

10b5-1 Plan Abuse

Practical Steps to Detect and Prevent

By J. David Washburn, Spencer C. Barasch and Christopher McRorie

The latest hot topic in corporate executive abuses may be manipulation of trades under prearranged trading plans established pursuant to Rule 10b5-1. Little has been said about the red flags that could indicate abuse of 10b5-1 plans. This article attempts to offer some practical guidance to corporate counsel to ensure that their 10b5-1 plans steer clear of SEC enforcement scrutiny.

DÉJÀ VU

Reminiscent of the 1980s, the heyday of *Wall Street* protagonist Gordon Gekko, along with real-life Wall Street insiders (and eventual felons) Ivan Boesky and Michael Milkin, who mesmerized the securities industry, today's equity markets are soaring and public companies are reaping extraordinary benefits. Consistent with its response to the 1980s merger and acquisition frenzy made infamous by Gekko's credo that "greed is good," the SEC again has made insider trading its top enforcement priority, partly in response to recent skepticism in Congress about the agency's effectiveness in policing the markets for insider trading.

In the current enforcement environment, the SEC is unlikely to leave any

stone unturned in its investigation of insider trading cases. Recently, SEC officials have voiced concerns that corporate executives may be using 10b5-1 trading plans — a safe harbor unavailable in the scandalous 1980s — to shield illegal insider trading. Hence, it is prudent that corporate counsel take a fresh look at their clients' use of 10b5-1 plans.

SEC INTENDED THAT RULE 10b5-1 PROVIDE FLEXIBILITY

In October 2000, the SEC enacted Rule 10b5-1 in order to clarify the law about when corporate executives who may come into possession of material nonpublic information can legally trade. The rule was intended to give executives opportunities to liquidate their stock holdings — to purchase a home or pay their children's college tuition, for example — without risk of inadvertently facing an insider trading inquiry.

Specifically, pursuant to Rule 10b5-1, trades made under pre-existing contracts, instructions or written plans adopted in good faith would fall under the safe harbor to "provide appropriate flexibility to those who would like to plan securities transactions in advance at a time when they are not aware of material nonpublic information" This grant of flexibility mitigated other parts of Rule 10b5-1 that enhanced the potential for exposure to insider trading liability, such as the codification of the SEC's view that "knowing possession" of inside information was sufficient

basis for liability under Rule 10b-5 rather than the harder to prove "use" of inside information standard that had been favored by some courts. Almost one-third of executives of S&P 500 companies report using prearranged trading plans.

FLEXIBILITY MAY HAVE BEEN ABUSED

According to a study by Assistant Professor Alan Jagolinzer of Stanford University, sales made by insiders relying on prearranged trading plans "tend to follow price increases and precede price declines generating statistically significant forward-looking abnormal returns." Dr. Jagolinzer's preliminary study found that sales under prearranged trading plans outperform the markets by an average of 5.6%. Previous results indicated that sales by executives without such plans actually lag the markets. Dr. Jagolinzer also found that 10b5-1 plan participants terminated their plans right before good news more often than would be expected without advance knowledge.

So, has manipulation of 10b5-1 plans been statistically proven? Dr. Jagolinzer will only say that he has identified an "empirical pattern." In contrast, the SEC considers these findings to be a bright red flag. In March, the SEC's Director of Enforcement noted the Enforcement Division's interest in the study, saying, "We're looking at this — hard ... We want to make sure that people are not doing here what they were doing with stock options. If executives are in fact

David Washburn, Corporate Partner, **Spencer Barasch**, Chair of the Corporate Compliance, Investigations and Defense group, and **Christopher McRorie**, Corporate Associate, are in the Dallas office of Andrews Kurth LLP.

trading on inside information and using a plan for cover, they should expect the 'safe harbor' to provide no defense." Subsequent articles in *Business Week* and *The Wall Street Journal* have compared the situation to the stock option scandals and suggested that this may be the "next big wave."

WHY SHOULD YOU CARE?

A thorough prophylactic review of a company's use of 10b5-1 plans is prudent for a number of reasons, especially in light of the possibility of SEC scrutiny. An insider trading investigation targeting a company's executives is an enormous distraction for company management and can bring negative publicity to the company as a whole. For many of the reasons that companies adopt "blackout" or "window" policies to curb insider trading, creating standard procedures in the adoption of 10b5-1 plans is now an indispensable corporate governance practice. The failure to create and follow such procedures could result in "company liability" when a company employee engages in illegal insider trading.

Moreover, inside and outside SEC counsel of public companies can now be criticized for failing to catch warning signs of trading plan abuse. Failures to report detected wrongdoing "up the ladder" could expose counsel to personal liability.

Prophylactic relief, however, may not be enough. Companies also should be incentivized to investigate historical practices. First, if abusive conduct was reasonably clear to an alert observer, the company could be accused of aiding and abetting the manipulative conduct. If the abuse involves manipulation of the timing of public disclosures, plaintiffs may characterize the timed releases of information as a violation by the company itself. Also, the company is generally in a better position in any enforcement actions where the company has taken proactive steps to detect wrongdoing and self-reported any abuses.

Each company must review its particular facts to determine whether the potential costs of reviewing past practices outweigh any benefits. In any

event, rigorous monitoring of future 10b5-1 plan enactments and trades will likely be expected by the SEC and the market.

ASSESSING POTENTIAL FOR MANIPULATION

Once a determination is made to review the historical operation of a 10b5-1 plan, reviewers should consider, as a threshold issue, whether they are sufficiently independent from the subject plans and trades to be properly regarded as objective. Attorneys who drafted the plans at issue or participated in disclosure timing decisions should consider recusing themselves lest the conclusions reached be discounted by follow-on observers such as the government, shareholders or auditors.

As in any investigation, the reviewer should have access to all tools available for this purpose, including document review, e-mail review and interviews of fact witnesses. A useful starting point may be to plot plan trades against the stock's trading history to see if patterns of profitable coincidences appear. The following list describes several additional steps that could be taken to reveal some of the 10b5-1 plan abuses that commentators speculate may exist.

Ensure that plans have been properly adopted and effectuated. Before becoming aware of material nonpublic information, the insider must irrevocably commit to the trade in a contract, instruction or written plan. With respect to any transaction under the plan, the insider must expressly specify the terms and date; provide a formula, algorithm or program for determining terms and times; or completely relinquish influence over how, when or whether to make trades. All purchases and sales must be made under the 10b5-1 plan; the insider cannot have altered or deviated from the plan or entered into a related hedging transaction. Finally, the safe harbor is not available if the 10b5-1 plan was part of a scheme to evade the insider trading rules or otherwise was not made in good faith.

Reviewers should obtain copies of the plans and review them for compliance with Rule 10b5-1. A reviewer should be satisfied that any required

company approvals were obtained for the form of the plan actually adopted and that actual trades were effected in accordance with plan terms. Prearranged trading plans are not required to be disclosed, so reviewers should also look for "backdated" plans, which may involve accessing the "meta-data" related to electronic copies of the plan, comparing trade dates with the dates of any public announcements that were made and checking Section 16 report disclosures relating to trades that may footnote reliance on the plan.

If the plan was effectuated through the discretionary investment authority of a broker, a reviewer should test the relationship between the broker and the insider. Are they acquaintances? Has the company reimbursed the insider for entertainment expenses involving the broker? If deemed necessary, a review could be made of phone records between the insider or company and the broker. At a minimum, an interview of the broker should occur to ascertain his independence. The reviewer should be satisfied that the broker was not influenced and did not come into possession of any inside information after the adoption of the plan.

Determine whether an insider was aware of material nonpublic information at the time the plan was adopted. An essential premise of properly functioning trading plans is that they were adopted when the insider was devoid of potentially market moving information. Reviewers may develop a timeline comparing the dates that prearranged trading plans were being considered and the date ranges that insiders came into possession of pieces of inside information. Often, brokers agreeing to implement a 10b5-1 plan ask the company to certify that no material nonpublic information exists at the adoption of the plan; the existence of such certifications should focus a reviewer on potential company liability for their accuracy.

Insiders are encouraged to build in a substantial delay or "waiting period" of one to six months between adoption of a plan and initial trading. While there is nothing that automatically disqualifies trades occurring near a 10b5-1 plan

adoption, such trades could suggest awareness of inside information if the trade turns out to have been near a high in the stock's price history.

Examine news release decisions. Next, a reviewer considering plan trades that specify particular trade dates or timing triggers should examine the role of plan participants in timing material disclosures. Consider whether news releases around the time of plan trades were issued on logical and appropriately identified dates. A reviewer should ask: Who is involved in the decision to release information? Does the record reflect any communication among the relevant parties concerning the release date selected? If a news release was postponed or accelerated, can a legitimate business reason for the change be identified? These inquiries relate not only to "released information," but also to information withheld from disclosure.

Some 10b5-1 plans are designed to appear more stringent by restricting trades to open trading windows, which typically open between earnings releases and subsequently filed financial statements. This could put pressure on decisions to push the release of certain details to the financial statements, such as one-time charges that bring earnings per share within guidance or material changes in nonoperating expenses.

Examine plan terminations and modifications. Terminating a plan will not, in and of itself, result in insider trading liability. The SEC, while acknowledging that the "non-trade" resulting from a 10b5-1 plan termination cannot generally form the basis of liability, has also indicated that "termination of a plan ... could affect the availability of the [10b5-1 plan] defense for prior plan transactions if it calls into question whether the plan was 'entered into in good faith.'" Likewise, compliance with the good faith requirement could be questioned by plan terminations followed shortly by new plans and trades. (Allegations of jumping in and out of 10b5-1 plans were involved in the recent insider trading proceedings against former Qwest International CEO Joseph Nacchio.)

Amendments to a 10b5-1 plan can be even more problematic. Any amendment should be considered the termination of the old plan and the adoption of a new plan. The analysis of whether the insider possessed material nonpublic information must be repeated at the time of the amendment. Multiple amendments will likely give rise to presumptions of bad faith.

Did the insider trade outside of a plan? Adoption of a plan does not necessarily preclude trading outside of a plan. However, trades made outside of the plan do not benefit from the safe harbor and could be indicia of strategic trading, especially if the outside trades seem to hedge against the effects of plan instructions. Reviewers should determine if there were identifiable financial needs or objectives motivating non-plan trades. The absence of extenuating circumstances does not mean that a trade need be considered tainted, but independent justifications for a trade beyond the profit motive can help to assuage doubts of skeptical outsiders.

Interview relevant parties. Any good investigation should involve questioning the people involved about the 10b5-1 transactions. Whoever made trades on behalf of insiders should be asked when the plan was communicated to him and the substance and timing of any communications with the insider or others at the company. The insider should be interviewed to elicit facts surrounding the purpose of the plan and the procedures followed in setting it up. A reviewer may also wish to interview attorneys that reviewed the plan, compliance administrators within the company, decision makers with respect to public disclosure timing and others.

Conclude the investigation. Reviewers should document all steps taken in the investigation and present any conclusions reached to the appropriate body at the company. If the report identifies any potential abuses, recommendations should likely include the engagement of independent outside assistance to investigate more exhaustively.

BEST PRACTICES GOING FORWARD

Any report prepared should include recommendations to improve the company's 10b5-1 plan processes going forward. Each of the steps above includes a corollary "best practice" for future 10b5-1 plan procedures that should be formalized in a written policy. Some examples of policy components that most companies will find useful are:

- The only 10b5-1-related exceptions to the company's blackout policies should be for formally adopted plans that have been reviewed by in-house counsel for compliance with the rule.
- 10b5-1 plans should only be initiated during an open trading window, and the first trade should be delayed until several months after adoption.
- Plans should not be permitted to be amended or terminated early in the absence of extraordinary circumstances.

Preferably, all 10b5-1 plans would be handled by the same fully independent broker, and in-house counsel would work closely with the broker to ensure that Section 16 reports are timely filed.

CONCLUSION

It is likely that trades under 10b5-1 plans will come under additional scrutiny in the near future. Companies should take proactive steps today to assure themselves that their own insiders are not likely to get caught up in investigations and that their policies are effective to prevent abuses. Some practical review steps can go a long way to comforting board members and GCs.

