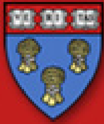
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The Best-Laid Plans of 10b5-1

Posted by Boris Feldman, Wilson Sonsini Goodrich & Rosati, on Wednesday February 6, 2013 at 9:53 am

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In the world of insider trading, Rule 10b5-1 plans are a blessing and a curse: a blessing, because they enable executives to diversify their company holdings in a stable, law-abiding manner; a curse, because they tempt cheaters into hiding their malfeasance in a cloak of invisibility.

For years, 10b5-1 plans received little scrutiny. In private shareholder lawsuits, plaintiffs' lawyers generally scrunched their eyes shut and tried to ignore them. The SEC, having created the structure, lost interest postpartum. As a result, aggressive insiders sometimes were able to use the plans in ways the framers never intended.

Recently, journalists have started to focus on the specifics of 10b5-1 plans, along with perceived abuses of them. [1] Those articles appear to have roused the SEC. So this may be a good time for counsel, both inside and outside, to revisit their existing plans. In this post, I address what I consider to be best practices under 10b5-1. This does not mean that contrary practices are improper or unlawful. Think of it, rather, as 10b5-1 for the risk averse.

Genesis

Prior to this millennium, sales of company stock by insiders tended to be ad hoc. When the executive thought her company's shares were trading at a high price, she would sell. If she thought the market undervalued the stock, she would hold. This created a fertile incubation environment for shareholder lawsuits under Rule 10b-5, the basic federal antifraud provision. If a company announced bad news and the stock dropped, plaintiffs would point to stock sales that occurred prior to that disclosure as evidence of a fraudulent scheme. Executives would often defend themselves by saying that they had a regular pattern of disposition, but, like the Holy Roman Empire, the trades were neither

regular nor grouped into a pattern.

Some commentators (including your author) advocated early on that executives put their shares into a blind trust if they really were making patterned sales. [2] But few executives were willing to disengage so formally from their trading decisions.

Then, in 2000, the SEC made either a Solomonic decision or a Faustian bargain (depending on your perspective). The SEC had lost several insider trading cases in which it was able to prove that an executive had been in possession of inside information at the time of the trade, but could not prove that she had made the trade because of the inside information. [3] So the Commission did what it has done in other contexts after losing in court: it changed the rules. [4] Following a rulemaking, the SEC adopted the new Rule 10b5-1. [5] The SEC gave itself what it could not win in litigation: establishing an insider-trading violation would now require only proof that the executive was in possession of undisclosed material information, not proof that she had used the information in deciding to trade. The quo for the quid, however, was that an executive could avoid the whole problem by entering in advance into a specified trading plan. Provided that the 10b5-1 plan was kosher, the executive would not be liable even if the subsequent trade occurred at a time when the executive had come into possession of material nonpublic information.

Practitioners and commentators applauded the new structure. [6] Executives initially were reluctant to embrace the new safe harbor for trading. Over time, however, more and more did so. The impact on shareholder class action lawsuits was dramatic. Courts dismissed securities fraud suits on the basis that the insiders' stock sales were not suspicious because they had been made pursuant to 10b5-1 plans. [7] It was rare for plaintiffs' lawyers to take these plans on by their own terms. Nor were there any reported SEC enforcement actions focused on the provisions of such plans. Not until the Wall Street Journal articles in late 2012 was a light shined on arguable manipulation of the plans.

Environmental Scan

In my admittedly anecdotal experience, most 10b5-1 plans are legit. Executives adopt them in the proper manner (e.g., at a time when they are not in possession of material nonpublic information). Most executives leave the plans alone and don't try to game them. By trading through the plan, an executive may leave some money on the table — that is, sell shares at non-peak prices. On the other hand, the executive has the benefit of trades continuing to occur at times when, if the trades were discretionary, they would be blocked by closed trading windows. My sense is that most executives who use trading plans are pleased that they went that route.

That is not to say that abuses do not occur. Moreover, now that the press has triggered public and regulatory scrutiny of the plans, aggressive features of the plan pose greater risk than in the past. Let me therefore suggest some "good housekeeping" features of plan design and implementation that enhance the odds of surviving such scrutiny.

Sit Simplex, Stulte

"Keep it Simple, Stupid." This should be the guiding motto of designing a 10b5-1 plan. The plans work well when they are plain vanilla. They risk getting the executive into trouble by adding bells and whistles.

What does that mean in practice? The plans make sense for an executive whose principal purpose is to diversify her wealth out of company shares over time, in a regular, predictable manner. Create it, leave it alone, let it play out. Plans do not make sense for a tinkerer — someone who wants to keep adjusting it, suspending it, restarting it, depending on market vicissitudes in the company's stock price. An executive who wants to time her trades — sell more when the price is high, sell less or none when the price is low — will probably be dissatisfied with the 10b5-1 approach.

Related to simplicity is consistency. In my opinion, a company should fashion a standard trading-plan template for its executives and directors. A company should not simply allow its executives to use whatever form their broker offers. In my experience, brokerage-firm templates are not always optimal in terms of 10b5-1 protection. The plan will have ramifications for the company, not just the individual, in the event of shareholder litigation. "That's what my broker gave me" is not a great answer.

The basic plan design is worthy of board of directors attention. That rarely happens, in my experience. Boards may discuss the concept of adopting trading plans. They usually do not focus on the key design elements.

A company probably cannot force an executive to use a particular form of 10b5-1 plan. It can, however, incentivize executives to do so. For example, a company might provide that an executive who adopts a non-conforming trading plan will not be indemnified for legal expenses in the event of a challenge to her trades.

Some may disagree and say that the company should keep its hands off individuals' plans, to avoid responsibility for them. That is a coherent objection. In my opinion, as a practical matter, the company is likely to feel the ramifications of a poorly designed plan and therefore has a legitimate interest in the matter. Moreover, 10b5-1 plans are usually a carve-out to a company's normal trading windows, so some degree of company review is warranted. The trading plans can also have an impact on the company's D&O liability insurance, further justifying corporate oversight.

Timing and Duration

Just as the success of a restaurant is all about location, location, location, so the efficacy of a Rule 10b5-1 plan is all about timing, timing, timing. The SEC guidance on the matter is spare: an executive may adopt the plan at a time when she is not in possession of material nonpublic information about the company. Analytically, this makes sense. Practically, it is difficult to apply. A senior executive almost always knows things about the company that are internal, potentially important, and could move the market if disclosed. But that can't mean that an executive may never adopt the plan, because that would render the regulatory option nugatory (and mean that an executive could never sell stock).

In general, the trading public is at the greatest informational parity with insiders just after the company releases its quarterly earnings report. That is typically when the company's trading window for discretionary sales opens. A relatively safe time to adopt the 10b5-1 plan, therefore, is when the trading window opens, usually 48 or 72 hours after the earnings release. That early in the quarter, an executive is unlikely to have much insight into how the new quarter will turn out.

The next question — arguably, the central question in trading plans — is when they take effect. There is no SEC guidance or industry standard on this issue. For example, some brokerage templates that I have seen allow trades to begin almost immediately after the plan is adopted. Some practitioners recommend waiting a specified period of time before the plan kicks in: two weeks, four weeks, or the like.

My own view is that a prudent structure is one that skips a quarter. For example, assume a company with fiscal quarters that coincide with calendar quarters. If the executive adopts a plan on January 20 — three days after release of December quarter results — she can have the trades begin on April 20 — three days after release of March quarter results. This is not to suggest that a shorter period is illegal or reflective of any wrongdoing. But in the litigation world, this seems to me to provide an appropriate balance. It allows for the passage, and reporting, of a full quarter after adoption of the plan. It reduces substantially the risk that plaintiffs' lawyers will be able to argue that the executive adopted the plan to accommodate anticipated near-term results.

The next timing question is duration. Again, there is no rule here. Some plans are designed to last just one quarter. Others go for a full year or multiple years. In my opinion, shorter equals greater litigation risk, longer equals lesser. Remember, if things go poorly for the company, a lawyer, with the benefit of hindsight, will claim that the executive adopted the quick-triggered, short-duration plan to unload shares before the bad news got out. That argument has less credibility with a plan that continues over a

longer period, during which the company's performance is more likely to vary in both directions.

Modification and termination: two four-letter words in the world of 10b5-1 plans. Neither is prohibited, but both should be avoided. On a simple level, a modification of a plan is subject to all the constraints of the initial adoption. Was the executive in possession of material nonpublic information at the time? Was the trading window open? How long was the lag time before the modification kicked in? Modification gives a plaintiffs' lawyer something to talk about. She will use it as a red-flag to try to demonstrate motive. To take a stark example: if, during the life of a plan, the executive amends it to triple the number of shares sold, the litigator will argue this shows she knew the stock was headed south and wanted to bail out before the bad news emerged. As a matter of risk avoidance, I discourage clients from modifying plans at all during their duration. [8]

A related issue is termination. Nothing precludes an executive from terminating a plan. Indeed, in my opinion, this is preferable to modifying the plan. Just beware that, if someone terminates a plan and then engages in discretionary trades, a plaintiffs' lawyer will claim that those trades are by themselves proof of scienter. Discretionary trades following termination of a plan can look more suspicious than discretionary trades would have looked absent a plan. Similarly, the course of terminating a plan, then adopting a new one, can give rise to suspicions that the plan is being used to shield inside knowledge, rather than to insulate against it. What I tell clients is that, if they terminate a plan, any subsequent plan that they adopt will be subject to greater judicial skepticism. [9]

Trading Formula

In designing a plan, the executive has great flexibility as to the formula for making trades. For example, she can direct the broker to sell sufficient shares to raise x dollars per quarter. Or she can direct the broker to sell y shares per quarter, or z percent of her holdings. None of these raises any issues.

Where one can run into trouble is in building a complex algorithm into the plan. For example, an executive might specify the sale of a shares at $10 per share, twice that volume at $12, triple that volume at $15. Alternatively, the executive might direct the broker to sell no shares if the stock is trading below y dollars or below the rolling 52-week average. There is nothing illegal about such trading formulae. Nevertheless, I do think they provide fodder for a plaintiffs' lawyer who is trying to paint a picture of manipulation. She will argue that they gave the company a tangible incentive to drive the price to that level, whether it is true or not. In terms of impression on a judge or jury, complex plan algorithms can help the plaintiff with her case.

Exclusivity

This is almost as important to me, from a defense perspective, as timing. I urge clients strongly not to make discretionary trades separate from their 10b5-1 plan so long as it is in effect. There is nothing illegal or per se improper about such trades. But, in the event of a subsequent stock drop, those extra-plan trades will be subject to heightened scrutiny. A plaintiffs' lawyer will argue that the insider was so eager to cash out before the bad news emerged that she dumped additional shares on top of those covered by the plan. Even though such accusations may be baseless, they can taint the defense case. In 10b5-1 plans, as in life, monogamy has much to recommend it.

Disclosure

The prevailing practice with respect to 10b5-1 plans is to make absolutely minimal disclosure. Some companies disclose that certain executives have adopted such plans. When a trade is reported on Form 4, it will indicate whether made pursuant to a 10b5-1 plan. That's it. Investors do not know when the plan was adopted or its duration, and they certainly don't know its terms. That is not surprising. No executive would want to disclose how many shares she is willing to sell at a particular price.

In the wake of the recent press coverage, my guess is that this is an area where the SEC will act. One possibility would be to require public disclosure of the adoption, modification, or termination of a plan, without disclosing the terms themselves. Alternatively, the SEC might require an executive to certify that she has obtained approval of her 10b5-1 plan from the compliance officer or board of directors. Whichever way the SEC goes, some disclosure enhancements are probably overdue.

What's Next?

The following is forward-looking, and actual results may differ substantially. I offer two predictions. First, the plaintiffs' bar is going to start taking 10b5-1 plans seriously. By way of analogy, when Congress adopted the safe harbor for forward-looking statements, the plaintiffs' bar responded with denial. Plaintiffs' lawyers didn't take on the safe harbor warnings by their terms: they just used boilerplate to negate every element ("the statements weren't forward looking; if they were, the warnings were inadequate; in any event, defendants acted with actual knowledge of falsity"). After years of losing motions to dismiss based on safe harbor warnings, plaintiffs' lawyers wised up and starting subjecting the actual warnings to scrutiny. Lo and behold, they prevailed in some cases by demonstrating that the cautionary disclosures failed to comply with the statute. Similarly here, plaintiffs' will start probing the plans. Notwithstanding the discovery stay under the Reform Act, there are ways to get at this information. I expect plaintiffs to start doing so, and then to attack weaknesses in

particular plans.

Second, the SEC is going to make law, apart from rulemaking proceedings, by entering into consent decrees. Regulation FD provides a lesson. For years, the SEC did not bring contested enforcement proceedings under Reg FD. Instead, the Commission persuaded issuers to enter into FD consent decrees that shaped public company disclosure practices. I expect the same with respect to 10b5-1 plans. Given the paucity of guidance on the contours of the plans, it could be challenging for the staff actually to bring and win lawsuits over their features. But consent decrees are much easier, and the staff likely will use them to establish best practices.

Until additional guidance is forthcoming, either from private litigation or the Commission, the best advice for risk-averse executives is *Sit Simplex, Stulte*.

Endnotes

[1] Susan Pulliam & Rob Barry, *Executives' Good Luck in Trading Own Stock,* Wall Street Journal, Nov. 27, 2012. http://online.wsj.com/article/SB10000872396390444100404577641463717344178.html?KEYWORDS=SUSAN+PULLIAM; Susan Pulliam & Rob Barry, *Investors Call for More Disclosure of Executive Trades*, Wall Street Journal, Nov. 29, 2012. http://online.wsj.com/article/SB10001424127887324020804578147193237802774.html?KEYWORDS=SUSAN+PULLIAM
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[2] Boris Feldman, Executive Stock Sales and Securities Class Actions, The Corporate Counselor, July 1999, available at http://www.law.com/jsp/article.jsp?id=90…; also available at http://www.borisfeldman.com/Blind_Trust.htm. Published in The Recorder, 1995.
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[3] *E.g.*, *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998); *United States v. Smith*, 155 F.3d 1051, 1069 & n.27 (9th Cir. 1998).
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[4] The SEC had done the same thing in the context of selective disclosure and Regulation FD.
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[5] Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, IC-24599 (Oct. 23, 2000). Obviously, the staff did not use a naming consultant in calling its creation Rule 10b5-1. No doubt future civilizations, absent a regulatory Rosetta Stone, will puzzle over whether Rule 10b5-1 is a typo for Rule 10b-5.

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[6] Boris Feldman, *Stock Trading Plans Under Rule 10b5-1*, No. 8 Cyberspace Lawyer 19 (2000); also available at http://borisfeldman.com/Stock_Trading_Plans.html.
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[7] *E.g., Metzler Investment GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1067 n.11 (9th Cir. 2008); *Elam v. Neidorff,* 544 F.3d 921, 928 (8th Cir. 2008).
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[8] For example, in *SEC v. Mozilo*, 2010 WL 3656068, at *10 (C.D. Cal. Sept. 16, 2010), the court found that adopting or amending five trading plans in the span of three months was suspicious enough to create a genuine issue of material fact with respect to the defendant's scienter. *See also Backe v. Novatel Wireless, Inc.*, 642 F. Supp.2d 1169, 1184-85 (S.D. Cal. 2009) ("Plaintiff's allegations that the Defendants amended their 10b5–1 plans to allow more stock sales based on their inside information coupled with the unusual pattern of sales supports an inference of scienter.").
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[9]For example, in *United States v. Nacchio*, 519 F.3d 1140, 1169 (10th Cir. 2008), *overruled on other grounds by* 555 F.3d 1234 (10th Cir. 2010) (en banc), the court held that termination and adoption of several plans in rapid succession could lead a reasonable jury to find scienter. There, the defendant had entered into a plan in February, cancelled it in March when the company stock fell, adopted a new plan in May with a floor set at the February stock price, traded during May, and then stopped trading for the rest of the year.
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0 Comments

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