
Considerations for a 10b5-1 trading plan

Important information for executives and corporate governance professionals

Because there is significant confusion in the marketplace about 10b5-1 plans, we have compiled the following questions and answers to help you make informed decisions about creating and implementing your trading strategy.

A properly executed Rule 10b5-1 trading plan is a binding contract, instruction, or written plan between an executive and the brokerage firm that will execute trades on his or her behalf. It stipulates the number of shares, price at, and dates on which an executive may trade securities, and may include a formula for determining these specifics. Once a plan is established, an executive should not influence or make any modification to the trading instructions within that plan.

Why consider a 10b5-1 trading plan?

Compensation packages that are designed to attract and retain the most talented executives, directors, and other key employees often include equity-based compensation, including stock options, restricted stock, performance awards, and stock appreciation awards (SARs). When these individuals want to sell shares of their company stock, they often find they are hampered by possession of material non-public information, their company's trading policies, and limited trading windows due to quarterly blackout periods.

Executives also have legitimate concerns about negative market reaction that selling company stock can bring and the administrative burdens of complying with Securities and Exchange Commission (SEC) regulations. As a result, selling opportunities may be so limited or the perceived burdens so imposing that an individual's portfolio becomes significantly overweighted in company stock.

SEC Rule 10b5-1 was adopted to help executives navigate this complex set of circumstances and to provide transparency to public markets as insiders sell their shares. This rule lets individuals establish a structured trading plan that can help alleviate many of the issues described above. Properly constructed and administered, these plans can provide an affirmative defense to allegations that they violated certain insider-trading rules and regulations.

What is an affirmative defense?

An affirmative defense limits or excuses a defendant's liability based on facts outside those claimed by the plaintiff. In the context of 10b5-1, if an individual makes a claim that an executive traded the company's stock while in possession of material nonpublic information (thus violating insider-trading rules), a valid 10b5-1 plan that triggered the trade would serve to prevent liability from attaching. The executive who claims the affirmative defense must still prove that the plan was in place before the trading occurred; that it was entered into and executed in good faith; and that it was not part of a plan or scheme to avoid acts prohibited by Section 10(b) and Rule 10b5-1.

What qualifies as a plan?

A properly executed plan must provide a written formula or directive that determines the number of shares, price, and dates on which the securities are to be purchased or sold, and does not permit you to exercise subsequent influence over transactions in the plan. Wells Fargo Advisors requires a written document for all 10b5-1 plans.

How specific does the plan have to be?

The trading directions within a 10b5-1 plan should be quite specific. However, these instructions can take many forms. The plan must include information regarding the date, price, and number of shares to be transacted. For example, the plan can state "Sell 20,000 shares at \$45 per share or better." Alternatively, a formula or algorithm can be created such as "On the second trading day of every month, sell 1,000 shares at market."

How long may trading plans last?

No minimum or maximum time frames are mandated by law. However, long plan durations will limit your flexibility to consider changing price targets and financial objectives. The average duration is six to 18 months. Individual issuers may impose term limitations in their corporate trading policies.

When can I enter into a plan?

You may enter into a plan only when you are in an open trading window and when you are not aware of any material nonpublic information. Close coordination with corporate counsel is suggested to ensure your protection. Your company will often want to review your plan to ensure that it complies with company policies.

Once I adopt a plan, how soon can I begin trading?

Current rules require a mandatory delay, commonly known as a "cooling off period" between the plan adoption date and the first possible trade date. For directors and officers (as defined in Rule 16a-1(f), this cooling off period is a minimum of ninety (90) days and as much as one hundred twenty (120) days, depending upon the timing of issuer's release of quarterly earnings for the period in which the plan was adopted. For non-executive officers and others, there is a required thirty (30) day cooling off period.

Can my trade go forward if I learn about material non-public information after adopting a plan but before the trade occurs?

Yes, as long as the plan was properly executed during an open window while you were not in possession of material nonpublic information.

May I change or cancel the plan?

Yes, modifications or terminations are allowed under the rules, but they are not recommended. Under current rules, modifying your plan will trigger a new required cooling off period before you can trade under the modified terms. Modification or termination of your plan could call into question whether you have met the good-faith requirements to have a valid plan and may create certain risks to you and your company. You should always consult with your corporate counsel or appropriate designated company personnel before you alter or cancel an existing plan. Some company policies restrict your ability to terminate or modify a plan, or require that you be in an open window period to take such action. You also must not be in possession of any material nonpublic information at the time you make an alteration or cancel the plan.

May I sell stock outside the plan?

Yes, however, such stock sales would not be protected under the affirmative defense provision of Rule 10b5-1. Be aware that SEC Rule 144 volume limits apply to the total amount of stock sold, both inside and outside of a 10b5-1 plan and if you sell stock that is committed to the plan, you may inadvertently modify or terminate the plan. Also, your corporate trading policy may prohibit such activity.

How do these trading plans affect trading windows and blackout periods?

Rule 10b5-1 does not eliminate the existence of company-specific trading restrictions. Company policy will determine trading windows and blackout periods. In addition, it is up to each company to decide whether to let employees create trading programs. However, trades established as part of a plan may allow you to trade through periods which would otherwise be closed.

Do I still have to complete documents such as SEC Forms 144 or 4?

Yes, establishing a 10b5-1 trading plan does not relieve you of other SEC regulatory filing requirements. For SEC reporting companies, Rule 144 forms must now be filed electronically through the EDGAR system and trade information may become publicly known much faster than it was in the past. As a result, Rule 144 filing information may become known prior to the Form 4 filing, which was not always the case in the past.

Can I have multiple plans in place at the same time?

You cannot have more than one plan actively trading at the same time. Current rules do allow you to adopt more than one plan, as long as the later plan does not begin trading until a current plan has fully executed or expired. This allows you to line up a series of plans in a "box car" approach, so that there is minimal interruption to trading activity. For instance, while your current plan is winding down, your next plan can be established, allowing the cooling off period to run, so that can begin trading under the new plan immediately after the current plan has concluded.

There are other limited exceptions carved out in the Rule. For example, you can use establish separate plans at multiple broker-dealers as long as they can be conducted in such a way that they operate as a "single plan" and the individual contracts, taken as a whole, meet the requirements of the Rule. There are also exceptions carved out for eligible sell-to-cover transactions. This exception only applies to sales which are necessary to cover tax withholding obligations from vesting event, where the executive has no control over the timing of such sales, and does not extend to the sales of any shares beyond those necessary to cover tax obligations (e.g. additional net shares).

Can I enter into a hedging transaction to protect the shares under the plan?

No. Rule 10b5-1 prohibits hedging shares while a plan is active.

What are the benefits to issuers?

One of the SEC's goals in creating Rule 10b5-1 was to provide clear information to market participants regarding insider transactions. A properly executed 10b5-1 plan can reduce the negative perception of insider stock sales by market participants and avoid the volatility that often results. In addition, your general counsel or other compliance officers may be relieved of the burden of having to make subjective determinations about what is considered material information.

Glossary

Affiliate. An individual who is in a position to influence the actions of a corporation. This includes persons such as directors, executives, and owners.

Blackout period. A temporary time frame in which trading in company stock is limited or denied.

Binding contract. Any agreement, oral or in writing, that is enforceable, such as an offer to buy or sell when the person to whom it is made accepts it and communicates acceptance.

Control stock. Stock held by an officer or director of a company, or by a person or a family with controlling interest in the company. Sales of control stock in the public market must comply with requirements of SEC Rule 144.

Corporate trading policy. Policy established by the issuer defining the terms and conditions that must be followed when employees engage in trading the issuer's securities.

EDGAR. SEC's Electronic Data Gathering, Analysis and Retrieval system

Form 4. A document that must be filed with the SEC whenever there is a material change in the holdings of company insiders (including shareholders owning 10% or more of the company's outstanding stock).

Insider. Any person who has knowledge of, or access to, valuable nonpublic information about a corporation. Examples of an insider are a company's directors and officers. Stockholders who own more than 10% of a company are also insiders.

Instructions. A person directs, orally or in writing, another person (e.g., a broker) to purchase or sell securities when the person is not aware of material nonpublic information.

"Material" information. Information regarding certain aspects of a company that would have at least a small impact on the company's share price if disclosed, or that a reasonable investor would consider important in making an investment decision.

"Nonpublic" information. Information that has not been disseminated in a manner making it generally available to investors.

Rule 144. An SEC rule that sets the conditions under which restricted, unregistered and control securities can be sold.

Securities and Exchange Commission (SEC). A government commission created by Congress to regulate the securities markets and protect investors. In addition to regulation and protection, it also monitors corporate takeovers in the United States. The statutes administered by the SEC are designed to promote full public disclosure and to protect the investing public against fraudulent and manipulative practices in the securities markets.

Trading window. A time period established by an issuer when it permits discretionary trading in its securities.