
Rule 10b5-1 Trading Plans: Common Questions and Practical Guidance

Since the adoption of Rule 10b5-1 by the SEC in October 2000, many of our clients have entered into pre-arranged trading plans to safely diversify their holdings in company securities. Under the rule, directors, executives, employees and others may trade a company's securities even during "blackout periods" or other periods in which they are aware of material nonpublic information, by adopting binding Trading Plans which specify ahead of time the amount, price and date at which the securities should be traded.

The use of such Trading Plans can yield a number of benefits:

- Boosting employee morale by providing a measure of liquidity with respect to stock compensation;
- Reducing the risk that employees may violate the insider trading laws;
- Minimizing the possibility of adverse publicity resulting from transactions in company securities by executives that are not made pursuant to Trading Plans; and
- Reducing the risk of shareholder lawsuits, which frequently rely on unusual sales by senior executives to demonstrate scienter in support of claims of market manipulation.

We take this opportunity to provide answers to some of the questions most frequently asked by our clients about Trading Plans: how to set them up, how to administer them, and how to maximize their value. In addition, we refer our clients to Mintz Levin's two other advisories on Rule 10b5-1, previously issued in September 2000 and in September 2001.

1. Who should I have administer my Trading Plan?

Most individuals use a brokerage firm to administer their Trading Plan, typically either a brokerage firm recommended by their company or their own personal broker.

A Trading Plan can also be set up in the form of a blind trust or other "discretionary" account managed by a fiduciary. In this type of Trading Plan, the control over some or all of the terms and conditions under which transactions are executed is delegated to the fiduciary. The terms and conditions not delegated are specifically set forth in the Trading Plan. The fiduciary chosen should be someone who (1) the insider believes is capable of making trading decisions on behalf of the insider; (2) is not influenced or controlled by the insider; and (3) does not have access to material nonpublic information regarding the company.

2. Are there different forms of Trading Plans, and which form should I use?

Many brokerage firms have their own form of Trading Plan and require that their form be used. However, most will negotiate changes to their standard form. Some brokerage firms will accept any form of Trading Plan. You should also check with your company to see if it has a recommended form or has negotiated a form with a particular brokerage firm. Since the forms have not yet been standardized within the brokerage industry and the brokerage firms are continually revising their forms based on negotiations with counsel and additional guidance from the SEC, we recommend that your counsel review your Trading Plan to assure that it addresses the issues discussed herein.

3. Should a period of time elapse between the execution of my Trading Plan and the first trade made under my Trading Plan?

Yes. We recommend a "lead-in" period for two reasons. First, the language of Rule 10b5-1 itself arguably provides a defense in situations in which the seller may have had material nonpublic information at the time the Trading Plan was established, but that information has either been disclosed to the public or become "stale" by the time the first trade is executed. The SEC, however, has not confirmed this position. Second, even if the rule itself does not explicitly provide a safe harbor in such situations, the "lead-in" period decreases the likelihood of an insider trading violation under the securities laws, which requires an intent to deceive the market by conducting trades based on inside information.

The amount of "lead-in" time may differ for different individuals and different companies, but should last as long as you reasonably estimate it will take for the inside information to be disclosed to the public or be rendered immaterial. For lower-level employees, it may take a few weeks; for top executives, it may take up to six months. In most cases, a two to three month "lead-in" period should suffice.

4. Have there emerged typical parameters for determining the date, price and number of shares to be sold pursuant to a Trading Plan?

Most plans state the date or dates upon which trades should be made (typically a particular day of the week or month), the number of shares to be sold on each date and a limit price at which the shares should be sold. If the trading price of the stock is below the limit order price, then the trade will not be made. Some plans specify a period of time during which a particular number of shares should be sold as long as the trading price is above a particular threshold. Most Trading Plans that authorize sales on particular dates provide for such sales on a weekly or monthly basis. Although allowed under Rule 10b5-1, most Trading Plans we have seen do not include an algorithm or computer program for determining amounts, prices and dates.

5. Does the plan administrator have any influence over the sales parameters?

Some brokerage firms require certain parameters to be used in order for them to easily monitor when trades should be made under a Trading Plan. To date, most brokerage firms have been manually monitoring Trading Plans to determine when trades must be executed, rather than relying on computer programs to automatically execute trades. The more complicated the trading instructions, the more chance that a trade could be missed which may create liability for the broker. See Question 15.

Brokerage firms can also recommend a feasible trading strategy. For example, for the sale of a large block of stock they can provide information as to whether the trade needs to be spread out over a few days or can be quickly executed. They can also help an insider structure a limit order that they believe will accomplish the insider's goals. If a brokerage firm does not want to handle your instructions because they are too complex for that firm to administer, it may be possible to find another firm or a money manager to execute the trades for you.

If you are subject to Rule 144 under the Securities Act, then you must be mindful of the applicable requirements of that rule for public sales of your shares, including the volume limitations in paragraph (e) of Rule 144. Some brokerage firms will not accept Trading Plans that call for more than 1% of a company's outstanding shares to be sold within a three-month period, regardless of the trading volume. Other firms require all sales of stock to be made through them to ensure compliance with Rule 144.

6. What should be the duration of my Trading Plan?

That depends on what your goals are. Under Rule 10b5-1, each Trading Plan must be entered into in "good faith" and not as a scheme to evade the law. The SEC has not released any guidance on the meaning of this standard; nonetheless, the shorter the duration and the more frequently a new Trading Plan is put into place, the greater the likelihood is that the Plan will not receive protection under the rule. Therefore, we recommend that trades be made over at least a six-month period in order to establish that the Trading Plan was entered into in good faith.

7. Are there different issues involved if I want to do cashless stock option exercises?

Yes. As a general rule, the mere exercise of employee stock options will not trigger insider trading liability, since the insider does not have any more inside information than the company does. Cashless exercises of stock options involve open-market transactions involving persons who are not aware of the same material nonpublic information as the insider, however, and such exercises may trigger insider trading liability and therefore must conform with the requirements of the rule to receive its protections.

You should first check your option agreements to make sure that your agreements allow payment via a cashless stock option exercise. If so, you should check with your company to determine how the company administers its cashless exercise program. Some companies allow employees to use the broker of their choice; other companies require that all cashless exercises be executed through a particular brokerage firm or a third party stock plan administrator. If cashless exercises are executed through a third-party stock plan administrator, the Trading Plan may also have to be administered by that entity; alternatively, the company and the stock plan administrator may be able to coordinate the mechanics of cashless option exercises on your behalf by your Trading Plan administrator. It is recommended that you give a power of attorney to exercise your options to your Plan Administrator and sign the stock option exercise documentation required by your company at the time of the execution of the Trading Plan.

8. Under what circumstances should my Trading Plan provide for automatic suspension and/or automatic cancellation due to unforeseen events?

As discussed in Question 10 below, Trading Plans may not be amended, and are at risk when terminated, at a time during which an insider is in possession of material nonpublic information. However, automatic suspension and cancellation provisions included in the Trading Plan itself allow trades to be halted or to take place at a later time without consideration of whether the insider may be in possession of material nonpublic information. Therefore, we recommend that your Trading Plan contain both automatic suspension and cancellation provisions. Typical triggers for cancellation and suspension include (1) the

death of the insider, (2) any sale which would violate Section 16, Rule 144, or any other federal or state law or regulation, (3) a vote by the company's Board of Directors to suspend all trading, (4) the commencement of a secondary public offering by the company, or (5) any merger, acquisition or reorganization in which the company's stock would be exchanged or converted.

9. Can the plan administrator unilaterally cancel my Trading Plan at any time?

Some forms of Trading Plans allow the plan administrator to unilaterally cancel the Trading Plan at any time. We recommend that a Trading Plan not permit unilateral cancellation by the plan administrator and instead only allow cancellation by the administrator for cause or upon the occurrence of developments beyond its control. If the plan administrator cancels a Trading Plan at a time when the insider is in possession of material nonpublic information, then the insider will not be able to establish a new Trading Plan until the information is publicly disclosed or becomes stale. This could cause hardship to the insider, who had expected the trades to be executed as provided under the Trading Plan. On the other hand, if the only change made to the Trading Plan is to appoint a new administrator without altering the substantive terms of the Trading Plan, it may be argued that the Trading Plan has not been "modified." The SEC has not confirmed this analysis.

10. May I modify or terminate my Trading Plan at any time?

Modifications may only be made at a time when the insider does not possess material nonpublic information. Some company's insider trading policies may limit the number of times or periods during which a Trading Plan may be modified. Many companies will not allow modifications to be made during a blackout period under a company's insider trading policy. In addition, the same "lead-in" time discussed in Question 3 should also be considered when modifications are made.

In contrast to plan amendments, a Trading Plan may, as a general rule, be terminated even when the insider does possess material nonpublic information: the failure to trade generally does not violate Rule 10b-5. The SEC has cautioned, however, that termination of a Trading Plan while in possession of material nonpublic information could affect the availability of the Rule 10b5-1 defense for prior plan transactions if it calls into question whether the Trading Plan was "entered into in good faith and not as part of a plan or scheme to evade" the insider trading rules. As stated above, the SEC has not given any guidance as to how it intends to interpret this language.

11. Is my Trading Plan consistent with my company's insider trading policy?

If your company's insider trading policy has not been revised to allow for Trading Plans, you will need to discuss with your company the need to revise its insider trading policy to allow sales during blackout periods or other periods when sales may not otherwise be allowed under the policy. Companies need to consider whether to revise their insider trading policies to allow persons subject to such policies to sell shares during the time when a company's trading window is closed. Not all companies permit insiders to create Trading Plans to allow insiders to sell stock during blackout periods, although we recommend that such policies be amended to accommodate Trading Plan transactions.

12. Does my Trading Plan need to be reviewed by my company, and if so, what is the scope of the review?

Most brokerage firms require some form of representation by both the insider and the company that the insider may enter into a Trading Plan and that the execution of the Trading Plan will not violate the company's insider trading policy, since the administrator does not want a company to stop settlement of a trade for these reasons. You should also check your company's insider trading policy, since most require the company to review and pre-clear either individual trades or a Trading Policy. Pre-clearance helps create a record of diligence and a good faith effort to comply with the requirements of Rule 10b5-1. It also gives a company the information it needs to respond to inquiries regarding sales by insiders and to suspend trading if necessary.

13. Will my company disclose to the public the fact that I have established a Trading Plan and disclose its terms?

If a company believes that the trading by executives or the volume of trades under a Trading Plan could trigger an adverse reaction to its stock price, the company may consider either issuing a press release or disclosing in a Form 8-K or Form 10-Q the fact that certain employees have entered into Trading Plans. However, if under the plan formula trades are not likely to take place (for example, when the price limit on a limit order is greatly below the current fair market value of the stock) or may not take place for some time, it might be more prudent to wait to inform the market of the existence of a Trading Plan. To date, most press releases we have seen announcing the establishment of Trading Plans have not identified the specific trading parameters of the Trading Plan, but merely that a Trading Plan has been entered into by a particular individual and the potential aggregate number of shares or percentage of the company to be sold; in this way, the company need not make a revised announcement if the Trading Plan is later modified. In addition, as discussed below, note that Form 144 requires disclosure, and Section 16 filings often indicate, that an individual is selling shares pursuant to a Trading Plan.

14. Will the administrator require me to provide indemnification under my Trading Plan?

It depends on the administrator. Some plan administrators require you to indemnify them only if you modify or terminate your Trading Plan; others require indemnification by both the insider and the company upon entering into the Trading Plan; some have no indemnification provisions at all. For those administrators that require an indemnification provision, you should try to limit the indemnification to those instances where you have acted with gross (as opposed to ordinary) negligence, or where it involves a material (as opposed to any) breach of the agreement with the administrator. In addition, you should try to avoid indemnification provisions that require you to pay for the administrator's attorneys' fees.

15. What recourse do I have against the administrator for failure to correctly implement my Trading Plan?

Unless you limit your recourse under the terms of the contract, you can ordinarily sue the administrator for any lost profits or losses incurred because of the broker's failure to execute the terms of the Trading Plan -- that is, you should be put in the same position as if the trade had been executed correctly. In most cases, however, you cannot expect to be compensated for "opportunity costs" (i.e., profits which would have been generated from further investing the money you would have had if the trade had been executed correctly) or for punitive damages.

16. What measures have administrators established to assure proper execution of Trading Plans?

Some brokerage houses have trading desk personnel whose sole job is to execute trades pursuant to Trading Plans. The individuals at these desks execute all trades and then report them to the individual's personal broker who then report the trades to the insider. This arrangement insulates the insider's personal broker from influencing trades under the Trading Plan and acts as further evidence that the insider does not have any influence over his or her Trading Plan.

17. What are the implications under Rule 144 and Section 16 with respect to Trading Plans? Who will ensure that I comply with these rules?

A Form 144 must be filed concurrently with the placing of the order to sell under your Trading Plan. The Form 144 should report all trades expected to take place within the next three months. Subsequently, a Form 144 should be filed contemporaneously with the first trade in each rolling three-month period. Many insiders provide their brokers with multiple Forms 144 executed in blank so that the broker can timely file the Form 144. It is important that the representation set forth on the Form 144 regarding the seller's knowledge of material information regarding the issuer be revised to state that the sale is being made pursuant to a previously adopted Trading Plan, state the date of the Trading Plan's adoption and that the seller's representation is being made as of that date.

Section 16 continues to apply to transactions pursuant to Trading Plans. As a precaution, the cancellation or suspension provision of a Trading Plan should contemplate the need to prevent a trade from happening if it would violate Section 16. Brokerage firms do not typically handle Section 16 filings. Section 16 reporting persons should make sure that the Trading Plan requires the plan administrator to provide them with the necessary information to make timely Section 16 filings. Some insiders have been stating on their Section 16 forms that the transaction was entered into pursuant to a Trading Plan to alert the market as to why a particular transaction took place, especially for transactions occurring during a company's blackout period.

18. May I trade the company's securities outside of my Trading Plan while the Trading Plan is in place?

Yes. Rule 10b5-1 does not prohibit trades outside of a Trading Plan, so long as the trades occur while you are not in possession of material nonpublic information. However, once a trading plan is in place caution should be taken before engaging in such trading. First, the parallel trading could be interpreted as a modification to the Trading Plan, thereby invalidating the safe harbor protection of the original Trading Plan. Second, the parallel trading could be viewed with more suspicion during an investigation if a Trading Plan is already in place (i.e., investigators could conclude that, since the insider has already arranged for a Trading Plan to diversify his or her holdings, then any trades conducted outside of the Trading Plan will be harder to justify as being conducted for reasons other than those having to do with possible possession of material nonpublic information). Also, any sales made outside of a Trading Plan would be aggregated with sales under the Trading Plan for purposes of Rule 144.