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Federal Prosecutors and Regulators Target 10b5-1 Plans – How to Mitigate Exposure and Maximize Compliance

BY ELIZABETH NOE & REY PASCUAL

Federal prosecutors and the Securities and Exchange Commission have launched investigations into whether certain corporate executives have engaged in improper trading of their companies' shares. The investigations appear to have resulted, in part, from a December 2012 article in the *Wall Street Journal* examining thousands of instances since 2004 when corporate executives made trades in their companies' stocks during the five trading days before the companies released material, potentially market moving news. The *Wall Street Journal* article specifically cited seven corporate executives who are now reportedly being investigated.

Most of the trades under investigation were made under executive trading plans established under Rule 10b5-1, which permit corporate insiders to trade their companies' stocks despite possessing non-public material information if they comply with the requirements of the rule, including that trades be scheduled in advance at particular times or prices.

The *Wall Street Journal* article cites as short comings of Rule 10b5-1 that (i) executives do not have to file trading plans with any regulatory authority; (ii) companies are not required to disclose the plan's existence to investors; (iii) executives are free to cancel or change their plans without disclosure and, most significantly, (iv) there is no rule about how long the plans must be in place before trading under the plans can begin.

We expect this regulatory focus on insider trades to continue and, in fact, increase over the next year. As a result, boards should specifically add insider trading and Rule 10b5-1 compliance to their agendas to identify and mitigate risk and analyze company practices for compliance with best practices. The focus should be on more than the strict literal compliance with the letter of the law; it should be on compliance with the spirit of the law.

Rule 10b5-1 Revisited

Rule 10b5-1 was intended in part to deter insiders from trading while in possession of non-public information, while also providing a safe harbor for insiders to make prearranged stock sales pursuant to a trading plan. Because corporate insiders are often privy to confidential information, it is difficult to ensure executives do not sell company stock when in possession of material non-public information. Since the planned sales are scheduled in advance of the trading dates and must be arranged at a time

when the individual is not aware of material nonpublic information, the trading is generally protected from accusations that the trades were based on inside information. Rule 10b5-1 provides an affirmative defense to Section 10(b) insider trading allegations when such trades are made pursuant to a preexisting, written trading plan. In addition, the affirmative defense is available only if the plan was entered into in good faith and not as part of a scheme to evade insider trading liability. In exchange for the safe harbor under Rule 10b5-1, plan participants must forgo their ability to influence trades after the plan is initiated.

Specifically, Rule 10b5-1 plans must meet certain requirements, including: (1) the plan must be established in good faith when the participant was not aware of inside information; (2) the plan must specify the number of securities to be traded and at what price the securities are to be traded, or it must include a formula for making such determinations; (3) a participant is prohibited from exercising any subsequent influence over how, when or whether to effect transactions; and (4) a participant may not alter or deviate from the terms of the plan, except that it is permissible to cancel a plan even if the participant is aware of inside information at the time of cancellation.[1] Companies and executives are not required to publicly disclose the existence or terms of Rule 10b5-1 plans.

Ten Things Boards and Executives Should Do

Perhaps the most important of the Rule 10b5-1 requirements is that the plan must be entered into in good faith and not as part of a scheme to evade insider trading liability. The trick is how to ensure that with the benefit of hindsight, the plan will not be viewed as a scheme to evade. The following are measures corporate executives and boards should consider to mitigate potential exposure or a government inquiry.

1. Ensure Rule 10b5-1 plans are well documented and include the required terms (share amounts, price mechanism, and date). It is advisable to require plans in a form approved by company counsel to confirm the plan complies with the requirements of the rule.
2. Retain copies of all Rule 10b5-1 trading plans and related documentation in the corporate files. In the event of later scrutiny, it is important to have a verifiable record of all actions related to the trading plan.
3. Review the company's internal trading policies and update if necessary to reflect best practices.
4. Require execution and modification of trading plans only during open trading windows and at times when the plan participants are not aware of material nonpublic information. Prohibiting execution of a 10b5-1 plan the last few days of a trading window will help ensure that participants do not possess such information at the time of execution. At the time plans are executed, executives should certify they do not possess material non-public information.
5. Consider a mandated period of delay between creation of a plan and commencement of trading (for example, one fiscal quarter).
6. Require that insiders have only one trading plan for a fixed duration of not less than 12 months.[2]
7. Educate directors, officers and employees of the company's insider trading and disclosure policies. Executives who execute Rule 10b5-1 plans should understand the requirements and limitations of the rule.

8. Consider public disclosure of Rule 10b5-1 plans. Although public disclosure is not required, and there may be certain disadvantages to disclosing planned stock sales by executives, it ensures a public record of the plan's existence, and may also assist if civil securities class action litigation is filed.

9. Ensure compliance with the requirements of Section 16 of the Securities Exchange Act of 1934, including timely Form 4 filings.

10. Audit Committees or internal auditors should routinely review compliance of Rule 10b5-1 trading plans. Suspicious trading or disclosure practices must be promptly and thoroughly investigated.

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If you have any questions concerning 10b5-1 plans or other securities compliance matters, please feel free to contact any of the following Paul Hastings lawyers:

Atlanta

Rey Pascual
1.404.815.2227
reypascual@paulhastings.com

Elizabeth Noe
1.404.815.2287
elizabethnoe@paulhastings.com

Los Angeles

William F. Sullivan
1.213.683.6252
williamsullivan@paulhastings.com

Thomas A. Zaccaro
1.213.683.3285
thomaszaccaro@paulhastings.com

New York

Barry Sher
1.212.318.6025
barrysher@paulhastings.com

Michael L. Zuppone
1.212.318.6906
michaelzuppone@paulhastings.com

Palo Alto

Peter M. Stone
1.650.320.1843
peterstone@paulhastings.com

Washington, D.C.

Morgan J. Miller
1.202.551.1861
morganmiller@paulhastings.com

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[1] See Final Rule: Selective Disclosure and Insider Trading, SEC Release No. 33-7881; 17 CFR 240.10b5-1.

[2] Rule 10b5-1 does not prohibit plan participants from creating multiple trading plans. It may be suitable in certain narrow circumstances for an executive to have multiple trading plans, such as for transactions on behalf of third party beneficiaries or trust accounts.