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**BUSINESS LITIGATION AND
CORPORATE TRANSACTIONS &
SECURITIES UPDATE****Does Your 10b5-1 Plan Protect You From Insider Trading Charges?**

The Securities and Exchange Commission's (SEC) recent charges against former Countrywide CEO Angelo Mozilo is a warning to corporate executives that the immunity from insider trading liability provided by so-called 10b5-1 plans is not unlimited. While these plans are still a legitimate and important means for executives who are heavily invested in their company's stock to diversify in an orderly and predictable way, the SEC's enforcement division will closely scrutinize any stock sales that prove in retrospect to be particularly fortuitous. Companies and their executives should take care that these plans are properly formulated and implemented so that they in fact protect executives in the intended manner.

OVERVIEW OF PLANS

The SEC's promulgation of Rule 10b5-1 in 2000 gave officers and directors who held a substantial number of shares in the public companies they serve a potentially valuable safe-harbor process for diversifying their portfolios.¹ By designing and following a so-called 10b5-1 plan, an officer or director can sell his or her company stock in the future through written, preset trading agreements entered into at a time when he or she has no material nonpublic information about the business. The rule's rationale is that there should be no opportunity for manipulation if the executive sets the terms for future sales at a time when he or she has no inside information, such as details of unfavorable financial results or news of defects in an important product. Trades made consistent with those plans are generally immune from a charge of insider trading.

Among other things, a 10b5-1 plan must:

- Be established in good faith when the participant was not aware of inside information.
- Specify the number of securities to be traded and the price at which the securities are to be traded, or include a formula for making such determinations.
- Prohibit the participant from later asserting any influence over any person who exercises discretion as to how, when or whether to effect the trades.²

HEIGHTENED SCRUTINY

In 2006, a study of these plans by Stanford University professor Alan Jagolinzer led to increased scrutiny of 10b5-1 sales by the SEC.³ Professor Jagolinzer analyzed more than 100,000 trades in 10b5-1 plans by more than 3,000 executives at almost 1,250 companies, and found that trades under such 10b5-1 plans beat the market by more than 6 percent during a period of six months, while executives at the same companies who traded without 10b5-1 plans beat the market by only

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1.9 percent. The study posited that this disparity could indicate that the executives had: (1) created their plans while they knew of bad news that had not yet be released to the public; (2) terminated plans (and therefore planned sales) before stock prices decrease; or (3) manipulated the content or timing of material disclosures after trades have already been planned.

CHARGES AGAINST MOZILO

Such abuse is precisely what the SEC has alleged against Mozilo. In its complaint, the SEC charges that Mozilo reaped more than \$139 million in illicit profits by selling shares of Countrywide through 10b5-1 plans he adopted in late 2006 and then modified in 2007. During that period, the SEC alleges, Mozilo knew that Countrywide was engaging in increasingly risky lending activity. Indeed, according to the complaint, Mozilo approved one of his 10b5-1 plans the day before he warned that his company was “flying blind” with respect to some of its mortgage loans.⁴

The Mozilo case is the first set of charges brought by the SEC under its program of increased scrutiny of 10b5-1 plans.⁵ While no one can predict with certainty whether additional cases will follow, it is more important than ever that any 10b5-1 plan be not only technically compliant with the rule, but also consistent with its spirit.

CONSIDERATIONS FOR ADEQUATE PROTECTION

With respect to plans currently in place or those proposed to be implemented, public companies should be mindful of several factors, including:

- ***Specific Trade Terms.*** Most importantly, a 10b5-1 plan must have definite parameters for the insider’s trades, including the amount, price and date of the securities trades. These terms cannot be changed, although termination of the plan in its entirety is permitted.
- ***Circumstances Under Which Protection May Be Lost.*** The insider whose trades are subject to the 10b5-1 plan must be made to understand that the affirmative defense provided by the rule may be lost if he or she trades outside the plan or alters the plan in a manner that does not meet the conditions of the rule.
- ***Oversight and Recordkeeping.*** Any 10b5-1 plan should be overseen by the company, and contemporaneous records should be made and kept that will document that the plan was formulated in a manner that complies with the rule.
- ***Relationship to Other Requirements.*** Other legal requirements may be implicated by the formulation and implementation of a 10b5-1 plan, including Rule 144, the avoidance of short-swing profit recovery under Section 16(b), the requirement to file Form 4s on a timely basis and the possible implication of plan trades and Regulation M and Rule 10b-18.



Despite the SEC's heightened scrutiny and the allegations in the Mozilo case, 10b5-1 plans are a valuable and legitimate mechanism for the orderly sale by insiders of company stock. Properly designed and implemented, these plans permit insiders with large holdings to diversify their assets outside of the confines of their company's narrow trading windows.

FOR MORE INFORMATION

If you have questions, please contact:

Thomas A. Aldrich	216.566.5749	Tom.Aldrich@ThompsonHine.com
David A. Neuhardt	937.443.6775	David.Neuhardt@ThompsonHine.com
David A. Wilson	202.263.4161	David.Wilson@ThompsonHine.com

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¹ See 17 C.F.R. § 240.10b5-1 (2008).

² See Selective Disclosure and Insider Trading, Securities Act Release No. 33-7881, Exchange Act Release No. 34-43154, 65 Fed. Reg. 51,715 (August 15, 2000). Rule 10b5-1 permits an executive to cancel a plan (and therefore a planned trade) even if he or she is aware of inside information. The SEC staff has stated that cancellation of the plan under such circumstances cannot be a basis for securities fraud under Rule 10b-5 because there is no actual trading in securities. However, cancellation of a plan could call into question whether the plan was entered into in good faith. SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Rule 10b5-1, Questions 120.17 & 120.18 (issued Mar. 25, 2009), available at <http://sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm>.

³ Alan D. Jagolinzer, *Do Insiders Trade Strategically within the SEC Rule 10b5-1 Safe Harbor?* (Stanford University Graduate School of Business, Working Paper, December 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=541502.

⁴ Complaint – Securities and Exchange Commission v. Angelo Mozilo et al., No. CV09-03994 (C.D. Cal. filed June 4, 2009), available at <http://sec.gov/litigation/complaints/2009/comp21068.pdf>.

⁵ The SEC has brought civil claims against Mozilo, seeking financial penalties. The U.S. Department of Justice had previously brought a criminal insider trading case against former Qwest Communications CEO Joseph Nacchio that included allegations of misconduct in connection with Nacchio's 10b5-1 plan. Nacchio was convicted on 19 counts in 2007 and is currently serving a six-year prison term.