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Individual Trading Plans Can Help Defend Securities Fraud Claims

By Lyle Roberts and Nicholas Porritt — July 7, 2004

As the indictments, trials, and convictions of executives continue to fill the headlines, the focus on corporate scandals that followed the collapse of Enron and the overall stock market shows little sign of dissipating.

The federal government continues to increase its scrutiny of public companies. The Securities and Exchange Commission was recently awarded a substantial increase in its budget, in part to increase its review of corporate financial statements and enlarge its investigative ability, and the Sarbanes-Oxley Act of 2002 created an entirely new and well-funded entity, the Public Company Accounting Oversight Board, with an express purpose of searching for accounting fraud.

Meanwhile, private securities class action filings continue at a steady pace and have seemingly rebounded from the reduction in filings that immediately followed passage of the Private Securities Litigation Reform Act of 1995.

The Sarbanes-Oxley Act also lengthened the limitations period for securities fraud claims, thus increasing the time the plaintiffs' bar may investigate potential lawsuits or await the outcome of government investigations. In short, the risk of being investigated or sued for securities fraud has never been higher.

Reducing Risk

There have been some regulatory developments, however, that can assist directors and officers, and their companies, in reducing litigation risk. One of the more important developments is the formal recognition of individual trading plans under SEC Rule 10b5-1. Rule 10b5-1 allows a defendant to establish as an affirmative defense to an insider-trading allegation by the SEC that the trades were made pursuant to a pre-existing trading plan. Although of direct relevance to SEC insider trading allegations, Rule 10b5-1 trading plans can also provide substantial assistance in the defense of private securities fraud claims.

In private securities fraud claims, plaintiffs routinely rely on trading by directors and officers as a key indicator of a fraudulent state of mind (referred to as "scienter"). A properly constructed Rule 10b5-1 trading plan, however, effectively takes the trading decision out of the insider's hands. Even large trades executed pursuant to a 10b5-1 trading plan should not create any inference as to the insider's state of mind. Indeed, courts are now starting to address this issue and, in at least one case, have found that the fact that the individual's trades were executed pursuant to a Rule 10b5-1 trading plan may negate any inference of scienter.

Although any Rule 10b5-1 trading plan will provide a defense to insider trading allegations by the SEC, they are not all equally effective in defending

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against securities fraud claims. The exact structure that is adopted, as well as when the Rule 10b-5 trading plan is put into place, can impact a court's decision on whether trades executed pursuant to the plan were suspicious.

In addition, it is critical that the court be able to consider the trading plan when the court is deciding whether the complaint sufficiently states a claim—and before the plaintiff is allowed to take any discovery. This requires that the company and the individual publicly disclose the plan, and the trades executed under the plan, in sufficient detail that the court may consider it on a motion to dismiss. A 10b5-1 trading plan that helps a defendant to successfully defend a securities fraud claim, but only after discovery has been taken, provides only minimal protection.

Below are some issues to consider when structuring and disclosing 10b5-1 trading plans, from the perspective of assisting the effective and efficient defense of securities fraud claims. While this is only one factor among many to consider when establishing a 10b5-1 trading plan, it is sufficiently important in the current environment that it should be expressly considered. Important benefits from adopting the plan may be lost or gained through relatively small changes to the plan and its surrounding disclosure.

Quick History: What is Rule 10b5-1?

Rule 10b5-1's primary purpose is to clarify the federal standard for insider trading and provide the SEC and federal government with authority for insider trading enforcement actions.

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Prior to Rule 10b5-1's adoption on October 1, 2000, the SEC had relied on Rule 10b 5 general anti-fraud rules as authority for prohibiting insider trading and there had been some confusion as to the precise legal standard for insider trading under this rule.

Specifically, there was a split of authority over whether the insider merely had to trade while in "knowing possession" of material non-public information or if the insider also had to "use" the material non-public information in executing his trade.

Rule 10b5-1 resolved this split by adopting the more expansive "knowing possession" standard. Because this standard creates the potential of significantly increased exposure for insider trading, Rule 10b5-1 also creates an affirmative defense for trades made pursuant to sales contracts or trading plans entered into *before* the insider became aware of the material nonpublic information, even if the trades are executed *after* the insider acquires the material nonpublic information. The defense focuses on the decision to trade, rather than the trade itself. The SEC noted in promulgating the rule that "the revised defense is designed to cover situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision."

The Requirements

The rule sets forth three alternative requirements for the contract or trading plan. The contract or plan must:

1. specify the amount of securities to be traded and the price;
2. include a written formula or algorithm or computer program that determines the amount of securities to be traded and the price; or
3. prevent the insider from exercising "any subsequent influence over how, when, or whether to effect purchases or sales."

Where an insider uses the final alternative and gives trading responsibility to a third party, the third party also must be unaware of any material nonpublic information when he trades.

A trading plan must be entered into before the insider becomes aware of the material nonpublic information, in good faith, and not "as part of a plan or scheme to evade the prohibitions of" Rule 10b5-1.

A trading plan will not prevent an insider from executing trades outside of the plan, but these trades will not be entitled to the protections offered by the rule.

Why Adopt A Rule 10b5-1 Trading Plan?

The primary benefit of any Rule 10b5-1 plan is that it allows corporate executives to sell their company stock to raise cash or diversify their portfolio, while providing a potential defense against insider trading allegations.


For example, in a recent SEC case against Healthsouth, the court denied the SEC's request to freeze the proceeds of alleged insider trading, in part because the court found that some of the trades had been made pursuant to a pre-existing trading plan.

An important corollary benefit of Rule 10b5-1 trading plans, however, is as an aid in preventing and defending securities fraud claims and shareholder derivative lawsuits. Securities fraud claims brought under the Securities Exchange Act's primary securities fraud statutes require a plaintiff to show the defendants acted with a fraudulent state of mind. Allegations of insider trading are often a critical part of the plaintiffs' attempts to show scienter. Indeed, the existence of insider trading may, in some cases, heavily influence the plaintiffs' decision to initially file the suit. With the benefit of hindsight, plaintiffs will argue that stock trades by insiders at "artificially inflated stock prices" demonstrate that these insiders had a motive to commit fraud. Similarly, allegations that an insider sold stock while aware of material nonpublic information can form the basis for shareholder derivative lawsuit for breach of fiduciary duty.

Both securities fraud and breach of fiduciary duty claims often depend on the insider using material nonpublic information when trading company stock to derive a personal benefit. An insider is not using nonpublic information when trades are executed under a Rule 10b5-1 trading plan; the decision to trade was made before the insider acquired any material nonpublic information, or the decision to trade was delegated to an independent third party. Accordingly, the court should draw no inference as to the insider's state of mind at the time the trades were made and, for a breach of fiduciary duty claim, should reject the idea that any illicit insider trading took place.

Rule 10b5-1 is still comparatively new, but some securities fraud cases involving Rule 10b5-1 trading plans are starting to appear. In a recent case against the CEO and CFO of Monterey Pasta Co., the court dismissed a securities fraud complaint on numerous grounds, including the ground that it failed to adequately plead scienter (see related links at right). The court noted that insider trading pursuant to Rule 10b5-1 trading plans "could raise an inference that the sales were pre-scheduled and not suspicious." This conclusion flows logically from the purpose and structure of Rule 10b5-1 and it is anticipated that other courts will agree.

RELATED LINKS

-  [Download The Complaint At Monterey Pasta Company](#)
-  [Download The Related Motion To Dismiss](#)

For a defendant to persuade a court that it should not draw any inference of scienter from insider trading done pursuant to a Rule 10b5-1 trading plan, however, he will probably have to meet two conditions:

1. the terms of the trading plan itself do not interfere with this argument; and
2. the court is able to consider the existence of the trading plan.

The first point depends on how the plan is structured and the second point depends on the accompanying disclosure.

Does The Structure Of The Trading Plan Matter?

Rule 10b5-1 allows for considerable flexibility in the structure of trading plans. The plans may range from a simple plan to sell a certain number or dollar amount of shares every month or quarter, to complex trading formulas based on the company's stock price.

The specific structure adopted by an insider will obviously depend on his unique circumstances. When defending a securities fraud claim, however, the primary objective in using Rule 10b5-1 trading plans is to emphasize that the insider had no motive to engage in the alleged fraud. With that overall goal in mind, it is possible to see that the structure of the trading plan makes a difference.

From a litigation prevention perspective, it is desirable to keep the trading formula as simple as possible, to spread out trades as much as possible, to trade on a fairly regular basis, and to keep the plan in place for a long period of time. Trading frequently and in relatively small amounts exposes insiders to the same market risk as other investors, is plainly consistent with maintaining an insider's liquidity and diversification, and minimizes any suggestion of suspicious trading.

If the trading formula is complex and generates occasional large sales, a plaintiff may be able to plausibly argue that the insider manipulated his trading formula or the company's performance to maximize his personal profits, the very argument that Rule 10b5-1 plans are designed to defuse.

For example, if an insider establishes a Rule 10b5-1 plan with limit prices in the trading formula (which is allowed by the rule), the insider is vulnerable to the allegation that he had a motive to artificially inflate the stock price above the limit price. Any litigation benefit from establishing the Rule 10b5-1 plan may be lost.

Similarly, to the extent that there is any discretion in executing trades pursuant to the Rule 10b5-1 trading plan, for example, in choosing the exact day or days of the month to sell the required number of shares, this discretion must be delegated to a broker. To avoid any suggestion of influence by the insider over the broker, the insider should probably not use his regular broker for his Rule 10b5-1 trading plan.

Plan Adoption And Termination

In addition to the terms of the trading plan, the manner in which it is adopted and/or terminated must be carefully considered to maximize the plan's effectiveness.

Rule 10b5-1 requires that any trading plan be adopted in good faith and at a time when the insider does not possess any material nonpublic information. Adopting a Rule 10b5-1 trading plan during an open trading window is the best way to meet these requirements, as the trading window reflects the company's existing judgment as to when insiders are least likely to possess material nonpublic information.

The trading plan should also provide that trades are not commenced for a significant period after its adoption, at least 30 days and preferably longer. Allowing trades to commence immediately after the Rule 10b5-1 trading plan is adopted creates a significant litigation risk if material adverse information is disclosed afterwards.

Similarly, a Rule 10b5-1 trading plan may elevate the litigation risk for any trades executed outside the plan. Because the insider is presumably meeting his needs for diversification and liquidity through his Rule 10b5-1 trading plan, a plaintiff would likely argue that any additional trades must be for another, illegitimate, purpose. Accordingly, it is prudent for insiders to limit their trading to a Rule 10b5-1 trading plan and avoid amendment or premature termination of the plan.

A recent example of the litigation problems that a poorly structured Rule 10b5-1 trading plan can create is SPX Corporation. The CEO of SPX Corporation announced his adoption of a Rule 10b5-1 plan on January 2, 2004. From January 6, 2004 to February 25, 2004, the CEO sold 727,200 shares pursuant to his Rule 10b5-1 trading plan, for approximately \$45.6 million in proceeds. This was almost half of the total shares subject to the plan. On February 26, 2004, however, SPX announced poor operating results for 2003 and warned that 2004 earnings were likely to be below expectations. SPX's stock price dropped and securities class action lawsuits swiftly followed. The CEO's stock sales were a centerpiece of the securities fraud allegations and drew criticism from analysts, one of whom told Reuters that the company's "credibility took a heavy blow ... on a combination of disappointing results and insider stock selling."

Lawsuits and questions about a company's credibility are the exact opposite of what a Rule 10b5-1 trading plan is supposed to achieve.

What Needs To Be Disclosed About A Rule 10b5-1 Trading Plan?

Even the best designed Rule 10b5-1 trading plan cannot help in defending a securities fraud claim at the start of a case if the court is unable to consider it in deciding a motion to dismiss. Congress recognized the importance of the motion to dismiss in securities fraud cases when it enacted heightened pleading standards and a discovery stay pending a decision on the motion to dismiss as part of the Private Securities Litigation Reform Act of 1995. The vast majority of securities fraud claims that survive a motion to dismiss are settled, and the settlement is often driven as much by the potential enormous costs of discovery as the liability risk.

Accordingly, if a Rule 10b5-1 trading plan cannot be considered by the court at the motion to dismiss phase of a case, it provides minimal protection against securities fraud claims.

Courts, however, only consider a prescribed number of documents when deciding a motion to dismiss. Courts generally will examine documents referenced in the complaint, as well as publicly available documents such as SEC filings, but may decline to go any further.

As it is unlikely a plaintiff will expressly reference a Rule 10b5-1 trading plan in the complaint, it is critical that any Rule 10b5-1 trading plan, as well as any trades made pursuant to the plan, are adequately disclosed by the company in its SEC filings so that the court can examine the information on a motion to dismiss.

With regard to the trades themselves, courts will routinely consider the Forms 4 filed by insiders with the SEC that document their trades. Where a trade has been executed pursuant to a Rule 10b5-1 plan, this fact should be noted on the Form 4 that documents that sale and is filed with the SEC. If this trade is later relied on by a plaintiff to demonstrate scienter, the court can be made aware that it was executed pursuant to a Rule 10b5-1 trading plan.

Merely disclosing that the trading was done pursuant to a Rule 10b5-1 trading plan, however, may not be enough to convince the court that no inference of scienter can be drawn. As a result, companies should also disclose the existence of the Rule 10b5-1 trading plan, as well as some or all of its terms, when the plan is adopted. The disclosure should be filed with the SEC.

From a litigation perspective, the disclosure should be as extensive as possible. This is an area, however, where it will be necessary to balance the privacy concerns of the executives adopting the plan with the potential litigation benefits from full disclosure.

Companies with Rule 10b5-1 trading plans have varied significantly in their disclosures, from simply announcing that a Rule 10b5-1 plan has been adopted, to announcing all of the details of the sales plan. At a minimum, companies should consider disclosing the basic terms of the plan, such as the number of shares it covers and the timing or formula for the trades, as these facts will have to be disclosed in any event when the trade is executed. Whatever degree of disclosure is adopted, the goal is to disclose sufficient information to allow the court to ascertain from the company's public SEC filings that the insider has successfully divorced his trading from any material nonpublic information he may have.

Wrap-Up: Avoiding Pitfalls

Rule 10b5-1 trading plans have the potential to provide substantial assistance in defending against securities fraud claims, but companies and their insiders will need to avoid a few pitfalls.

As a threshold matter, companies should require insiders to obtain permission to establish a Rule 10b5-1 trading plan. This will allow the company to confirm that the plan fully complies with Rule 10b5-1's requirements.

More comprehensively, companies may want to consider requiring their directors and officers—as some companies already do—to *only* trade in company stock pursuant to approved Rule 10b5-1 trading plans. This requirement could be part of the individuals' employment agreements and be made public through SEC filings. The value to a company in reduced litigation risk, positive investor relations, and (potentially) lower directors and officers insurance premiums, may compensate for any resistance to the concept from director and officer candidates.

As for the structure and disclosure of the Rule 10b5-1 trading plans, they should be as long and as simple as possible, avoid any possibility of influence by the insider over the trades themselves, and provide for a significant period to elapse before trades commence.

The adoption of the Rule 10b5-1 trading plans and their terms, at least in summary form, should be publicly disclosed and every trade executed pursuant to the plans should be expressly identified as such on the Forms 4 filed with the SEC.

Following these basic procedures will allow companies to maximize the benefits of Rule 10b5-1 trading plans, at a time when securities fraud defendants frequently need all the assistance they can get.

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