

Rule 10b5-1 Plans

A topical review of SEC Rule 10b5-1 and the flexibility it affords corporate executives seeking methods of managing their ownership in company stock

Executive Consulting of Raymond James

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Corporate trading policies limit the number of days when company insiders are allowed to transact in their stock. These restrictions may reduce the number of days in open trading windows to less than 60 days per year.

These trading restrictions can make it difficult for company executives to manage their personal holdings, which often represent a source of concentration risk within their broader investment portfolios.

Utilizing a 10b5-1 plan allows the insider to establish a trading plan that allows for transactions in the stock during blackout periods that surround important corporate events, announcements and quarterly earnings releases.

As long as the plan is established in good faith at a time when the executive is not in possession of material, nonpublic information; defines the price, number of shares, and dates for any transactions; and prohibits any future influence over execution by the executive who does not continuously cancel existing plans while instituting a new plan shortly thereafter, the executive receives an affirmative defense against allegations of insider-trading violations.

ILLUSTRATIVE STOCK PRICE CHART OVER ONE CALENDAR



The above charts are hypothetical and do not represent a specific security.

SEC Rule 10b5-1

Rule 10b5-1 offers corporate insiders a way to transact in company stock over a predefined period of time, even if the insider becomes aware of material, nonpublic information during the transaction period, as long as the transaction is done according to a pre-existing plan that was established when the insider was not aware of any material, nonpublic information.

10b5-1 plans allow a corporate executive to institute a mechanical buying, selling, or hedging program while in an open trading window that is then set on autopilot and executes transactions in company stock for the executive over time according to the parameters of the plan.

This tool can be useful for executives that face limited windows of opportunity to transact in company stock due to strict corporate trading policies. These policies can sometimes limit the number of days in which an insider can transact in stock to fewer than 60 days in a calendar year.

History of Rule 10b5-1

Rule 10b5-1 was created in October of 2000 to help settle an insider-trading issue that arose from conflicting decisions by the courts of appeals. The conflict arose in determining the actions that would trigger insider-trading rule violations by executives in possession of material, non-public information. Some courts decided that a violation only occurred if the executive used the material, nonpublic information as the basis for a transaction in company stock. Others felt that it was a violation to transact in company stock while in possession of the information – regardless of whether it affected the executive’s decision or not.

The SEC decided the broader “possession” based standard would be used in defining insider-trading violations. This caused concern that executives, who are often in possession of material, nonpublic information, would face overly burdensome restrictions on managing their ownership of company stock. Thus, the SEC included within Rule 10b5-1 an affirmative defense for insiders that establish a transaction plan following the guidelines of the rule.

Requirements of Rule 10b5-1

In order to be effective and provide the insider with an affirmative defense against allegations of insider-trading, a 10b5-1 plan must meet certain requirements.

- The plan must be in writing and established in good faith at a time when the executive is not in possession of material, nonpublic information.
- The plan must specify the number of securities to be traded, the price at which transactions should take place, and the dates on which transactions should occur. These inputs can be static or formula driven.
- The plan prohibits the executive from exercising any further influence over how, when, or whether to effect trades under the plan specifications.

In addition to the requirements of Rule 10b5-1, the plan must also adhere to the company's internal trading policies regarding open trading windows for corporate executives. Additionally, corporate counsel is often required to provide a statement approving the plan before it can be enacted.

Changes to Existing Plans

Changes to an existing 10b5-1 plan are allowed as long as they are made when the executive is not in possession of material, nonpublic information and in an open trading window. Typically, the company must approve the changes before they can be enacted.

Cancellations can occur at any time, even if the executive is in possession of material, nonpublic information.

However, the "good faith" requirement for executives entering into 10b5-1 plans cannot be overemphasized. Insiders may lose the affirmative defense afforded by Rule 10b5-1 if changes or cancellations are deemed to have been made as part of a plan to evade insider trading laws.

Careful consideration should go into setting up a 10b5-1 plan to avoid the need to make future modifications or cancellations of the plan. Before a plan is changed or cancelled, the executive should consult with their personal legal counsel and corporate counsel to determine if the modification will result in a negative consequence from an SEC investigation.

Best Practices

In order to maximize the flexibility and effectiveness of a 10b5-1 plan, Executive Consulting recommends the following strategies when implementing a 10b5-1 plan:

- **Implement the plan on a portion of your holdings** | Some executives have the perception that a 10b5-1 plan to sell stock must involve all of their company shares. This is not the case. Implementing the plan on a portion of your shares offers you continued flexibility on the shares not in the plan, and may present a better signal to the market of your belief in the long-term prospects for the company.
- **Use a short duration** | 10b5-1 plans can be for any duration, however, we recommend setting them up for no longer than one year. This way, as market conditions change over time, the trading strategy can be adjusted without changing the plan while in effect.
- **Use the plan to be disciplined** | Building specific price limits into a 10b5-1 plan allows you to create a disciplined plan for transacting in company stock, avoiding emotional biases that can lead to compromised financial decisions.
- **Set it and forget it** | The SEC has clearly identified situations involving 10b5-1 plans that are modified or cancelled repeatedly as a sign of potential violations of the 'good faith' requirement within Rule 10b5-1. Corporate executives should think through the variables of a plan thoroughly prior to implementation and then allow the plan to proceed without change or cancellation except for in extreme situation where a modification or cancellation is absolutely necessary. Even if the executive is not in possession of material nonpublic information, changing or cancelling a plan could give the appearance of insider trading if an unexpected news announcement were to come out shortly after the adjustment in favor of the executive's plan alterations.
- **Use a seasoning period** | A common part of 10b5-1 plans is to build in a delay between when the plan is adopted and when the first transaction can occur. This 'seasoning period' puts some distance in between the time the variables of the plan were determined and when the first trade occurs, which can strengthen the argument that the trades were not reliant upon any material nonpublic information. The most common seasoning period is thirty days, although it can be shorter or longer depending on the executive's circumstances and the company's trading policies.
- **Keep it straightforward** | In order to avoid confusion or misinterpretations of the plan's objectives, trading instructions should be kept as clear and concise as possible. Complicated algorithms based on rolling volume and price data are possible, but open the door for potential grey areas that put the decision to execute or not into the hands of a trader without a clear understanding of the executive's intentions. Keeping the trading instructions as straightforward as

possible helps to ensure the executive's objectives are met by the plan's execution.

Communication of the Plan

Corporate executives are typically concerned about the impact their stock sales have on market perceptions. If sales occur under a 10b5-1 plan at inopportune times, executives worry that they will receive criticism from existing shareholders.

To minimize the risk of adverse publicity from transactions executed by insiders under their 10b5-1 plan, we recommend the following techniques:

- The company should consider publicly disclosing new 10b5-1 plans through a press release, 8-K filing or reference in the next 10-Q filing; there is no need to disclose the specific terms of the plan but it should indicate that a plan was adopted by the individual or a general statement that certain executives at the company have adopted a sales plan pursuant to Rule 10b5-1
- Include a time delay between the plan's creation/disclosure date and effective date for when transactions can occur, often referred to as a "seasoning" or "cooling-off" period
- Footnote Form 4 and Form 144 filings with a statement identifying that the transactions occurred pursuant to an existing 10b5-1 plan

Regulatory Considerations

While 10b5-1 plans allow insiders to transact in company stock through corporate trading blackout periods, they do not eliminate the regulatory restrictions placed on company affiliates under Rule 144 or Section 16.

An "affiliate" is generally defined as a person who controls or is controlled by the company. This category includes officers, directors, and beneficial owners of more than 10% of the outstanding shares.

Affiliates who are selling company stock under a 10b5-1 plan must follow certain guidelines pursuant to Rule 144 of the Securities Act of 1933, which include:

- **Volume limitations** | During any three-month period, the amount of stock that can be sold is the greater of the average weekly trading volume during the prior four calendar weeks or 1% of the outstanding shares
- **Notice of sale** | Form 144 must be sent to the SEC at or prior to the time an order to sell is entered

- **Manner of sale** | Shares may only be sold through brokers' transactions or a market maker in the stock; buy interest may only be solicited through natural buyers that have approached the broker or seller within the past 10 business days
- **Holding period** | Registered shares held by insiders do not have a holding period requirement; unregistered shares owned by anyone must be beneficially owned for at least six months before they can be sold or hedged
- **Public information** | There must be adequate current public information available on the company

Section 16 of the Securities Exchange Act of 1934 also applies to affiliates of publicly traded companies. This regulation has three sections:

- **Filing forms** | Section 16 designates Forms 3, 4 and 5; Form 4 must be filed upon any change in beneficial ownership
- **Short swing profits** | Sales and purchases in company stock will be matched to opposite transactions that occur within six months of each other, calculated both forward and backward, and if the transactions generate any profit, it must be disgorged back to the company
- **Prohibition on short sales** | Affiliates may not sell company stock short, which involves selling shares borrowed from a stock lender instead of shares owned outright by the individual

Additional Applications

The most common application of 10b5-1 plans allows insiders to sell a portion of their holdings through a mechanical program over a predefined time period. However, there are additional strategies that can be built into a 10b5-1 plan worth noting, including:

- **Purchasing stock** | Company insiders can establish a plan to purchase stock if the market price hits a desired entry point; plans can also be used to facilitate corporate share repurchases
- **Exercising options** | 10b5-1 plans can be used to exercise both non-qualified and incentive stock options if the executive is concerned about being in a corporate trading black-out when the option contracts are set to expire; the plans can accommodate any type of exercise method as well
- **Stock vesting events** | Executives with restricted stock, restricted stock units, performance shares and other award types that have a future vesting date typically

need to pay a tax withholding at the time of vest; sales required to fund the withholding can be built into a 10b5-1 plan

- **Personal milestone events** | Individuals with a specific future event that requires a significant cash outlay, such as a child's college education or a vacation home purchase, may use a 10b5-1 plan to generate the necessary liquidity
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Sample Plan Terms

Below are examples of commonly used inputs for a variety of 10b5-1 plan applications.

- Sell 500,000 shares of XYZ at a price of \$50 or better with a maximum of 50,000 shares sold in any given trading day
- Sell 1,000,000 shares of ABC in total, 250,000 shares at a limit price of \$40, 250,000 shares at a limit price of \$42, 250,000 shares at a limit price of \$44, and 250,000 shares at a limit price of \$46
- Exercise an incentive stock option for 20,000 shares of LMN if the stock's market price exceeds the option's strike price by \$20
- Execute a two year variable prepaid forward contract with a 100% floor and 120% cap on 250,000 shares of GHI as long as the upfront payment on the contract exceeds 84% and the stock is above \$40
- Sell an amount of stock resulting in total proceeds net of commissions that approximates the published semester tuition rate for the University of Higher Education on December 1, 2011

Conclusion

A Rule 10b5-1 plan is an effective tool available to public company executives. Navigating the complexities of insider trading regulations requires the assistance of a team with expertise in Rule 144, Section 16 and Rule 10b5-1. The Raymond James Corporate & Executive Services team has designed and executed 10b5-1 plans for thousands of clients over the years. Our team is available to provide advice in developing a 10b5-1 strategy, drafting the necessary contracts and executing transactions according to the plan's instructions.

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