

## Rule 10b5-1 Plans: Safe Harbor or Pirates' Cove?

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As company counsel or a key adviser, you've had responsibility for ensuring compliance with Section 10(b) of the Securities Exchange Act, including prohibitions against insider trading. Now you have another 10(b) issue to worry about – whether executives' and directors' ("insiders") 10b5-1 stock selling plans will provide effective safe harbors.

Clearly, insiders have many legitimate reasons for selling company stock – to diversify their investments, cover tax liabilities or meet personal financial needs. Nonetheless, internally enforced "black-out dates" preceding quarterly earnings releases and possession of material non-public information can severely impair their ability to do so. To clarify these muddy waters, in 2000 the Securities and Exchange Commission ("SEC") promulgated Rule 10b5-1 to dredge out a "safe harbor" that would enable insiders to sell their company's securities without a fear of being prosecuted or sued for trading on "inside information."

By and large, 10b5-1 plans (often sponsored by brokerage firms) have been a success: billions of dollars of stock have been sold annually since 2000 by insiders relying on them – \$8.6 billion in S&P 500 stock during 2006 alone.<sup>1</sup> Most

well-structured 10b5-1 plans prescribe the dates, prices, and future conditions that must occur before sales take place (all beyond participants' control). So the public (and the SEC) should have a reasonable expectation that these trades did indeed take place independent of the insiders' knowledge.

But a recent academic study conducted by Stanford University assistant professor Alan Jagolinzer<sup>2</sup> found that executives of public companies selling stock pursuant to 10b5-1 plans appear to have earned abnormally high returns compared to those selling outside such plans. More pointedly, the research suggests, based on nearly 100,000 trades from 2003 to 2005, that 10b5-1 plan participants' stock sales have followed price increases and preceded price declines, allowing those insiders to beat the market by 5.6%. Some of the fact situations are quite suspect and could lead one to conclude that the "safe harbor" that Rule 10b5-1 was intended to create may have become more of a pirates' cove where insiders use the rule to shield what would otherwise be illegal trades.

As you might expect, Jagolinzer's research and the commentary it generated has drawn the SEC's attention. Flush with success in securing executive resignations, injunctions, disgorgements and civil penalties based on stock option



backdating schemes, the SEC staff is now turning its sights on 10b5-1 plans. Just this March, SEC Enforcement Chief Linda Chatman Thomsen stated in a public speech that "We're looking at this — hard. We want to make sure that people are not doing here what they were doing with stock options."<sup>3</sup>

What's counsel to do? The following paragraphs present a primer on how 10b5-1 plans are supposed to work, how insiders may have been abusing them and a short list of actions you can take to help evaluate whether these plans are used as intended. We'll also explain how forensic investigators can help if you find yourself involved with allegations relating to a 10b5-1 plan.

### How 10b5-1 plans are supposed to work

Rule 10b5-1, effective October 23, 2000, can provide an affirmative defense for insiders who might otherwise be deemed to be trading "on the basis of" material nonpublic information as prohibited by Rule 10b-5. To avoid even the appearance of impropriety, insiders can set up trading plans designed to insulate them from claims of having used inside information to their advantage.

<sup>1</sup> Searcy, Dionne & Kara Scannell, "SEC Now Takes a Hard Look At Insiders' 'Regular' Sales," *Wall Street Journal* (April 4, 2007), p. C1.

<sup>2</sup> Jagolinzer, Alan D., "Do Insiders Trade Strategically within the SEC Rule 10b5-1 Safe Harbor?" (revised December 6, 2006), p.2. See <http://ssrn.com/abstract=541052>.

<sup>3</sup> Linda Chatman Thomsen, Director, Division of Enforcement, U.S. Securities and Exchange Commission, Remarks at the 2007 Corporate Counsel Institute (March 8, 2007), [www.sec.gov/news/speech/2007/spch030807tct2.htm](http://www.sec.gov/news/speech/2007/spch030807tct2.htm), para. 27.

Under rule 10b-5, the insider must, before becoming aware of any material nonpublic information, enter into a binding contract to purchase or sell company securities, instruct another person to execute the trade for the insider's account, or adopt a written plan for trading company securities. The contract/instructions/plan must either (a) specify the amount, price, and date; (b) provide a written formula or algorithm, or computer program, for determining amounts, prices, and dates; or (c) prevent the insider from exercising any later influence over how, when, or whether to effect purchases or sales (and the insider's agent must also not have access to material nonpublic information when trading). Then, of course, the trade in question must actually take place under the contract/instructions/plan, without deviating from it or hedging against the subject transaction.

## Possible manipulation

10b5-1's requirements look simple and straightforward. But what if a CEO set up a 10b5-1 plan whereby the CEO immediately started selling \$1 million in shares daily for the next 13 trading days? Then, due to announced accounting charges and cuts in staff, that company's stock slid more than 50% within six weeks after the CEO's selloff? Reasonable minds could infer that the CEO had some material inside information before setting up his 10b5-1 plan.

Or what if an insider sets up a 10b5-1 plan calling for the sale of shares, then cancels the plan prematurely just when bad news is to be released to the market? Although it is legal to cancel 10b5-1 plans, it can raise suspicions that the insider knew that the company's stock price would go down and wanted to avoid selling shares at a loss.

These scenarios present only two of the ways that insiders might use 10b5-1 plans in ways other than what the SEC expected when creating the rule's safe harbor. Even if the trades in each case proved to be legitimate, the appearance of impropriety may attract attention from the SEC or plaintiffs' bar and generate unwelcome publicity.

## What if one or more of your insiders is already the subject of an insider trading allegation, investigation or claim?

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Deloitte FAS professionals can perform proactive analyses or investigation assistance into potential 10b5-1 plan abuses. Specific services include:

- Economic modeling of insider trading activity to identify transactions exhibiting indicia of abnormal returns or other unusual characteristics
- Forensic collection of relevant electronic and hardcopy evidence, including email
- Analytics of evidence gathered to identify potential issues of safe harbor provisions

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