



Theory and Practice of SEC Rule 10b5-1(c) Stock Trading Plans

Certified Equity Professional Institute
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Potential Liability for Insider Trading





- Allegation that insider purchased or sold stock in connection with material nonpublic information (MNI)
 - Officers and directors
 - Employees
 - Anyone else who obtains information from insider (lawyers, other consultants, tippees)
- What is MNI? Anything a reasonable investor would find material to decision to purchase or sell



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- SEC insider trading proceeding
 - Trade itself is the offense (violated Rule 10b-5)
 - Target: any insider, including employees and tippees
- Private securities or derivative action
 - "Suspicious" trades used to plead *scienter*
 - Targets
 - Section 16 reporting persons because their trades are public knowledge
 - Issuer (liable because officers liable)
 - Board of Directors (for failing to stop insider trading)



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- August 2000: SEC adopts Rules 10b5-1(a) and (b), which lowers standard of insider trading liability to awareness (not use) of MNI
- SEC recognized that awareness standard could reach innocent conduct: trading “where it is clear that the information was not a factor in the decision to trade.”
- Rule 10b5-1(c) thus creates affirmative defense to SEC insider trading liability for trades made pursuant to preexisting contract, instructions, or written plan adopted in good faith
- May now be exclusive defense if there is awareness

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Basics and Benefits of 10b5-1(c) Trading Plans

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10b5-1 (c) creates affirmative defense to SEC insider trading liability for trades made pursuant to preexisting contract, instructions, or written plan adopted in good faith



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10b5-1(c) creates affirmative defense to SEC insider trading liability for trades made pursuant to preexisting contract, instructions, or written plan adopted in good faith

- Insider must prove that defense applies
- Does not prevent SEC from suing
- Formally, does not apply in private class actions (but...)
- Plan must cover the challenged trades
- Cannot alter or deviate from plan
- Not if corresponding or hedging transaction or position
- Adopted when insider not aware of MNI



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10b5-1(c) creates affirmative defense to SEC insider trading liability for trades made pursuant to preexisting contract, instructions, or written plan adopted in good faith

- Binding contract to trade in amount, price, and date
- Instructions to another person to execute specific trade on specific date
- Written document that specifies or sets a formula for the amounts, prices, dates of purchases or sales
 - Formula allows delegation of discretion
 - Price can be fixed price or limit price
- Not part of scheme to defraud

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- For the SEC: "The rule provides specific guidance on how a person can plan future transactions at a time when he or she is not aware of MNI without fear of incurring liability. We believe that this guidance will make it easier for corporate insiders to conduct themselves in accordance with the laws against insider trading."
- To combat private plaintiffs
 - Results in nonsuspicious pattern of sales -- not dumping large block of shares just before bad news
 - If insiders less subject to liability, so are issuers and directors
- Allows portfolio diversification and financial planning

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- Easier to administer than blind trust
- Allows insider to trade outside of window and during blackout periods.
- Provides insider flexibility in managing personal finances.



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- Adoption of plan may be alleged as motive for fraud by class action plaintiffs
- Compared to trading windows, more likely to have ill-timed sale (just before adverse news)
- Divergence from trading plan may be alleged as evidence of scienter
- Relatively untested in courts



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- *Wietschner v. Monterey Pasta Co.* (N.D. Cal. 2003), *In re Netflix, Inc. Securities Litigation* (N.D. Cal. 2005): 10b5-1(c) trading plan negated inference of suspicious trading in private class action
- *SEC v. Lent*, No. C 04-4088 FMS, slip op. (N.D. Cal. Jan. 28, 2005): 10b5-1(c) not applicable if plan adopted after adverse MNI already known to insider
- *SEC v. Scrushy* (N.D. Ala. 2003): 10b5-1(c) could provide defense where exercise of option in 2002 was made on last day allowed under 1991 Stock Option plan
- *SEC v. Lipson* (7th Cir. 2002): 10b5-1(c) creates a “safe harbor” if MNI not used in the insider’s trading

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- January 22-29, 2001: CEO sells 29M shares for nearly \$900 million – first sales in 5 years
- March 1, 2001: Oracle announces earnings miss
- September 1, 2004: Ninth Circuit holds that the stock sales, combined with other allegations, pleaded securities fraud
 - Even though they were only 2.1% of his holdings, the CEO’s “truly astronomical” sales were suspicious in amount and timing
- In January 2004, the CEO adopted 10b5-1(c) plan (which company disclosed in press release) as part of a long term strategy to diversify assets and obtain liquidity

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- CEO sold shares immediately prior to pre-announcement of poor quarter
- CEO claimed sales were pursuant to pre-existing estate plan, but had no documentation to this effect
- Seventh Circuit held that if jury believed CEO, would have provided defense to SEC insider trading liability
 - Must be more than showing that there was a legitimate reason to sell; must show that same sales would have been made regardless of MNI due to pre-existing plan
 - Characterized 10b5-1(c) as a “safe harbor”
- However, jury was rational to disbelieve CEO

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Advising the Insider (and the Issuer)

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	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Number of Plans	27	342	463	433	1011

133% Increase


Key Factors

- Most issuers revised their Insider Trading policy
- Insiders/Issuers feeling more comfortable
- Issuers advocating Rule 10b5-1 plans to all employees subject to windows
- Increasing # of Issuers disclosing terms of their employees' trading plans & publishing Insider trading policies on their websites.

-Oracle -Alcoa
-Netflix -Reebok

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Key Considerations in Plan Design

- What's involved in establishing a trading plan?
 - Issuer Trading Policy allows for trading plans
 - Open window/not aware of MNI
 - ML only accepts written plans
 - Adopted in good faith/client representations
 - Specifies amount, price and date
 - Reviewed & approved by client/issuer counsel
- What is the typical duration of a plan and when can trading start?
 - Start date, end date, cooling off period
 - Consider window policy of Issuer

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Key Considerations in Plan Design

- How are Rule 10b5-1 plans priced/Trading Strategies?
 - # of shares, dollar amount, deposit of stock, an event
 - Cashless Exercise of stock options
 - Type of trade (limit, market, set of limit prices-allows for multiple target prices)
 - Filing implications (Rule 144, Form 4)
- What provisions are available if the stock isn't sold in a given period or if the stock is thinly traded?
 - Carry forward provisions
 - Trading caps

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Key Considerations in Plan Design

- Can my plan be modified or terminated?
 - Trading suspension provisions
 - Plan modifications and best practices
 - Termination provisions
- Rule 144 Practices and Delivery Requirements
 - Rule 144 Forms
 - Stock Powers/Irrevocable Delivery Notices
 - Trade Notification (Form 4 Reporting)

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SEC Reporting Requirements for Corporate Insiders

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- Officer & Director Equity Service (ODES)
- ExecuFile™

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Reporting Requirements

- Section 403 of Sarbanes-Oxley(2002) accelerated Form 4 reporting to 48 hours after the transaction occurred
- Paper filings no longer accepted (6/30/03)
- SEC enforcing strict guidelines and providing little relief for late filers.



Current Environment

- Executives profoundly impacted by 48 hour reporting
- Work Flow process within office of Corporate Secretary, General Counsel and CFO is evolving
- A dozen third party service providers offering internet and software solutions

ODES Service Features

- Pre-trade (open market purchase & sale) Clearance
- Post-trade confirmation with all transaction details
- Electronically fill Form 4 with Merrill Lynch trade data through ExecuFile



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Dear Jonathan Wilcox:
Below is the transaction information for:
JEFF DONNELLY
Trade Date: 06/29/2004
Transaction Type: PURCHASE
Settlement Date: 07/02/2004
Symbol: MER

PRICE	QUANTITY
\$54.2500	1

TOTAL QTY FOR THIS E-MAIL: 1

Did you know? As a contact designee for a Merrill Lynch Officer and Director Equity Service client, you can report this trade directly to the SEC within minutes, with Execufile.com.*

Click here to take a tour of Execufile.com www.execufile.com.



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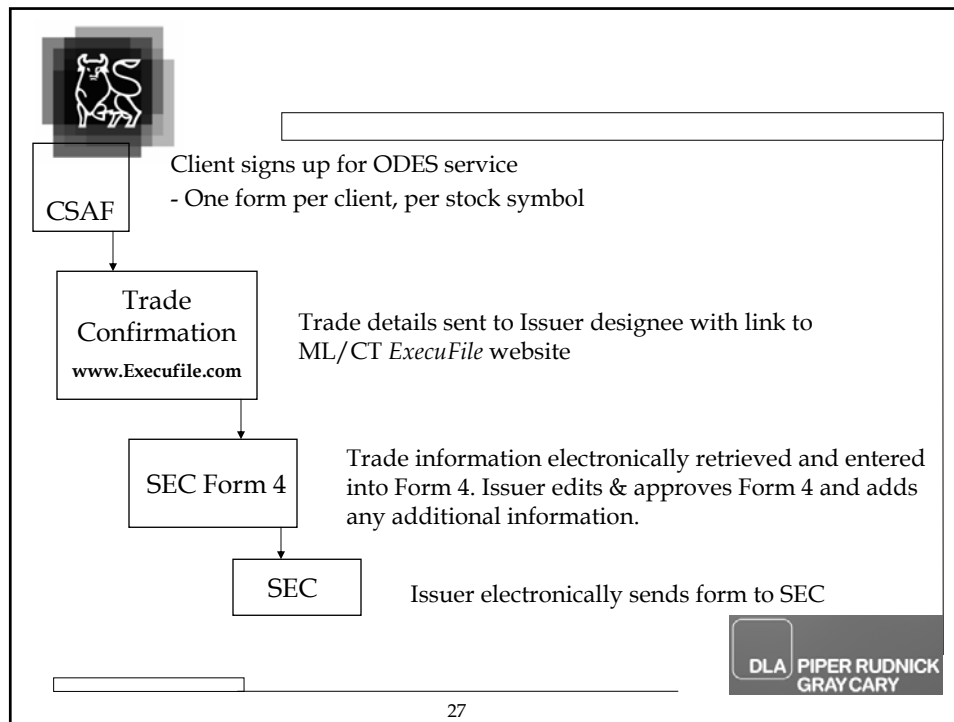




- Service is effective as a reminder when a trading plan extends over a long period of time.
- Used as a 'heads up' for Insider Filings.



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- Website service available 24/7 via secure username/password
 - Forms 3, 4 and 5, Schedules 13G and 13D, 12b-25 and Form144 can be prepared
 - Open market purchase and sale transaction details imported directly from Merrill Lynch
 - Data storage and filing history capabilities
 - \$3395/year unlimited filings for unlimited number of insiders
- 
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- **Section 16 Reporting** - The individual reporting person is responsible under Section 16 of the Securities Exchange Act of 1934, as amended, for compliance with the reporting requirements of Section 16 and filing timely and accurate reports with the SEC. Merrill Lynch neither prepares nor files Section 16 reports on behalf of clients.
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