

Rule 10b5-1 Trading Plan Best Practices

The following document addresses a few of the most salient points concerning the implementation of a Rule 10b5-1 trading plan.

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Insider trading restrictions can be a constant headache for companies and their executives. Executives who receive a significant portion of their compensation in the form of options, restricted stock, or stock grants, have a continual need to purchase or sell stock. Yet SEC regulations, company insider trading policies, and fears of allegations of insider trading keep many executives from properly diversifying their holdings.

Rule 10b5-1 trading plans are an ideal solution to this problem. Properly-drafted Rule 10b5-1 plans allow executives flexibility to sell stock without regard to limitations imposed by companies' insider trading policies while complying with SEC regulations. They also provide an affirmative defense to allegations of insider trading.

The following addresses a few of the most salient points concerning the implementation of a Rule 10b5-1 trading plan.

HOW RULE 10B5-1 PLANS WORK

Rule 10b5-1 creates an affirmative defense to charges of insider trading by creating a plan for future purchases or sales of stock. Rule 10b5-1 says that, so long as the plan is adopted at a time when the entering party is not in possession of material non-public information, the entering party is protected from insider trading liability even if they come into possession of material non-public information by the time stock transactions actually occur.

To be effective, a Rule 10b5-1 plan must be in writing and must meet three requirements. It must state the:

- Number of shares to be bought or sold. This can be designated as a number of shares, as a percentage of the executive's holdings, or as the number of shares needed to produce a specific dollar amount. Rule 10b5-1 plans can provide for multiple transactions, therefore, different amounts of shares can be designated for each purchase or sale.
- Prices at which the shares will be bought or sold. This can be designated as a specific dollar price, a limit order price, or as the prevailing market price. Prices can include multiple transactions at different prices to provide flexibility.
- Timing of the purchases or sales. This can be designated as a specific date or time, or at the time at which a specific event occurs.

THE BENEFITS OF RULE 10B5-1 PLANS

Rule 10b5-1 plans are easy to implement and use. Baird has a standard 10b5-1 contract available for your use. Once a plan is in place, the plan's instructions are executed without further assistance from the client.

Rule 10b5-1 plans, if properly prepared, can help executives comply with SEC trading regulations, such as sections 13 and 16(b). They can also allow executives to trade outside company "trading windows." Many companies have insider

trading policies specifically permitting transactions made pursuant to Rule 10b5-1 plans to occur outside trading windows and without compliance with other limitations, such as pre-clearance requirements. This is a huge benefit for executives, who often find they are prohibited from making trades in their company's stock as many as nine months of the year. Rule 10b5-1 plans also create a built-in protection against allegations of insider trading. Transactions made pursuant to Rule 10b5-1 plans can thus be made while the executive possesses inside information regarding unannounced mergers or acquisitions, upcoming financial results, new products, and the like.

The main restriction on the use of Rule 10b5-1 plans is that, to be valid, they must be adopted while the executive does not possess material non-public information. The executive must also refrain from attempting to influence how, when, or whether transactions will be made pursuant to the plan.

Rule 10b5-1 also has a general "good faith" provision that gives the SEC the right to challenge the affirmative defense created by Rule 10b5-1 when it suspects abuse. For this reason, it is recommended that executives refrain from modifying or canceling plans once they are in place (although modifications are permitted by Rule 10b5-1 and may be appropriate in rare cases). It's also a good idea to include a termination clause which will suspend trading upon, among other occurrences, the company's merger or acquisition, an underwritten public offering, a change in the executive's employment status, and a number of personal events, such as divorce, ill health, and bankruptcy.

THE FLEXIBILITY OF RULE 10B5-1 PLANS

Many executives fear Rule 10b5-1 plans might force them to purchase or sell stock at inopportune times or at unfavorable prices. But Rule 10b5-1 is sufficiently flexible to accommodate almost all financial or business objectives. So while a Rule 10b5-1 plan might give very straightforward instructions ("sell 1000 shares at the market price on the 15th of every month for the next 2 years"), it could also provide for very sophisticated trades tailored to an executive's financial situation and goals.

The following strategies should be considered for maximizing the flexibility of a Rule 10b5-1 plan:

- **Short duration** - Rule 10b5-1 plans can be of any duration. One frequent objection to Rule 10b5-1 plans, that they lock executives into trading strategies that may become outmoded over time, can easily be overcome.
- **Small percentage of holdings** - Some executives mistakenly believe that Rule 10b5-1 plans must cover all their holdings. Not so. An executive can make only a small part of his holdings (perhaps 20 or 25 percent) subject to Rule 10b5-1 instructions. Alternatively, an executive could provide for sales of a small portion of his holdings on a regular schedule, but provide for sales of a larger portion if certain price targets are reached. One caution: it is strongly discouraged for an executive to trade outside a currently-in-place plan. Trades outside a plan not only lose all the protections available under Rule 10b5-1, but they also are hard to explain as part of a pre-planned diversification strategy.
- **Minimum Price "Floors"** - No one wants to sell stock at a low price. One easy way to prevent this is by including a minimum price floor in every Rule 10b5-1 plan. Multiple price floors, which increase over specified periods of time, can also be used.
- **Multiple Price Targets** - Executives who want to maximize their return can create a matrix of future price targets. This strategy addresses a common concern of executives -- that plan sales will occur at prices that will feel, in hindsight, to have been too low. Executives can deal with this risk by providing for sales of certain numbers of shares at easily achievable price targets, and additional sales in the (less likely) event that more aggressive price targets are achieved.
- **Indices, Price Gaps and Industry Moves** - Some executives base trading decisions on how their company's stock performs relative to various market or industry indices, or relative to certain selected competitors. Rule 10b5-1 is flexible enough to accommodate these types of strategies. A plan could, for example, provide for sales when a particular market indicator rises 10 percent in a two-month span, or when one company's stock outperforms a benchmark index (or a competitor's stock) by 10 percent over a specified period. Sales could

also be triggered by a 'gap' in a company's stock price: for example, when a company's stock opens more than 5 percent over the prior day's close.

- **Personal Financial Milestones** - Stock sales are often driven by a number of personal financial considerations, including home purchases or remodels, college tuition payments, and the like. All of these can be built into custom-tailored Rule 10b5-1 plans. For example, a plan could provide for sales 15 days before a college tuition payment for the executive's child is due, with the number of shares to be sold linked to the average cost of tuition as published by the college.

PUBLICITY REGARDING RULE 10B5-1 PLAN SALES

Executives are rightly concerned about the impact their stock sales might have on investors. They worry that future stock sales effected under a Rule 10b5-1 plan might occur at inopportune times and could lead to criticism (or even lawsuits) by shareholders.

Executives may take the following steps to minimize the risk of adverse publicity from trades made under their Rule 10b5-1 trading plans:

- **Publicly disclose new plans** - Shareholders dislike surprises. The best way to prevent unhappy surprises is to make a public disclosure each time an executive adopts a new Rule 10b5-1 plan. Investors are less likely to react negatively to stock sales if they know in advance about an executive's plan. Some CEOs have issued press releases or used Form 8K to disclose the adoption of new Rule 10b5-1 plans. There is no need to provide the details of the plan.
- **Delay transactions until after public disclosure** - It is sometimes recommended that Rule 10b5-1 plans have an effective date at least 30 days after the plan is publicly disclosed to shareholders. This minimizes the risk of adverse publicity and also should help combat any "good faith" challenge to the plan by the SEC. After all, a plan is only effective if it is adopted while the seller does not possess inside information. The seller's defense on this issue is strengthened if some time passes before the first sales are made.
- **Report plan sales on Form 4s** - Executives must file Form 4s reporting all transactions in their company's stock. It is recommended that Form 4s for sales made pursuant to Rule 10b5-1 plans specifically note that the sales were made pursuant to the plan. That way, investors or analysts monitoring stock sales by insiders will know the sales were made pursuant to a previously-established trading plan, and do not represent a current investment decision by the executive.

CONCLUSION

Rule 10b5-1 trading plans can help one diversify their holdings of company securities in an orderly and regular fashion. If properly designed, disclosed, and followed, such plans can accomplish one's investment goals, without being limited by insider trading policies, and while creating an affirmative defense to insider trading.

For more information, contact your Baird Financial Advisor.