RAYMOND JAMES

Understanding 10b5-1 passive investment plans

Rule 10b5-1 plans provide an affirmative defense against insider trading claims for insiders wanting to trade company securities.

Company securities trading can wedge executives and other corporate officers between restrictive transaction windows and increased Securities and Exchange Commission scrutiny of sales made by those perceived as company insiders. A Rule 10b5-1 plan can help relieve that pressure.

SEPARATING THE DECISION FROM INFORMATION

By creating a passive investment plan, executives and other insiders can put distance between their intent to buy or sell securities and any material nonpublic information they may come to possess.

SEC regulations characterize this type of plan as an affirmative defense against an insider-trading claim. They are particularly useful for executives who need to regularly sell company equity for cash or diversification, but they can be useful for others with access to sensitive information.

Creating and following a plan is not an absolute defense, however. Effective plans are made in a good faith, attempt to follow the spirit of the law, built with rigor and durability and created without knowledge of any material nonpublic information.

Definitions

RULE 10B5-1: A Securities and Exchange Commission (SEC) rule that defines and prohibits insider trading – the purchase of a security on the basis of material nonpublic information.

RULE 10B5-1 PLAN: As company executives and others come into frequent contact with material nonpublic information about their companies, the SEC provided for the creation of these individual trading plans, which are intended to separate the decision to trade from any acquisition of material nonpublic information.

PLAN ESSENTIALS

Rule 10b5-1 plans are only as valuable a defense as their rigor. A plan should be created with:

- Specificity and schedules: Trades should be conducted on specified triggers like price changes, by schedule or by computer-aided algorithm for a limited but meaningful amount of time.
- No material nonpublic information: Plans should not be created or modified when participants possess material nonpublic information.
- Passive transactions: A plan participant should enable a third party to carry out the plan instructions and avoid making discretionary trades covered by the plan for the duration.

BENEFITS BEYOND PROTECTION

In addition to their role as an affirmative defense, Rule 10b5-1 plans can allow participants to trade company stock during blackout periods as long as the plan is clearly defined and complies with other regulatory restrictions.

Directors, officers and anyone who may come into contact with material nonpublic information – including executive assistants, employees and vendors – can custom design a plan to meet the diversification requirements or their custom needs.

Companies can benefit from executives and officers maintaining Rule 10b5-1 plans – to reduce the need to evaluate insiders' stock sales, and, if necessary, to defend against public criticism of stock sales that seem questionable.

PARTS OF A PLAN

How a passive investment plan achieves its goals allows for many options and interpretations, but general principles provide a guide.

DON'T PLANT A POISONED TREE

Setting up a Rule 10b5-1 plan while possessing material nonpublic information can invalidate it as a defensive tool, no matter how the plan is structured. Any modifications to the plan should likewise follow the same guidance, though participants should be wary of making changes often.

MAKE ONLY ONE

It's important to have just one Rule 10b5-1 plan, lest it appear you are using multiple passive investment plans to misuse or violate the spirit of affirmative defense as allowed by the regulation.

SET CLEAR CONDITIONS

Conditions triggering sales or purchases of company securities should be well-defined and simple to interpret, whether they are set by calendar date, value, price or computer-designed algorithm.

USE AN OUTSIDER

Select an independent third party to make transactions based on the instructions described in the plan. This avoids the risk of appearing to make discretionary trades affected by insider knowledge.

BUILD A DELAY

It is a best practice to set at least a 30-day waiting period into the plan, before a transaction can take place. This reduces the perception that a plan was made to take advantage of current conditions.

LIMIT THE TIME

The plan should remain in effect for a meaningful period of time, typically one year.

COORDINATE WITH OTHER TRADES

Plan participants should build their plans to conform to other rules, including those set by Rule 144 and Section 16, and in coordination with other restricted stock transactions not covered by the Rule 10b5-1 plan. All reporting requirements and selling restrictions continue to apply.

RULE 144: An SEC regulation that dictates the conditions when restricted, unregistered and controlled securities can be sold or resold.

SECTION 16: An SEC rule that describes reporting rules directors, officers and principal shareholders must follow.

CONSIDER PUBLICIZING THE PASSIVE INVESTMENT PLAN

Executive stock trades can breed discontent or anxiety among other shareholders. Companies may consider publicizing the passive investment plan to avoid bad publicity that could come from inadvertent but unfortunate timing.

STRENGTHEN COMPANY POLICY

It's in the best interest of the company for executives and officers to adopt compliant plans, so it may be advantageous to make policy more structured. Uniformity is an option, but not the only one.

START TAKING ACTION

Your financial advisor can help you set up a thorough Rule 10b5-1 plan and provide advice about additional steps to take.

Raymond James does not provide legal services. Please discuss these matters with the appropriate professional.

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