General Counsel Update

DAVIS POLK & WARDWELL

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Rule 10b5-1 Selling Plans: Time to Revisit Corporate Policies

Insider selling plans under SEC Rule 10b5-1, once considered a virtual safe harbor, are increasingly coming under scrutiny. A December 2006 academic study looked at 117,000 plan transactions over the past five years and found that, on average, 10b5-1 trades outperformed the market by about 6 percent six months after the trades were executed, suggesting "that, on average, trading within [rule 10b5-1] does not solely reflect uninformed diversification." Even though there are a number of benign reasons why such outperformance might occur, the study evoked memories of the statistical analyses that touched off the option backdating scandals.

Over the past year the concern has gathered momentum:

» SEC officials have suggested on several occasions that 10b5-1 plans could become a new enforcement target.

» The former CEO of Qwest was convicted of insider trading even though some of the trades in question were under plans.

» Executives at Countrywide and other companies are coming under scrutiny for recent sales following amendments to their 10b5-1 plans.

» The plaintiffs' bar no longer appears to view 10b5-1 sales as conveying virtual immunity.

These developments are causing corporate policymakers to revisit whether 10b5-1 plans are desirable and, if so, what limits companies should impose on insiders. We have discussed this issue with a wide range of companies and can report that corporate America is all over the map on this subject, with no "best practices" consensus having emerged. Some prominent companies have banned the use of 10b5-1 plans altogether. Others have imposed stringent limits on the formation and amendment of plans. Still others continue to actively encourage the use of 10b5-1 plans and have applied a comparatively light touch with such limits.

We think that there is a sensible middle path through this confused landscape, one that preserves the real benefits of the rule while safeguarding against the major risks. This is not an area where one size fits all, but the following points may be helpful as the beginning of a discussion.

Should we just ban 10b5-1 plans altogether? We believe this is an overreaction. Remember that insiders are going to be selling in any event, so the real choice is between automatic selling under a plan or discretionary selling under normal insider trading policies, with trading widows and blackouts and the like. It seems odd to us to conclude that selling under a conservatively-designed plan would be viewed as more risky than discretionary sales. We think the real discussion should concern how to set the limits: conservative enough to protect against the major risks, but not so stringent as to discourage insiders from setting up plans in the first place.

Should we encourage insiders to trade through 10b5-1 plans? The least risky insider sales are those that are part of a clear pattern. If the founder sells 100,000 shares every month to fund her foundation, then any particular month's sales should not arouse suspicion. Most executives don't have that luxury, but the principle remains: ideally senior management, who are the most vulnerable because of the value and public reporting of their trades, should be encouraged to sell in relatively modest increments over an extended period. In the first instance, of course, this is a cultural norm that needs to be modeled from the CEO down. A 10b5-1 plan is an excellent tool to implement this approach.

When should plans be created? Attacks are likely to focus on what was known at the time of plan creation or amendment, since the seller has the burden of demonstrating that the plan was created "before becoming aware of the [material nonpublic] information." The best time to put a plan in place is generally in the immediate aftermath of an earnings announcement, when the public disclosure is most current.

Worst case: CEO establishes or amends a plan at the end of the second month of the quarter, just before the trading window closes. The trigger price for sales is set just below current market. The stock drifts down, a huge sale is triggered, the company misses its quarter, the stock collapses. In this case the 10b5-1 plan may have given the CEO a false sense of security with respect to sales that should never have occurred.

What about waiting periods? Waiting periods are a good antidote to the problem described above. Many companies require that a trading plan be established only during an open trading window, and that trades under the plan may not occur for a specified period (often 30-60 days) or until after the opening of the succeeding trading window. This creates a separation of at least several weeks and will tend to rebut the notion that the insider was motivated by material nonpublic information.

Should we permit insiders to amend or terminate plans? The temptation is to say no, since it undercuts the whole notion of an automatic selling program, and a sequence of starts and stops can give rise to an inference of manipulation. But the desire for flexibility is natural, and if the program really is unalterable then people may be inclined not to use plans. A reasonable compromise may be to treat an amendment like a new plan, including waiting periods.

What other limits should we consider? Maximum term (we often see two years), maximum percentage of holdings sold in any given period, rules for setting price floors: any or all of these may be appropriate in a particular case.

Should we publicly announce when an insider adopts a plan? The SEC proposed this as a Form 8-K requirement but did not include it when the revised form was adopted in 2004. Even so, increasing numbers of companies are making these announcements with respect to senior management, generally including the number of shares covered but not the other details of the plan. These announcements are said to be in the spirit of "transparency," but given their limited content we worry that they may be misunderstood and may give rise to speculation. We generally are not seeing companies announce amendments or terminations.

Should we cut off 10b5-1 plan sales when a material corporate development occurs or is about to occur? The rule does not require this, and the idea runs counter to the basic idea that sales under the plan should relate back to the information in hand when the plan was established, not a current situation. But there are circumstances where a cutoff should be considered. The optics of insider sales being reported in the midst of a crisis—or, even worse, just before a crisis is announced—could be too much to contemplate.

Should we apply the same rules when insiders or the company itself <u>acquires</u> shares? We think that acquisitions often raise different concerns than selling plans and would not necessarily be governed by the same policies.

Please call your Davis Polk contact if you'd like to discuss these issues.