

SECURITIES ALERT

RULE 10b5-1 TRADING PLANS UNDER FIRE



Executives who participate in Rule 10b5-1 trading plans should beware. The SEC may be shifting its focus from the stock option backdating scandal that monopolized the headlines in 2006 to investigate trading by company insiders under Rule 10b5-1 trading plans. Similar to the stock option backdating scandal, a study by a university professor, in this case, Alan D.

Jagolinzer, an assistant professor at the Stanford University Graduate School of Business, has brought the safe harbor of Rule 10b5-1 under fire.

The SEC enacted Rule 10b5-1 in 2000 to protect trades made by company insiders from civil or criminal penalties if the trades are planned in advance and at times when such insiders do not possess material nonpublic information. However, the study by Jagolinzer raised eyebrows at the SEC as to whether insiders are in reality making strategic and planned trades under the Rule 10b5-1 safe harbor. The study revealed that trades made under Rule 10b5-1 trading plans beat trades made outside of such plans by nearly 6 percent. Is this just a coincidence? The SEC is not convinced. In recent speeches, Linda Chatman Thomsen, director of the SEC's Division of Enforcement, indicated that the SEC is taking a hard look at whether these plans are being abused to facilitate trading based on inside information.

Although Rule 10b5-1 sets forth certain requirements that insiders must follow when establishing a trading plan, insiders still have a large degree of flexibility regarding the plan, including the ability to terminate the plan at any time, to begin trading immediately after adopting the plan and to set up multiple short-term plans. This flexibility partially may explain the results of the Jagolinzer study, which reflected that a large portion of Rule 10b5-1 sales were made prior to the release of adverse news and that insiders often terminate plans before positive shifts in the stock price.

New Century Financial Corp., a mortgage firm whose stock recently collapsed, is one company that already may be the target of an SEC investigation for sales made under Rule 10b5-1 trading plans. Months before the collapse of New Century's stock, two of its founders sold significant amounts of stock under trading plans, raising the question of whether they knew or at least suspected that the company's demise was imminent. Increased SEC scrutiny of trades made by executives of other companies is likely to follow.

To avoid an SEC investigation, companies and their insiders are urged to carefully review any existing or currently proposed Rule 10b5-1 trading plans and the underlying trades. Most companies regulate Rule 10b5-1 trading plans through their insider trading policies, often requiring insiders to obtain pre-clearance before entering into the plan. Although not currently mandated by Rule 10b5-1, companies and insiders should consider the following best practices when adopting such plans:

- Prohibit trading under the plan for a period of time after the plan is adopted. Although it is fairly common for trading plans to have a 30-day waiting period, insiders should consider extending this time frame to 60 or 90 days to minimize arguments that the insider had knowledge of material inside information prior to the trade.
- Avoid terminating a trading plan prematurely. An insider who terminates a trading plan early may create a question of whether the insider entered into the trading plan in good faith, particularly if the insider then enters into another trading plan shortly thereafter. Companies and insiders may consider including a provision in the trading plan that allows the insider to terminate the plan only in limited circumstances.
- Avoid plans that involve large sales over a short period of time. Several insider trades that are currently under review involve an insider selling significant amounts of stock in a relatively short period prior to a large decline in stock price. Plans that provide for regular sales over a period of time are less likely to raise suspicion.
- Adopt a trading plan only during the company's "open window" trading period. Entering into a plan during a window period will strengthen the insider's argument that he or she was not in possession of inside information.

CONTACT INFORMATION

If you have questions about the SEC's interest in Rule 10b5-1 trading plans, please contact:

Ambika Kuckreja
akuckreja@akingump.com
1.866 AKIN LAW

Austin	Beijing	Dallas	Dubai	Houston	London	Los Angeles	Moscow
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