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Insider Trading: New Rules, New Planning Opportunities

The SEC recently adopted new insider trading rules that clarify and expand the prohibition against insider trading. New Rule 10b5-1 also includes affirmative defenses that enable an insider to structure a selling program that will not violate insider trading laws. The new rules, which were adopted at the same time as Regulation FD, took effect on October 23, 2000.

Although adopted with little fanfare, the new insider trading rules – particularly the new affirmative defenses – may have more far-reaching implications than Regulation FD for insiders of public companies.

Public companies should review their insider trading policies and practices in light of these new rules, and individual insiders should consider adopting pre-arranged trading programs. See **"Planning Opportunities Under the New Insider Trading Rules"** below.

Rules 10b5-1 and 10b5-2 and the adopting release are available on the SEC's website at www.sec.gov/rules/final/33-7881.htm.

Overview of the New Rules

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 have been interpreted by courts to prohibit the purchase and sale of a security of any issuer *on the basis of* material nonpublic information about that security or issuer, in breach of a *duty of trust or confidence* owed to the issuer or the party providing the information. New Rule 10b5-1 defines "on the basis of" and provides affirmative defenses against insider trading liability. New Rule 10b5-2 defines several circumstances in which a person has a "duty of trust or confidence."

Rule 10b5-1 - Establishment of the Awareness Standard

Before the enactment of Rule 10b5-1, courts had been split on whether insider trading liability required proof that a trader actually "used" material nonpublic information or whether proof that a trader was in "knowing possession" of such information at the time of a trade was sufficient. *New Rule 10b5-1 provides that a person has traded "on the basis of" material nonpublic information if the person was "aware" of the material nonpublic information when making the purchase or sale.* It is not necessary to prove that the trader used or was otherwise influenced by the information in making the trading decision.

Rule 10b5-1 also sets forth two affirmative defenses or exceptions to liability. These defenses effectively serve as safe harbors from the application of Section 10(b) and Rule 10b-5 for persons who trade while aware of material nonpublic information.

Affirmative Defense Based on Prior Contract, Instruction or Written Plan

The first affirmative defense is available to any individual or entity that can demonstrate that the purchase or sale in question occurred pursuant to a binding contract, specific instruction or written plan that the person put into place before becoming aware of the material nonpublic information.

Under this defense, a person who trades while being aware of material nonpublic information will not be liable for insider trading if the person can demonstrate that he or she took one of the

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following steps *before becoming aware of the material nonpublic information*:

- entered into a binding *contract* to purchase or sell the security;
- *instructed* another person to purchase or sell the security for the instructing person; or
- adopted a *written plan* for trading securities.

The contract, instruction or written plan must either:

- specify the amount, price and date of the transaction;
- include a written formula, algorithm or computer program for determining the amount, price and date of the transaction; or
- not permit the person for whom shares are being purchased or sold to exercise any subsequent influence over how, when or whether to effect purchases or sales, while at the same time ensuring that the person effecting the trades is not aware of any material nonpublic information at the time of the trades.

Definitions. The definitions of amount, price and date are important elements of the affirmative defense:

- "Amount" means a specified number of shares or a specified dollar value of shares.
- "Price" means the market price on a particular date, a limit price or a fixed dollar price.
- "Date" means (1) in the case of a market order, the specific day on which the order is to be executed or (2) in the case of a limit order, a day on which the limit order is in force.

Deviations from the contract, instruction or written plan. To take advantage of the first affirmative defense, a person must carry out the trading activity in accordance with the specifications of the contract, instruction or written plan. If a trader deviates from or alters the specifications while in possession of material nonpublic information, the defense will not be available for subsequent trades. It is unclear whether the affirmative defense will also be lost retroactively for trades already completed. A person may, however, change the specifications of the contract, instruction or written plan during a time in which he or she does not possess material nonpublic information without losing the availability of the affirmative defense. The SEC believes that any change made by a person in good faith at a time when he or she is not aware of material nonpublic information constitutes the creation of a new contract, instruction or written plan.

Hedging eliminates availability of defense. A person will lose the availability of the rule's affirmative defense if he or she entered into a corresponding or hedging transaction that has the effect of offsetting a trade made in accordance with a contract, instruction or written plan.

Good faith requirement. In order to rely on the defense, a person must enter into the contract, instruction or written plan in good faith and not with the intent to evade the insider trading prohibitions.

Benefits and drawbacks of pre-arranged trading programs. There are both benefits and drawbacks of pre-arranged trading programs.

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If a pre-arranged program is established and followed, it will offer the following benefits:

- Pre-arranged trading will provide insiders with an opportunity to diversify their holdings with confidence that the insider will not violate the insider trading rules even if the insider is aware of material nonpublic information at the time a trade is executed under the program.
- Any pre-arranged trading program that is announced publicly could deflect adverse public and media reaction to transactions that may otherwise suggest that an insider took advantage of material nonpublic information.
- Prior public announcement of a pre-arranged trading program could reduce the likelihood of a company becoming the target of shareholder litigation since allegations of insider trading are frequently an important part of class action

litigation commenced against a company after a sudden drop in stock price.

However, pre-arranged trading programs also present several drawbacks:

- The insider loses some investment control (and in the case of a blind trust, all investment control) over the trading activity.
- If public disclosure of a pre-arranged trading program is made, any failure of the insider to sell in accordance with the plan could raise questions in the market.
- Trading under a pre-arranged trading program does not eliminate the possibility that a lawsuit could be filed alleging insider trading. The insider has the burden of proving that he or she sold pursuant to a pre-arranged trading program established in accordance with Rule 10b5-1.

Additional Affirmative Defense Available to Entities

The second affirmative defense is available to *entities* that can demonstrate that:

- the individual making the investment decision on behalf of the entity was not aware of material nonpublic information; and
- the entity had implemented reasonable policies and procedures, taking into consideration the nature of its business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information.

This defense is not available to natural persons.

Blind Trusts: Another Possible Route

In addition to the affirmative defenses of Rule 10b5-1, the SEC has indicated that an insider may be protected from liability for insider trading with respect to any purchase or sale of shares through a "blind trust." While the SEC has not established parameters for a "blind trust," we believe that:

- the trust should not be established at a time when the insider possesses material nonpublic information;
- the insider should turn over all investment authority to the trustee; this means that the insider may neither be consulted about, nor exercise influence over, the timing, amount or price of any purchase or sale transaction;
- the trustee should be an independent third party;
- the trust should be irrevocable; and
- the trustee must not be in possession of material nonpublic information at the time of any purchase or sale.

If the trust is considered an "affiliate" of the company, as would often be the case, the terms of the trust should allow for the company to suspend sales to the extent required by any pooling lock-up periods or as otherwise required by law.

Rule 10b5-2 – Duty of Trust or Confidence in Misappropriation Cases

The misappropriation theory of insider trading provides that a person violates Rule 10b-5 by misappropriating and trading on inside information in breach of a duty of trust or confidence. The theory applies most clearly in cases involving misappropriation of confidential information in breach of an established business relationship, such as an attorney-client or employer-employee relationship.

New Rule 10b5-2 extends the misappropriation theory to family or other non-business relationships. Under this rule, a person receiving confidential information under the following circumstances owes a duty of trust or confidence, and thus would be liable for insider trading under the misappropriation theory if:

- the person agreed to keep the information confidential;
- the persons involved in the communication had a history, pattern or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; or
- the person who provided the information was a spouse, parent, child or sibling of the person who received the information, unless it is

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shown affirmatively, based upon facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality.

Planning Opportunities Under the New Insider Trading Rules

Examples of Pre-Arranged Trading Programs

The affirmative defenses contained in Rule 10b5-1 serve as guidelines for the creation of programs that allow an individual or entity to prescribe in advance the timing and terms of securities trades. For example, an insider could:

Pre-arranged trading programs can be set up according to the affirmative defenses contained in Rule 10b5-1.

- enter into a written plan to:
  - ~ sell a fixed number or fixed dollar amount of shares at the prevailing market price on a fixed day every quarter;
  - ~ sell a fixed number or fixed dollar amount of shares at the prevailing market price the day after the stock closes at a new high;
  - ~ sell a fixed number or fixed dollar amount of shares on the first day that the stock price reaches a certain dollar amount; or
  - ~ sell a fixed number or fixed dollar amount of shares on a fixed day every quarter, provided the stock price is not lower than a certain dollar amount (or a fixed dollar amount that increases by some percentage every month);
- provide his or her broker with instructions to immediately sell all shares received under an employee stock purchase plan;
- enter into a written plan for programmed exercise and sale of stock options; or
- enter into a trust arrangement (which need not be as restrictive as the blind trusts which are discussed above) delegating to the trustee the authority to sell stock subject to general parameters as to timing and price established at the time that the trust is created.

What Should Companies Do?

- Advise insiders of the opportunities and the pitfalls of pre-arranged trading programs.
- Encourage use by insiders of best practices. See "Best Practices for Pre-Arranged Trading Programs" below.
- Review insider trading policies to determine whether they should be revised to:
  - ~ allow purchases and sales of company securities during any blackout period if such purchase or sale is made pursuant to a pre-arranged trading program meeting the requirements of Rule 10b5-1; or
  - ~ prohibit insiders from establishing or modifying pre-arranged trading programs during any blackout period under the company's internal policies.

It is permissable under Rule 10b5-1 to allow trading activity pursuant to a pre-arranged trading program to take place during a blackout period. However, to avoid the appearance of improper trading by insiders, a company may determine as a matter of policy to continue to restrict trading activity, including trading pursuant to pre-arranged trading program, during a blackout period. While there is no right or wrong answer to this policy question, the argument for allowing trading activity pursuant to a pre-arranged trading program to occur during a blackout period is stronger when the program is structured to include weekly or monthly transactions, rather than only quarterly transactions. If a pre-arranged trading program includes only quarterly transactions, then it would be prudent to schedule those transactions to occur shortly after the company's quarterly earnings announcement.

It may also be permissable for an insider to establish a pre-arranged trading program during a company blackout period provided that trading activity under the program is delayed until the blackout period ends and any material nonpublic information is disclosed to the public. Nevertheless, to avoid the appearance of improper trading by insiders, a company may determine as

a matter of policy to prohibit insiders from establishing pre-arranged programs during any blackout period.

- Require approval by the company of any pre-arranged trading program proposed by persons subject to a company's insider trading policies.
- Consider public disclosure of pre-arranged trading programs (through a press release, Form 8-K or periodic filing made pursuant to the Securities Exchange Act). Public disclosure of pre-arranged trading programs has advantages and disadvantages:
  - ~ Public disclosure of trading pursuant to a pre-arranged trading program could have the effect of deflecting any adverse public and media reaction to transactions that may otherwise suggest that an insider took advantage of material nonpublic information. Public disclosure may also reduce the likelihood of a company becoming the target of shareholder litigation.
  - ~ However, if advance public disclosure is going to be made, the company and the insider need to be comfortable with the possible need in the future to update the disclosure and to answer potentially embarrassing questions if the insider does not proceed with a transaction in accordance with the original plan.
- Encourage insiders to include, in any Form 144, Form 4 or Form 5 reporting a transaction made pursuant to a pre-arranged trading program, a footnote stating that fact.
- Consider structuring company repurchase programs in accordance with Rule 10b5-1.
  - ~ Rule 10b-18, which provides a safe harbor under certain stock manipulation rules for company stock repurchase programs, does not provide protection against insider trading claims. Accordingly, companies engaged in stock repurchase programs often have suspended repurchases during company blackout periods. Under Rule 10b5-1, companies can implement repurchase programs while the company is not aware of material nonpublic information and can continue to make repurchases in accordance with the plan, whether or not the company is aware of material nonpublic information.
  - ~ In order to maintain flexibility to modify the plan when the company is not aware of material nonpublic information, a company may wish to adopt a written plan that includes a formula for repurchase activity rather than to delegate complete authority to a third party.
  - ~ In any event, the company should continue to structure any repurchase program in accordance with Rule 10b-18.
- Encourage use of written confidentiality agreements with third parties because new Rule 10b5-2 extends the misappropriation theory to anyone who has agreed to keep the information confidential.

Best Practices for Pre-Arranged Trading Programs

Individual insiders who wish to adopt pre-arranged trading programs should follow the following practices to maximize the likelihood that the affirmative defenses offered by Rule 10b5-1 will be available to them:

- Document in writing all contracts, instructions or written plans that are intended to meet the requirements of the defense (plans must be in writing; contracts and instructions are not required to be in writing but should be).
- Do not enter into the contract, instruction or written plan while aware of material nonpubic information or during a blackout period.
- Obtain approval from the company of any contract, instruction or written plan, if required under the company's policies, and in any event inform the company in advance.
- Design the program to require suspension or termination of any contract, instruction or

Insiders should be encouraged to use best practices to maximize the likelihood that the affirmative defenses will be available to them.

written plan upon notice by the company that trading activity would have an adverse effect on the company (such as a sale by an insider that would jeopardize pooling of interests accounting treatment for a merger or would interfere with lock up obligations imposed on insiders in connection with a public offering) or cause a violation of law (such as an offering by a company that would cause purchases by an insider to violate Regulation M or a merger of the company that would cause sales by an insider to result in liability under Section 16).

- Avoid making changes to the program to the extent possible because any change will call into question the availability of the defense.
- Consider Section 16 and Rule 144 implications. The rules relating to insider reporting and short swing profit liability of Section 16 of the Securities Exchange Act and the requirements of Rule 144 continue to be applicable to transactions executed in accordance with a pre-arranged trading program. However, a "blind trust," under which all investment authority is turned over to a trustee, may be exempt from the reporting obligations and short swing profit liability provisions of Section 16 under the Securities Exchange Act.

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