

Frederic W. Cook & Co., Inc.

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New Insider Trading Rule To Provide Clarity For Insiders

The Securities and Exchange Commission has adopted Rule 10b5-1 to clarify issues with respect to insider trading. This new rule, effective as of October 23, 2000, will allow insiders and other investors, such as top executives and board members, to buy or sell stock in their companies no matter how much inside information they have so long as they have committed in advance to do so and had no inside information when they made the commitment.

Many executives would like to sell their company stock for diversification, estate planning and cash flow reasons. However, company blackout periods and insider trading restrictions often hinder or prevent executives from doing so. The SEC's enactment of Rule 10b5-1 provides three instances when executives can buy or sell securities and not violate insider trading laws, i.e.:

- when the executive demonstrates that prior to becoming aware of inside information, he or she had entered into a binding contract to purchase or sell the security
- when the executive demonstrates that in advance of becoming aware of the information, he or she had instructed another to execute the trade
- when the executive demonstrates that before becoming aware of the information, he or she had adopted a written plan for trading securities.

Background

Generally, the antifraud provisions of the securities acts were designed to protect investors, to ensure fair dealing in the securities markets, and to promote ethical business practices. Consistent with these objectives, Rule 10b-5 was promulgated pursuant to Section 10(b) of the Securities Exchange Act of 1934. This rule made it unlawful for any person to employ any deceptive or manipulative device in connection with the purchase or sale of a security.

Historically, insider trading restrictions have developed through a series of SEC pronouncements and judicial decisions in civil and criminal enforcement cases involving fraud charges. As a result, there have been issues on which various courts have reached differing conclusions. The SEC's adoption of Rule 10b5-1 resolves one such issue. (See Appendix for the statutory language of the rule)

The New Rule

Prior to the adoption of Rule 10b5-1, the Commission needed to show in its insider trading cases that either (1) the defendant “used” inside information in trading, or (2) that the defendant merely traded while in “knowing possession” of the information. Traditionally, the SEC argued that a person may be liable for trading while in “knowing possession” of the nonpublic information. In contrast, others argued that a person is not liable unless it is shown that he or she “used” the information for trading. Several courts of appeal have reached different decisions on which standard should be used in the analysis.¹ Because of this inconsistency, the SEC thought that it would be beneficial to define the scope of Rule 10b-5, as it applies to the “use/possession” issue.

Rule 10b5-1 attempts to balance both standards and provides that insider trading liability only arises when a person trades while “aware” of material nonpublic information. In addition, the new rule offers several affirmative defenses.² Specific affirmative defenses under Rule 10b5-1 are situations when it is clear that the person did not use the information he or she was aware of. The SEC stated that “awareness, rather than use, most effectively serves the fundamental goal of insider trading law – protecting investor confidence in market integrity.” Furthermore, the SEC asserted that “the awareness standard reflects the common sense notion that a person who is aware of inside information when making a trading decision inevitably makes use of the information.”

In the past, insider trading compliance has been a constant headache for executives. An executive’s effort to diversify by trading some of his or her company-owned stock was often scrutinized by outside investors. In addition, many executives were prevented from trading in company stock during designated blackout periods. These blackout periods can arise numerous times throughout the year and significantly reduce the window of time that executives can execute trades.

Add to that the threat of prosecution for insider trading, which could result in hefty fines and embarrassment to the executive and the company, it is no wonder that executives and corporations were asking the SEC for clarification on the issue. Under the new rule, if the executive complies with one of the affirmative defenses, then he or she will be free from prosecution under the insider trading laws.

The Affirmative Defenses

Taken as a whole, the affirmative defenses are designed to cover situations in which a person can demonstrate that the material nonpublic information was not a factor in his or her trading

¹ See *United States v. Teicher*, 987 F.2d 112 (2d Cir.) (suggesting that “knowing possession” is sufficient to trigger insider trading liability and further stating that “unlike a loaded weapon which may stand ready but unused, material information can not lay idle in the human brain.”); *SEC v. Alder*, 137 F.3d 1325 (11th Cir. 1998) (holding that “use” was the ultimate issue, but that proof of “possession” provides a “strong inference” of “use” that suffices to make out a prima facie case); *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998) (requiring that “use” be proven in a criminal case)

² An affirmative defense is defined as a defense which amounts to something more than a mere denial of the plaintiff’s allegations. It acts as a complete bar to litigation if the defendant proves the specific elements of the affirmative defense. The SEC “safe harbor” is similar in concept to an affirmative defense.

decision. The goal of the provision is to provide appropriate flexibility to those who would like to plan securities transactions in advance, at a time when they are unaware of material nonpublic information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material nonpublic information.

One defense requires the person to demonstrate that prior to becoming aware of the information, he or she had entered into a binding contract to purchase or sell the security. This defense permits persons to carry out pre-existing contracts to buy or sell securities as long as the person was not aware of material nonpublic information at the time the contract was entered into.

Another defense requires the person to demonstrate that in advance of becoming aware of the information, he or she had instructed another to execute the trade. For example, this defense would apply to an executive who instructs his or her broker to execute a plan to sell stock in accordance with Rule 144 at the expiration of a required holding period. If the executive provides the instructions without awareness of any material nonpublic information, the broker can then complete the previously instructed sales plan even if the executive later becomes aware of inside information.

A third defense makes the person demonstrate that before becoming aware of the information, he or she had adopted a written plan for trading securities. For instance, an employee wishing to adopt a plan for exercising stock options and selling the underlying shares could, while not aware of material nonpublic information, adopt a written plan.

With respect to the purchase or sale of the security, each of the three affirmative defenses requires the contract, instructions or plan to meet one of the following three criteria:

- 1) Expressly specify the amount³, price⁴ and date⁵ on which the securities were to be purchased or sold;
- 2) Provide a written formula or algorithm for determining the amount, price and date, or
- 3) Prevent the person from exercising any subsequent influence over how, when, or whether to effect purchases or sales.

Thus, in the preceding example, the employee's plan for exercising stock options could contain a formula for determining the specified percentage of the employee's vested options to be exercised and/or sold at or above a specific price. The formula might provide, for example, that the employee will exercise options and sell the shares one month before each date on which her son's college tuition is due, and link the amount of the trade to the cost of the tuition.

Lastly, each affirmative defense is available only if the person entered into the plan, contract, or instruction to trade in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1. For example, if an insider entered into a contract to sell 10,000 shares of his or her company's stock on January 1, 2001 (four months from now) without being aware of material

³ Amount means either the specified number of shares or specified dollar value of securities.

⁴ Price means the market price on a particular date, limit price or particular dollar price.

⁵ Date means the day on which the order is to be executed if it is a market order or the day on which the limit order is in force.

nonpublic information, this would qualify as an affirmative defense under Rule 10b5-1. However, if the insider later accelerated the timing of the planned sale in order to complete it ahead of a negative corporate news release that the insider recently learned about, this would constitute a lack of good faith on the part of the insider and the affirmative defense would fail.

Summary

Rule 10b5-1 defines when a sale or purchase of a security occurred “on the basis of” material nonpublic information. Under the rule, a person trades “on the basis of” material nonpublic information if the person making the purchase or sale was aware of the material nonpublic information at the time of the purchase or sale. However, the rule provides exclusions for certain situations in which a trade resulted from a pre-existing plan, contract, or instruction that was made in good faith by the insider. Insiders will benefit from this rule because it provides greater clarity on how they can plan and structure securities transactions at a time when they are not aware of material nonpublic information without fear of incurring liability.

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Specific questions concerning this topic should be addressed to corporate counsel. General questions may be addressed to Louis Taormina in our New York office at (212) 986-6330 (ltaormina@fwcook.com). Copies of this letter and other published material are available on our website at www.fwcook.com.

Appendix - Statutory Language of 10b5-1

Section 240.10b5-1 is added after Section 240.10b-5 to read as follows:

§ 240.10b5-1 Trading "on the basis of" material nonpublic information in insider trading cases.

Preliminary Note to § 240.10b5-1: This provision defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Section 10(b) of the Act and Rule 10b-5 thereunder. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect.

- (a) General. The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and §240.10b-5 thereunder include, among other things, 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.
- (b) Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this Section, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.
- (c) Affirmative defenses.

(1)(i) Subject to paragraph (c)(1)(ii) of this Section, a person's purchase or sale is not "on the basis of" material nonpublic information if the person making the purchase or sale demonstrates that:

(A) before becoming aware of the information, the person had:

- (1) entered into a binding contract to purchase or sell the security,
- (2) instructed another person to purchase or sell the security for the instructing person's account, or
- (3) adopted a written plan for trading securities;

(B) the contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section:

- (1) specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;
- (2) included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
- (3) did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and

(C) the purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

(ii) Paragraph (c)(1)(i) of this Section is applicable only when the contract, instruction, or plan to purchase 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 this Section.

(iii) This paragraph (c)(1)(iii) defines certain terms as used in paragraph (c) of this Section.

(A) Amount. "Amount" means either a specified number of shares or other securities or a specified dollar value of securities.

(B) Price. "Price" means the market price on a particular date or a limit price, or a particular dollar price.

(C) Date. "Date" means, 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). "Date" means, in the case of a limit order, a day of the year on which the limit order is in force.

(2) A person other than a natural person also may demonstrate that a purchase or sale of securities is not "on the basis of" material nonpublic information if the person demonstrates that:

(i) The individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and

(ii) The person 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.