



The Securities Enforcement Practice of Sidley Austin LLP

Sidley has substantial experience to assist companies and their executives in responding to and defending against SEC enforcement actions, criminal investigations and other governmental inquiries.

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SEC Plans Heightened Scrutiny of Rule 10b5-1 Trading Plans

In response to a recent study by Stanford University Professor Alan Jagolinzer, SEC Enforcement Director Linda Chatman Thomsen noted the “possibility” that Rule 10b5-1 trading plans “are being abused in various ways to facilitate trading based on inside information.” As a result, she said, the SEC is looking at these plans “hard.”

The SEC adopted Rule 10b5-1 in August 2000 to allow executives and directors of public companies to execute trades in their own company’s stock regardless of whether they possess material, non-public information at the time of the trade. Such trades are permissible only if 10b5-1 plans were created and implemented prior to the individual possessing such information.

In order to qualify for the Rule’s safe harbor, the person must have entered into a binding contract to purchase or sell securities, provided instructions to another person to purchase or sell securities, or adopted a written plan for trading securities — all *before* becoming aware of material, non-public information. If trades are executed pursuant to a written plan, the plan must: (1) specify the number of and price at which securities are to be purchased or sold, as well as the date on which the securities are to be purchased or sold; (2) identify a formula or an algorithm for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities are to be purchased or sold; or (3) not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales.

In addition, the person must act in good faith and not as part of a plan to evade the prohibitions against trading on the basis of inside information found in Rule 10b5-1. The good faith provision provides the SEC a basis to challenge the affirmative defense created by Rule 10b5-1 if they have reason to suspect abuse of the Rule.

The study by Professor Jagolinzer showed that executives trading pursuant to 10b5-1 plans performed 6% better than the market, while executives who traded without such a plan

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outperformed the market by only 1.9%. Although Professor Jagolinzer was cautious to warn that his research said nothing about whether any illegal or improper conduct had occurred, numerous observers have begun speculating as to the cause of the discrepancy. Among the speculation: the possibility that insiders are manipulating the timing of public disclosure of material information in order to favorably impact trading dates in their 10b5-1 trading plans; the possibility that plans are being implemented when insiders might be aware of good — or bad — news coming down the pike; and the possibility that insiders may be “timing” the market and terminating 10b5-1 trading plans on short notice if the plan would cause them to execute a trade at a time that would be disadvantageous.

If the SEC follows through on Director Thomsen’s promise to look hard at these plans, executives can expect the Commission

to focus, for example, on the sudden acceleration of planned trades, executives who stop and restart plans, operate with multiple plans or frequently modify plans. And if the SEC truly does want to “make sure that people are not doing here what they were doing with stock options,” general counsels should expect that some of the scrutiny will be focused on them. The prudent course for public companies is to publicly disclose their senior executives’ Rule 10b5-1 trading plans, require a “cooling off” period between the adoption of a plan and the first trade thereunder, exercise particular caution when an executive who has terminated a plan wishes to commence a new plan, and rigorously assess whether insiders are aware of material non-public information at the time a plan is adopted.