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THE SEC'S NEW INSIDER TRADING RULES

New Rules 10b5-1 and 10b5-2 Are Intended Primarily to Make It Easier for the SEC to Prosecute Insider Trading Cases. But Rule 10b5-1 Has Two Affirmative Defenses that Offer Several Potential Benefits to Insiders, Including Full Protection from Antifraud Liability for Pre-Planned Trading Programs.

by Peter J. Romeo and Alan L. Dye

On the same date that the Securities and Exchange Commission ("SEC" or "Commission") adopted Regulation FD, it also adopted two new insider trading rules.[1] These new rules clarify the application of Rule 10b-5 under the Securities Exchange Act of 1934 ("1934 Act"),[2] which prohibits fraud in connection with the purchase or sale of a security.

Rule 10b5-1 addresses the previously unsettled question whether insider trading liability requires proof that the trader "used" material nonpublic information in connection with a purchase or sale, or whether it is sufficient simply to show that the trader "knowingly possessed" such information at the time of the transaction. The rule also establishes two affirmative defenses from insider trading liability under Rule 10b-5 that are likely to be widely utilized by individuals and entities in connection with preplanned trading programs.[3] Rule 10b5-2 defines the types of family and non-business relationships that give rise to a duty of trust or confidence which, if dishonored, would support a claim that the trading person "misappropriated" inside information in violation of Rule 10b-5. This article discusses each of these rules and the circumstances under which they are likely to be applied.

Rule 10b5-1

Rule 10b5-1 defines the circumstances under which a person will be deemed to have traded on the basis of material nonpublic information in insider trading cases. In doing so, the rule resolves the "use versus possession" debate that has existed for many years under Rule 10b-5. The SEC has argued that "knowing possession" of material nonpublic information at the time of a trade is sufficient to sustain a claim that the trade violated Rule 10b-5. Others, however, have contended that proof of the actual use of such information in making the trade is required for such a claim to succeed. Three federal appeals courts have addressed the issue in recent years and have reached different results.[4] The Supreme Court has not dealt with the question, although its prior descriptions of insider trading violations as involving trading "on" or "on the basis of" material nonpublic information suggest that it may favor the "use" test.[5]

Not surprisingly, given the fact that Rule 10b5-1 is an SEC creation, the rule implements the "knowing possession" approach advocated by the SEC. But the rule balances the use of that approach with two affirmative defenses that relieve from liability any person who trades while "aware of" material nonpublic information if the person qualifies for the use of one of the defenses. In effect, each defense provides a safe harbor from insider trading liability for persons able

1. The SEC took these actions on August 15, 2000, and announced them in a release (the "Adopting Release") numbered as follows: 33-7881, 34-43154, IC-24599. The release is available on the SEC's website at http://www.sec.gov/rules/final/33-7881.htm. The new rules became effective on October 23, 2000, and their text is set forth in 17 C.F.R. § 240.10b5-1 and 10b5-2.

2. 17 C.F.R. § 240.10b-5

3. See, e.g., G. Rosenberg, Insiders Get a Sturdy Tool to Rake in Stock Gains, New York Times (September 27, 2000, at C-1); K. Pender, Rule Change Will Make It Easier for Insiders to Make Legal Trades, San Francisco Chronicle (September 26, 2000, at C-1).

4. See *U.S. v. Smith*, 155 F.3d 1051, 1069 and n.27 (9th Cir. 1998), cert. denied, 525 U.S. 1071 (1999) (requiring that "use" be proven in a criminal case); *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998) ("use" required, but proof of possession provides strong inference of use); and *U.S. v. Teicher*, 987 F.2d 112, 120-21 (2d Cir., cert. denied, 510 U.S. 976 (1993) (suggesting that "knowing possession" is sufficient).

5. See *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (trading "on" inside information); and *U.S. v. O'Hagan*, 521 U.S. 642, 651-52 (1997) (trading "on the basis of" inside information). One observer has expressed the view that Rule 10b5-1 "almost certainly conflicts with" the Supreme Court's decision in *U.S. v. O'Hagan*, and therefore is not only "ill-conceived" but also may be "doomed" if challenged. D. Jeffrey, *Knowing Too Much – New Rule on Insider Trading (Wrongly) Punishes for Possession of Information*, Legal Times (November 20, 2000, at 34).

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to meet its conditions.[6] To deal with concerns that this approach might eliminate the requirement enunciated by the Supreme Court to prove scienter in insider trading cases,[7] the rule states that it "does not modify the scope of insider trading law in any.....respect" other than defining what constitutes trading on the basis of material nonpublic information.[8] Thus, scienter will continue to be deemed to exist where a person trades while aware of information that the person knows, or is reckless in not knowing, is material and nonpublic.

The "Awareness" Standard

Rule 10b5-1 begins with a succinct summary of insider trading law by stating that the "manipulative and deceptive devices" that are prohibited by Section 10(b) of the 1934 Act and Rule 10b-5 under the Act include:

> the purchase or 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 that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.[9]

The rule then states that, subject to the affirmative defenses set forth later in the rule, a person will be deemed to have purchased or sold a security "on the basis of" material nonpublic information if the person was "aware of" the information when making the purchase or sale.[10] The SEC believes that the awareness standard is appropriate because it "reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of that information."[11] By using "awareness" as the standard for determining the existence of an insider trading violation, the rule precludes a trader from claiming that material nonpublic information in the person's possession had no effect on the decision to trade.

It is uncertain what will be necessary to show that an insider was "aware of" material nonpublic information at the time of trading. In many instances, awareness will be obvious from the surrounding circumstances, as in the case of a director who attends a board meeting at which such information is discussed. But in some situations, only circumstantial evidence (such as records of an insider's telephone calls) may be available, making proof of awareness difficult.

Affirmative Defenses

Rule 10b5-1 provides two affirmative defenses from liability for the purchase or sale of a security while aware of material nonpublic information, each of which is discussed in more detail later in this article. The first defense is available to any person (including an entity) who can demonstrate that the transaction occurred pursuant to a binding contract, trading instruction,[12] or written plan that came into existence before the person became aware of material nonpublic information.[13] The second is available only to an entity (*i.e.*, any person other than a natural person) which can demonstrate that: (i) the individual who made the investment decision for the entity was not aware of any material nonpublic information, and (ii) the entity had implemented reasonable policies and procedures to ensure that individuals making investment decisions for it would not violate the insider trading laws.

According to the SEC, these defenses should not conflict with the conditions of the exemptive rules adopted by the Commission under the insider reporting and short-swing profit provisions of Section 16 of the 1934 Act.[14] This is so, even though the Section 16 rules are not coextensive with the insider trading defenses under Rule 10b5-1 and provide no exemption from liability under Section 10(b) and Rule 10b-5.[15]

6. The Commission stated in the Adopting Release in § III.A.1. following n.99 that it was not formally designating the affirmative defenses of Rule 10b5-1 as non-exclusive safe harbors, as had been suggested by some commenters. According to the Commission, to do so "would effectively negate the clarity and certainty that the rule attempts to provide." Notwithstanding this statement, the defenses should, in the authors' view, have essentially the same effect as safe harbor rules.

7. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Chiarella v. U.S.*, 445 U.S. 222 (1980).

8. See Preliminary Note to Rule 10b5-1 and Adopting Release, § III.A.1.

9. Rule 10b5-1(a).

10. Rule 10b5-1(b)

11. Adopting Release, § III.A.2., citing *U.S. v. Teicher*, 987 F.2d at 120. The Commission added that the awareness standard "will provide greater clarity and certainty than a presumption or 'strong inference' approach" suggested by some commenters on its proposal to adopt the rule. Adopting Release at n.105. The Commission also expressed disagreement with those commenters who stated that "aware" was an unclear term that may be interpreted to mean something less than "knowing possession." In its view, "aware" is a term meaning "having knowledge; conscious; cognizant" that has a much clearer meaning than "knowing possession," a term that has not been defined by case law. Adopting Release n.105.

12. The instruction can be either written or oral. See, e.g., Adopting Release, § III.A. 2. at n. 118 (employee participant in employee stock purchase plan or Section 401(k) plan "could provide oral instructions as to his or her plan participation").

13. Rule 10b5-1(c)(1). Pursuant to Rule 10b5-1(c)(1)(ii), this defense can be relied upon only if the contract, instruction, or plan was entered into in good faith andnot as part of a plan or scheme to evade the prohibitions of the rule.

14. Adopting Release, § III.A.2 at n. 123. Section 16 requires officers, directors and ten percent owners of issuers that have a class of equity securities registered under Section 12 of the 1934 Act to (i) file public reports with the SEC of their transactions and holdings involving the issuer's equity securities, (ii) disgorge to the issuer any profits on "short-swing" transactions (*i.e.*, any purchase and sale, or sale and purchase, of the issuer's equity securities within less than six months), and (iii) refrain from short sales of the issuer's equity securities. For an extensive discussion of Section 16, see P. Romeo and A. Dye, *Comprehensive Section 16 Outline* (August 2000) and other publications by the authors relating to Section 16 published by Executive Press, Inc., Concord, CA, tel. no.: (925) 685-5111, website: TheCorporateCounsel.net.

15. *Id*, at n. 122-23.

Benefits of the Defenses

Compliance with either of the affirmative defenses should provide a number of benefits to the trading person.

Protection From Liability. Foremost among the benefits of the defenses is protection from insider trading liability. Prior to the adoption of the new rules, the securities laws provided no means of assuring that a transaction by an insider would escape liability under Rule 10b-5. This was in contrast to other potentially applicable requirements under Section 16 of the 1934 Act and the registration provisions of the Securities Act of 1933 ("1933 Act), all of which are complemented by SEC rules prescribing methods for obtaining assured protection from liability.[16] The new defenses now close the loop on the application of the final provision, Rule 10b-5, most likely to apply to insider transactions.

Reduction of Adverse Perceptions. The affirmative defenses of Rule 10b5-1 also provide a means of muting investor and media concerns about questionable transactions by company insiders. Open market sales by such persons in particular may attract unwanted attention, due to the perception of many investors that such sales may reflect a lack confidence in the company. This perception can be exacerbated by the fact that the sales often are concentrated during relatively brief trading windows mandated by the issuer to limit the possibility that the transactions will occur at a time when the insider is in possession of material nonpublic information.[17] The new defenses make it possible to spread sales and other transactions over a more lengthy period of time, thereby reducing their potential for an adverse market impact. Perhaps more importantly, where the timing of a trade by an insider appears suspicious because the trade occurred shortly before the occurrence of a major event involving the issuer, a ready response to inquiries from the media and shareholders that should quell all concerns is that the insider made the decision to trade well in advance of the transaction pursuant to an SEC rule. The potential avoidance of bad publicity is a major benefit of the affirmative defenses, and should prompt insiders and their companies to consider the defenses seriously.

Potential Salutary Impact on Class Action Lawsuits. It appears possible that use of the affirmative defenses could have benefits for issuers in class action lawsuits alleging that disclosure activities by the issuer were fraudulent under Rule 10b-5. Plaintiffs in these lawsuits frequently have attempted to satisfy the heightened pleading standards for scienter under the Private Securities Litigation Reform Act of 1995 by asserting that sales by insiders after the issuer allegedly made misleading or inaccurate disclosures, or before the issuer allegedly delayed making adverse disclosures, constituted evidence of scienter on the part of the issuer because the sales established a motive for the insiders to cause the issuer to violate Rule 10b-5.[18] At least one decision has suggested that sales by insiders pursuant to a "periodic divestment plan" would not constitute scienter under this approach.[19] Therefore, there is a real possibility that the basis for establishing scienter outlined above will not be sufficient where allegedly suspicious transactions by insiders occurred pursuant to trading plans or programs established well in advance of the period when the issuer allegedly acted fraudulently under Rule 10b-5.

Additional Trading Flexibility. Insiders and issuers should not overlook the fact that the affirmative defense for trading plans provides greater trading flexibility for them. In the past, insiders generally were restricted to effecting transactions in a narrow trading window under terms that often were dictated by the market. The defense that permits use of a trading plan, however, now allows an insider to time a single transaction to occur on a particular date outside of a window period to meet a specific objective (e.g., to provide funds for a scheduled house purchase). Or, the insider may use the defense to devise a trading plan for multiple transactions over a prescribed period of time that may involve fixed price limits, formula pricing, or delegation of discretion to another person. Further, an insider could structure a plan for participation in benefit plans of the issuer. For example, an insider could program in advance contributions to 401(k) plans, as well as exercises of stock options and sales of the securities acquired upon exercise. Finally, an issuer could establish a trading plan for the purpose of conducting a stock repurchase program or engaging in a hedging strategy with full confidence that transactions under the plan would not violate Rule 10b-5.

16. The Commission has provided such comfort under Section 16 through the adoption of a variety of exemptive rules, which are set forth in 17 C.F.R. §§ 240.16a-1 ff. Comfort with respect to the non-application of the registration provisions of the 1933 Act to certain sales of securities can be found in Rule 144 under the Act, 17 C.F.R. § 230.144. The rule provides a safe harbor from registration for sales of securities by affiliates of the issuer and by holders of restricted securities of the issuer if all applicable con ditions of the rule are satisfied. For more information about Rule 144, see note 38 infra.

17. These trading windows typically commence within a day or two after the release of quarterly or annual earnings data and continue for a period of a few weeks or more.

18. See, e.g., In re *Silicon Graphics Securities Litigation*, 183 F.3d 970, 986 (9th Cir. 1999), in which the Ninth Circuit held that a sale by an insider would support a claim of scienter "only when it is dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." The Third Circuit has held in *In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1424 (3d Cir. 1997) that "plaintiffs must allege that the trades were made at times and in quantities that were suspicious enough to support the necessary strong inference of scienter."

19. *Ressler v. Liz Claiborne, Inc.*, 75 F. Supp. 2d 43 (E.D.N.Y. 1998), aff'd sub. nom *Fishbaum v. Liz Claiborne, Inc.*, 189 F. 3d 460 (2d Cir. 1999).

Defense Based on Prior Contract, Instruction, or Plan

As previously stated, one of the two available affirmative defenses applies when a person makes a purchase or sale pursuant to a binding contract, specific instruction, or written plan that came into existence before the person became aware of material nonpublic information. This defense is intended to cover situations in which a person can demonstrate that material nonpublic information was not a factor in a trading decision.[20] The Commission has indicated that this defense should provide flexibility to persons who would like to plan transactions in advance at a time when they are not aware of inside information, so that they can carry out those transactions later, at a time when they may be aware of such information.[21] A person can rely on the defense only when the contract, instruction or plan to buy or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b-5.[22]

Insiders and issuers should not overlook the fact that the affirmative defense for trading plans provides greater trading flexibility for them. In the past, insiders generally were restricted to effecting transactions in a narrow trading window under terms that often were dictated by the market. The defense that permits use of a trading plan, however, now allows an insider to time a single transaction to occur on a particular date outside of a window period to meet a specific objective (e.g. to provide funds for a scheduled house purchase). Or, the insider may use the defense to devise a trading plan for multiple transactions over a perscribed period of time that may involve fixed price limits, formula pricing, or delegation of discretion to another person. Further, an insider could structure a plan for participation in benefit plans of the issuer. For example, an insider could program in advance contributions to 401(k) plans, as well as exercises of stock options and sales of the securities acquired upon exercise. Finally, an issuer could establish a trading plan for the purpose of conducting a stock repurchase program or engaging in a hedging strategy with full confidence that transactions under the plan would not violate Rule 10b-5.

Applicable Requirements. To rely on the defense applicable to transactions occurring pursuant to a pre-existing contract, instruction, or plan, the trading person (which can be an individual or an entity) must be able to demonstrate all of the following:

Before becoming aware of material nonpublic information, the person:

- Entered into a binding contract to purchase or sell the securities,
- Instructed another person to purchase or sell the securities for the instructing person's account, or
- Adopted a written plan for trading the securities;[23]

The contract, instruction, or plan either:

- Specified the amount, price, and date of the transaction;[24]
- Included a written formula or algorithm, or computer program, for determining amounts, prices, and dates;[25] or
- Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales;[26] and

The purchase or sale occurred pursuant to the contract, instruction, or plan.[27] (For ease of discussion, the pre-existing contract, instruction, or plan generally will be referred to hereafter as either a "trading plan" or a "trading program.")

Important Terms. Three terms critical to the above defense (hereafter referred to as the "trading plan defense"), all of which are utilized in the second element described above, are defined as follows:

- "Amount" means either a specified number of shares or other securities or a specified dollar value of securities;[28]
- "Price" means the market price on a particular date or a limit price, or a particular dollar price;[29] and
- "Date" means: (i) in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution), and (ii) in the case of a limit

20. *Id.* at n. 115
21. *Id.*
22. Rule 10b5-1(c)(ii).
23. Rule 10b5-1(c)(1)(i)(A).
24. Rule 10b5-1(c)(1)(i)(B)(1).
25. Rule 10b5-1(c)(1)(i)(B)(2).
26. Rule 10b5-1(c)(1)(i)(B)(3). The SEC noted that a person would not satisfy this provision where it established a delegation of authority under which the person retained some ability to influence the decision about how, when, or whether to purchase or sell securities. Adopting Release n.116.
27. Rule 10b5-1(c)(1)(i)(C).
28. Rule 10b5-1(c)(1)(iii)(A).
29. Rule 10b5-1(c)(1)(iii)(B).

order, a day of the year on which the limit order is in force.[30]

Establishing a Trading Program. When establishing a trading program, the primary objective should be to assure that all applicable elements of the trading plan defense are expressly addressed. The best method of meeting this objective is to document the program in writing,[31] making certain in the process that the program covers all of the essential requirements of the defense. Further, it probably would be beneficial to announce the program publicly at the outset (perhaps on the issuer's website or, in the case of a sale, in the "Remarks" section of a Form 144 Notice of Sale report). Such an announcement would both furnish useful information to the investing public and provide a ready source of evidence in the event the issuer wished to cite the program in its defense against a lawsuit alleging that the trades are evidence of scienter under Rule 10b-5.

To minimize the possibility of questions arising about compliance with the requirement that the trading program be established at a time when the trading person is not aware of material nonpublic information, the trader should seek to establish the program at a time when there can be little doubt on this point. For example, establishing the program on the first date of the company's trading window after the release of earnings data should eliminate any concerns on this front. Similarly, to limit the possibility of questions being raised about the independence of a person to whom discretionary trading authority is granted under a trading program, it would be best to select a person (such as a broker or bank) with whom only a professional, arms' length relationship exists. The arrangement with this person should expressly indicate that the person may not trade at any time when the person is aware of material nonpublic information.

Drafting Considerations. When drafting a trading program, the following considerations should be kept in mind, among others:

Nature of Program. The trading program may take a wide variety of forms, including instructions to a broker, a margin loan or other secured loan agreement, an option exercise and sale program, a blind trust, or any of several other forms. Regardless of which form is chosen, it should be specifically identified.

Terms of Transactions. The program should either specify precisely how determinations as to amounts, prices, dates, and frequency of transactions are to be made (e.g., by a designated formula or algorithm), or delegate discretionary trading authority to a named party who neither is subject to the influence of the person who established the program nor is privy to material nonpublic information about the issuer.

Duration of Program. The program should specify a termination date, unless the intention is to continue the program for an indefinite period under specified guidelines until there either are no more securities available (in the case of sales) or no more funds available (in the case of purchases).

Allowances for Unforeseen Events. The program should make allowances for unforeseen events outside the control of the insider that would warrant automatic cancellation of program transactions. These events might include the announcement of a proposed merger of the issuer, or an occurrence that would cause the transaction either to violate the law (such as an offering by the issuer that would result in purchases by insiders in proximity of the offering violating Regulation M),[32] or to have an adverse effect on the issuer (such as a sale that would cause the issuer to lose pooling treatment for a merger).

Restrictions on Parties Effecting Transactions. Unless the program specifically delegates discretionary trading authority to a named party, the program should indicate that any person executing program transactions may not deviate from the instructions provided in the program. In addition, the program should state that no transaction under the program may be effected by a person who is aware of material nonpublic information at the scheduled time of the transaction. And where the program delegates discretionary trading authority to another party, the program should indicate that such party must make all trading decisions independently, without any influence from the person who created the program.

Notification and Reporting Compliance. The program should contain provisions instructing the parties effecting transactions under the program to provide timely notification of such transactions to the trading person for purposes of assuring compliance with applicable reporting requirements, such as those arising under Rule 144 under the 1933 Act and Section 16 of the 1934 Act.

30. Rule 10b5-1(c)(1)(iii)(C).

31. Rule 10b5-1(c)(1)(i)(A)(3) requires trading plans to be written, but does not require binding contracts or trading instructions to be in writing. Because a written program leaves no room for doubt as to its content, and provides the highest form of evidence in the event the program is questioned by regulators or is at issue in litigation, such a program clearly is preferable in all circumstances.

32. Regulation M , 17 C.F.R. § 242.100 ff., sets forth requirements applicable to a variety of transactions or events, including distributions by issuers and selling security holders, passive market making in Nasdaq securities, stabilizing activities, and short selling in connection with a public offering, that implicate the antifraud provisions of Section 17(a) of the 1933 Act and the antimanipulation provisions of Sections 9, 10(b) and 15(c) of the 1934 Act.

Effects of Deviations. The ability to rely on the trading plan defense for transactions to be effected in the future depends not only on having a trading plan that is explicit as to the terms and timing of the transactions, but also on carrying out the specifications without change.[33] Any deviation from, or alteration to, the specifications (whether by changing the amount, price, or timing of the purchase or sale) will render the defense unavailable.[34]

Although deviations from a trading plan are not permissible, it is possible for a person acting in good faith to modify such a plan at a time when the person is not aware of material nonpublic information.[35] In such a situation, a purchase or sale that complies with the modified trading plan will be deemed to have been made pursuant to a new trading plan.[36] It would be unwise, however, for a person to engage in frequent modifications of trading plans, as this could present concerns about the person's good faith in establishing the plans.

The SEC has not addressed the question whether it is possible to terminate a trading program prior to completion. It seems reasonable to assume, however, that if modification of the terms of a trading program is permissible during a period when the insider is not in possession of material nonpublic information, early termination also should be allowable during such a period. Moreover, early termination should not have any effect on prior transactions that occurred before the program was terminated, based on the theory that no violation of Rule 10b-5 can flow from a decision not to buy or sell a security.

Another question not specifically addressed by the SEC is whether a person can engage in other transactions involving the issuer's securities at the same time transactions in such securities are occurring pursuant to a Rule 10b5-1 trading program. Nothing in the rule suggests that these other transactions are forbidden. They would, however, have to be judged individually on their own merits under Rule 10b-5.

Impact of Hedging. The availability of the trading plan defense also is conditioned on the trader not entering into, or altering, a corresponding or hedging transaction or position with respect to the securities subject to the arrangement.[37] Thus, the defense will not be available for a program obligating the writer of call options to sell the underlying securities at specific prices if the writer later enters into a hedging transaction designed to capture the profits that would be foregone if the price of the security were to rise above the strike price of the options. It appears, however, that it would be permissible to adopt a new trading plan for the purpose of hedging an existing equity position, as contrasted to engaging in the disqualifying act of hedging a position committed to under an existing trading plan.

Role of the Issuer. Issuers are not compelled to do anything under the rule with respect to the trading plan defense. But the defense can be beneficial to them, both by reducing the risk that their insiders will violate the insider trading laws and by minimizing the possibility of adverse publicity with respect to trades by the insiders. Consequently, issuers would be well advised to consider doing all of the following:

- Provide a memorandum to all officers and directors briefly describing the operation and ramifications of the trading plan defense and offering to assist them in structuring trading programs to fit within the defense;
- Require advance approval of any proposed trading programs by officers and directors as part of the process of preclearing insider transactions (assuming the issuer has a preclearance requirement);
- Review the issuer's insider trading policy and make appropriate changes, such as creating an exception from the window period requirements for trades that qualify for the trading plan defense and including a provision encouraging officers and directors to structure their open market transactions in a manner that will qualify the transactions for the defense; and
- Make a public announcement of trading plans by officers and directors, perhaps on the issuer's website in a section captioned "transactions by insiders."

Compliance With Other Laws. Establishing a trading program is likely to implicate other laws beyond Rule 10b-5. Section 16 of the 1934 Act and Rule 144 under the 1933 Act are paramount among these other laws because they apply generally to public company insiders, the persons most likely to avail themselves of the trading plan defense.[38]

33. See Rule 10b5-1(c)(1)(i)(C).
34. *Id*.
35. Adopting Release, n.111.
36. *Id*.
37. Rule 10b5-1(c)(1)(i)(C).
38. Section 16 is described in Note 14 supra. Rule 144 provides a safe harbor from the registration provisions of the 1933 Act for sales of restricted securities (*i.e.*, securities acquired in a nonpublic or similar exempt transaction from the issuer or an affiliate) and securities held by affiliates (*i.e.*, persons who have a control relationship with the issuer), provided all applicable conditions of the rule are met. The conditions of the rule are (i) there must be current public information available about the issuer at the time of sale, (ii) the securities must have been held at least one year if they are considered restricted securities, (iii) the amount sold during any three-month period cannot exceed the greater of one percent of the outstanding securities of the class or the average weekly trading volume of the class during the four calendar weeks preceding the sale, (iv) the securities must be sold in brokers'

State laws also may be an important consideration with respect to a trading program. A substantial majority of states have adopted a version of the Uniform Securities Act. This Act contains a provision similar to Rule 10b-5, but presently provides no relief from that provision of the type found in Rule 10b5-1. In addition, a few states, such as New York and California, have adopted their own provisions prohibiting illicit trading by insiders. These provisions are subject to a number of uncertainties regarding their application, and similarly do not contain any relief of the type provided by Rule 10b5-1.

Application to Specific Transactions

Some of the considerations to bear in mind with respect to the application of the affirmative defenses of Rule 10b5-1 to transactions under trading programs are described below

Exercises of Employee Stock Options. A pre-planned trading program may include exercises of employee stock options and sales of the stock acquired upon exercise.[39] While the exercises may not raise a concern, due to the fact that the party on the other side of the transaction (i.e., the issuer) presumably is aware of the same information as the insider, the sales might occur at a time when the option holder is aware of material nonpublic information. Faced with such a possibility, the option holder could design a program well in advance of the expiration date that utilizes a formula for determining the percentage of the person's vested options to be exercised and / or sold at or above a specific price.[40] Alternatively, the formula could provide for the exercise of options and sale of the acquired shares during a specified period (such as one month) before each date on which a specific obligation (such as a college tuition payment) is due, and link the amount of the trade to the tuition amount.[41]

Exercises of Standardized Options. A pre-planned trading program also may include exercises of standardized options (also known as "exchange-traded options").[42] The exercise program may be as simple as advising a third party to whom authority has been granted to exercise outstanding options to do so when the strike price is met. Or, more likely, it may involve exercises of such options as one of the components of a trading strategy that becomes operative at prescribed market prices. In either circumstance, the rule should be available to provide a ready defense to any claim that inside information was misused in connection with the exercise.

Acquisitions of Stock Under Broad-Based Employee Benefit Plans. It is possible to structure participation in a broad-based employee benefit plan, such as a Section 401(k) plan or an employee stock purchase plan, to fit within the trading plan defense. Acquisitions of issuer stock through payroll deductions under these types of plans could qualify for the defense if the acquisitions were made pursuant to either oral instructions as to plan participation or a written plan.[43] The transaction amount could be based on a percentage of salary to be deducted under the plan, and the transaction price could be based on a percentage of the market price.[44] The date could be determined in accordance with a formula contained in a written plan, or could be controlled by the administrator or investment manager of the benefit plan.[45] Where the date of acquisition is controlled by the administrator or investment manager, that person must not be aware of material nonpublic information at the time of executing the transaction, and the employee must not exercise influence over the timing of the transaction.[46]

Transactions Involving Trusts. Trusts are highly flexible devices that can operate in a wide variety of ways, some of which would be well suited for reliance upon the trading plan defense. The type of trust that would most easily qualify for the defense is a "blind trust," although the SEC has indicated that a blind trust does not need the protection of the rule.[47] Under such a trust, the settlor turns over all investment authority to the trustee and is not informed of, or consulted about, trust transactions prior to their occurrence. As a result, these transactions should satisfy the requirement of the defense applicable to arrangements under which the person for whose account a trade is made is not permitted, after entering into the arrangement, "to exercise any subsequent influence over how, when, or whether to effect purchases or sales."[48] Other

38. continued
transactions or directly to a market maker, and (v) a notice of sale on Form 144 must be filed with the SEC if the amount to be sold exceeds 500 shares or has a market value in excess of $10,000. In addition, Rule 144(k) provides that restricted securities held at least two years by a person who is not an affiliate of the issuer, and has not been an affiliate during the immediately preceding three months, may be sold by the person without the need to comply with any of the requirements of Rule 144.

39. Adopting Release, § III.A.2., following n. 116.

40. *Id.*

41. *Id.*

42. Some of the persons who commented on Rule 105b-1 while it was in the proposal stage thought that the exercise of standardized options should not be subject to the rule, on the theory that the relevant investment decision is made when the person purchases the option, not when the option is exercised. The Commission disagreed with this view, based on its belief that the decision to exercise a standardized option is a separate investment decision. The Commission, however, did say that Rule 10b5-1 permits a person to pre-arrange, at a time when the person is not aware of material nonpublic information, a plan for exercising standardized options in the future. Adopting Release, n.115.

43. Adopting Release, § III.A.2., n. 118.

44. *Id.*, n.119.

45. *Id.*, n. 120-21.

46. *Id.*, n. 121.

47. See the proposing release for the new insider trading rules, Release No. 34-42259 n. 91 (1999).

48. Rule 10b5-1(c)(1)(i)(B)(3). See also Adopting Release n.123.

types of trusts could have the same effect, where the person relying on the trading plan defense is not able to exercise any influence over the terms or timing of transactions in the issuer's securities.[49] Thus, a beneficiary of a trust who has no investment control over a trust should be able to rely on the defense for transactions by the trust involving securities of the beneficiary's company, provided neither the trustee nor any other person having influence over trust transactions is aware of material nonpublic information when engaging in such transactions.

Transactions Involving Portfolio Securities. Transactions in securities of an insider's company held in the portfolio of an entity (such as a corporation, partnership, or limited liability company) in which the insider has a pecuniary interest can be insulated from Rule 10b-5 liability under the trading plan defense. Transactions in portfolio securities can qualify for the defense in much the same manner as transactions by trusts.[50] For example, where an insider is a limited partner of a partnership, the insider should be able to rely on the defense for purchases and sales by the partnership of securities of the insider's company, assuming the insider had no influence over the partnership's transactions and the persons who did have such influence were not aware of material nonpublic information when engaging in the transactions.

Discretionary Trading Accounts. A discretionary trading account is an account with a broker or investment manager under which the person establishing the account turns over full investment discretion to the broker or investment manager. The effect of a discretionary trading account is to shift all investment decision-making to a securities professional. As a result, a person who establishes a discretionary trading account ordinarily should be able to rely on the portion of the trading plan defense available to persons who do not exercise any subsequent influence over purchase or sale transactions.[51] Merely setting goals or objectives at the time the account is established would not appear to be a disabling factor, since the defense is denied only when the person exercises "subsequent influence over how, when, or whether to effect purchases or sales."[52] Note, however, that if the broker or investment manager who makes the investment decisions for the person's account becomes aware of material nonpublic information, the defense would not be available for transactions effected during the period such information remains material and nonpublic.[53]

Pledges. A pledge of securities is considered a sale by the pledgor for purposes of the antifraud provisions of the 1934 Act, but not necessarily other provisions of the securities laws.[54] When a default by the pledgor occurs, the resulting sale of the pledged securities would likely be treated as having been made by the pledgor, since the pledgor was the one whose default made the sale necessary. The question under Rule 10b5-1 is whether the trading plan defense is rendered unavailable because of the pledgor's ability to control the transaction by preventing the default through a payment on the loan or other means, such as depositing more collateral. It may be argued that the defense should remain available because the pledgor, by making the pledge, effectively instructed the pledgee to sell the pledged securities upon a default, and did not "exercise" any subsequent influence over the sale at the time of the default. As for the pledgee, there would not appear to be any need to rely on the trading plan defense to liquidate the securities upon the default. The reason is that any material nonpublic information in the possession of the pledgor should not be attributed to the pledgee except in circumstances where the pledgor actually conveyed that information to the pledgee.

Loans. A loan of securities should not present any significant concerns for either the lender or the borrower under the antifraud provisions of the 1934 Act. Those provisions apply only to a purchase or sale of securities, and a loan does not involve either type of transaction.

Issuer Repurchases. Issuer repurchase programs are relatively commonplace, typically being initiated when the price of the issuer's stock has declined significantly. Many, if not most, issuers conduct these programs in accordance with Rule 10b-18, which provides a safe harbor from the anti-manipulation provisions of Section 9 of the 1934 Act. The adoption of Rule 10b5-1 now make it possible to insulate repurchase programs from the antifraud provisions by relying on the safe harbor from those provisions provided by that rule. According to the SEC, an issuer operating such a program will not need to specify with precision the amounts, prices, and dates on which it will repurchase its securities. Rather, an issuer could adopt a written plan, when it is not aware of material

49. *Id.*

50. See generally Adopting Release n.123.

51. The same defense should be available to an issuer in connection with an issuer repurchase program where the issuer provides general objectives to a broker for executing transactions but does not exercise any subsequent influence over the transactions. See the discussion of issuer repurchase programs later in this article.

52. Rule 10b5-1(c)(1)(i)(B)(3).

53. *Id.*

54. *Marine Bank v. Weaver*, 455 U.S. 551, 554 n.2 (1982). A pledge also is viewed as a sale for purposes of the antifraud provisions of the 1933 Act. *Rubin v. U.S.*, 449 U.S. 424 (1981). Notwithstanding these decisions, a pledge may not be a sale for purposes of the registration provisions of the 1933 Act. See Loss, *Fundamentals of Securities Regulation*, 260-262 (1988). And a pledge is not deemed a sale for purposes of Section 16 of the 1934 Act, as discussed later in this section.

nonpublic information, that uses a written formula to derive amounts, prices, and dates. Or the plan could simply delegate all the discretion to determine amounts, prices, and dates to another person who is not aware of the information – provided that the plan did not permit the issuer to (and in fact the issuer did not) exercise any subsequent influence over the purchases or sales.[55]

Because the delegation approach would preclude the issuer from retaining any ability to influence the decision about how, when, or whether to purchase or sell securities,[56] it may not be as desirable as the written plan approach. A written plan that prescribes specific guidelines for repurchases of its stock would provide the issuer with greater control over the repurchase program. Moreover, the written plan could subsequently be modified at a time when the issuer is not in possession of material nonpublic information about itself,[57] thereby providing an additional element of control not present with the delegation approach. Regardless of whether the delegation of authority or written plan approach is used, in all instances the issuer would be well advised to follow the guidelines of Rule 10b-18 with respect to the manner of execution of transactions under the repurchase program.

Defense for Entities

As noted previously, Rule 10b5-1 also provides an affirmative defense for purchases and sales of securities by issuers and other entities who can demonstrate that (i) the individual who made the investment decisions for the entity was not aware of any material nonpublic information, and (ii) the entity had implemented reasonable policies and procedures to ensure that individuals making investment decisions for it would not violate the insider trading laws.[58] This defense is an alternative, available only to entities, to the trading plan defense discussed above.[59]

The Reasonable Policies and Procedures Requirement. The Commission indicated that the requirement of prior implementation of reasonable policies and procedures designed to prevent illicit insider trading was derived from a similar defense in Rule 14e-3 under the 1934 Act relating to insider trading in tender offer situations.[60] According to the Commission, the Rule 10b5-1 requirement should be interpreted essentially in the same manner as the standard in Rule 14e-3 from which it was derived.[61]

Hedging Transactions. Some concerns about the above defense were expressed by the Securities Industry Association ("SIA") in its letter commenting on the rule while it was in proposed form. One concern was that the defense would not allow institutions to engage in "dynamic hedging" in circumstances where the institution's trading desk, while managing its proprietary position through a hedge, also was aware of material nonpublic information. The Commission's response was that the defense should not be available in such situations if the same trader who is aware of the material information is making the trading decisions for the firm.[62] It added, however, that the trading plan defense of paragraph (c)(1) of the rule would allow a broker-dealer to manage risk by devising a formula for hedging at a time when it is not aware of material nonpublic information.[63] Alternatively, the Commission noted that the broker-dealer could segregate its personnel and otherwise use information barriers (commonly known as "Chinese walls"), so that the trader for the firm's proprietary account did not become aware of the material nonpublic information.[64]

Market Liquidity Concern. A second concern expressed by the SIA was that the defense for entities could unintentionally have the effect of impeding market liquidity when broker-dealers participate in takedowns from shelf registration statements and other block transactions.[65] The basis for the concern was that the rule would create uncertainty as to whether a broker-dealer holding an order to execute a block transaction could continue to conduct regular market making in that same security.[66]

55. Adopting Release, § III.A.2. at n.116.

56. Adopting Release n. 116.

57. Adopting Release n.111.

58. See Rule 10b5-1(c)(2).

59. Adopting Release, § III.A.2.

60. Adopting Release, § III.A.2. at n.125. The Commission addressed the origin of the provision in the course of responding to a comment by the American Bar Association that the term "reasonable policies and procedures…to ensure" against insider trading differed from the standard in Section 15(f) of the 1934 Act requiring a broker or dealer to establish, maintain, and enforce written policies and procedures "reasonably designed" to prevent insider trading. The Commission's response noted that Rule 14e-3 predates Section 15(f) and also uses the "to ensure" language, which the Commission understands has not created any problems of compliance with Rule 14e-3. Adopting Release n. 125.

61. Adopting Release n.125. The two requirements do not use precisely the same language, so there may be room for some differences in interpretation. The Rule 10b5-1(c)(2) standard requires that the entity relying on the defense demonstrate that it

> had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material nonpublic information, or those that prevent such individuals from becoming aware of such information.

The Rule 14e-3 standard is set forth in paragraph (b)(2) of that rule and reads as follows:

> Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that the individual(s) making investment decision(s) would not violate paragraph (a), which policies and procedures may include, but are not limited to: (1) those which restrict any purchase, sale and causing any purchase and sale of any such security, or (ii) those which prevent such individual(s) from knowing such information.

62 Adopting Release n.125.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

The Commission's response was that "ordinary market making does not present insider trading concerns if a customer who places an order with a broker dealer has an understanding that the broker-dealer may continue to engage in market making while working the order."[67] In the Commission's view, ordinary market making by a broker-dealer would not involve a "misappropriation" of the customer's information in violation of the insider trading laws "because it would not involve trading on the basis of the information in a manner inconsistent with the purpose for which it was given to the broker."[68] The Commission cautioned, however, that if a broker-dealer is engaged in extraordinary trading for its own account when aware of unusually significant information regarding a customer order, "it is possible, based on the facts and circumstances, that the broker-dealer would be held liable for insider trading or for front-running as defined by SRO rules."[69]

Rule 10b5-2

The Commission adopted Rule 10b5-2 to close a gap in the insider trading laws regarding the circumstances under which family and personal relationships might result in a "misappropriation" of material nonpublic information for trading purposes. Under current law, a family member who receives a "tip" of such information and then trades on it violates Rule 10b-5, as does a family member who trades in breach of an express promise of confidentiality.[70] But a family member who trades in breach of a "reasonable expectation" of confidentiality does not necessarily violate the rule.[71]

To eliminate the above anomaly and clarify the application of the misappropriation theory, Rule 10b5-2 sets forth a nonexclusive list of situations in which a person who engages in a purchase or sale of securities will be deemed to have done so on the basis of a misappropriation of material nonpublic information:

- When the person agrees to maintain the information in confidence;
- When both the person disclosing the information and the person receiving it have a history, pattern, or practice of sharing confidences, such that the recipient knows or reasonably should know that the person disclosing the information expects the recipient to maintain its confidentiality; or
- When a person receives or obtains the information from his or her spouse, parent, child, or sibling, unless the person can demonstrate that he or she neither knew nor reasonably should have known that the information was expected to be kept confidential and there was no agreement or understanding that it would be kept confidential.

The third situation described above does not apply to communications of inside information from anyone other than the close family members specifically identified in it. Therefore, it does not extend to communications from grandparents, in-laws, aunts and uncles, or nieces and nephews. Moreover, it does not extend to communications from domestic partners, step-parents, or step-children, based on the Commission's experience that most instances of insider trading involving family members have involved spouses, parents, children or siblings.[72]

Rule 10b5-2 is likely to make the Commission's life easier when it seeks to prove that Rule 10b-5 was violated in insider trading cases involving close family members or other persons with a history of sharing confidences. There are, however, some interpretive issues that will have to be resolved along the way. For example, it is unclear what will constitute a "history, pattern, or practice of sharing confidences." Although a one-time experience of sharing confidences would not seem on its face to be sufficient, this is not entirely certain. Similarly, it is not settled whether the confidences for which a history has been established can relate to any type of matter, including those of a purely personal or social nature, or whether the prior shared confidences must involve investments or securities.

Notwithstanding the existence of interpretive issues regarding the breadth and application of Rule 10b5-2, the rule will heighten the exposure on both the civil and criminal levels of persons who obtain information from family members or others with whom they historically have shared confidences. As a result, the rule should reinforce the advice traditionally given by many lawyers to their clients that with respect to transactions by immediate family members, an insider should treat the transactions as if they were based on the same information available to the insider.

67. *Id.*
68. *Id.*
69. *Id.*
70. See generally the discussion in § III.B.1. of the Adopting Release following n.126.
71. *Id.*
72. Adopting Release, § III.B.2.