of material nonpublic information, the employee could adopt a written plan for determining the specified percentage of the employee's vested option to be exercised or sold at or above a specified price.

- An employee could acquire company stock through payroll deductions under an employee stock purchase plan or a Section 401(k) plan. The employee could provide oral instructions, or a written plan, as to plan participation. The date, price and amount of the purchases or sales could be set forth in the instruction or plan or alternatively, the date, price and amount of the transaction could be determined by the plan administrator or investment manager provided that such person is not aware of material nonpublic information.

The Release notes that, in response to numerous commenters, the defense has been revised to permit substantial flexibility in the development of trading plans. As proposed, the Rule required that any contract, plan or instruction specifically identify the amount, date and price of any transaction. As noted above, the Rule as adopted permits the trader to provide a formula, algorithm or computer program to determine amounts, dates and prices. Additionally, the Rule as adopted permits the trader to confer discretionary authority on a person not in possession of material nonpublic information to determine amounts, dates and prices.

OBSERVATIONS

The Rule provides corporate insiders with a significant new mechanism for diversifying wealth held in the form of company stock. A carefully devised trading plan will enable corporate insiders to sell company stock throughout the year and not merely during "window" periods following quarterly disclosures. The new Rule is designed to permit flexibility in the development of these trading plans. The SEC modified the Rule to provide for greater flexibility to those "who would like to plan securities transactions in advance at a time when they are not aware of material nonpublic information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material nonpublic information."

As previously noted, however, Rule 10b5-1 has not been approved by any court and may be the subject of judicial interpretation in the future. If, as anticipated, these trading plans

become widespread, the SEC may provide additional guidance under the Rule. Additionally, it should be noted that the "trading plan" defense is not a safe harbor or exception to liability; it is an affirmative defense. Accordingly, trading plans must scrupulously comply with the Rule's criteria.

Corporate entities should not be overly concerned that by adopting such trading plans for their employees, they thereby increase the likelihood that the company will be found to have violated the securities laws. In securities fraud cases brought under Rule 10b-5, plaintiffs offer insider stock transactions that are unusual in amount, price, or timing as evidence of scienter. Insider transactions that are made pursuant to trading plans that meet the Rule 10b5-1 criteria will not provide evidence of scienter because any transaction made pursuant to a valid 10b5-1 trading plan is, by definition, made independent of any knowledge of material nonpublic information.

* * *

If you have any questions concerning the new Rule, please contact George Krouse (g_krouse@stblaw.com) or Michael Chepiga (m_chepiga@stblaw.com) of this firm at (212) 455-2000.

SIMPSON THACHER & BARTLETT LLP