



A Primer on SEC Rule 10b5-1: Affirmative Defenses For Insider Trading

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Securities and Exchange Commission (“SEC”) Rule 10b5-1, issued in 2000, provides a means for corporate insiders and others to engage in certain prearranged securities transactions without running afoul of the prohibition on trading on the basis of material nonpublic information about the securities. It is unclear to what extent the rule has been utilized. With the recent increase in stock prices, however, the utility of the rule should not be overlooked by executives and other insiders who are searching for a means to diversify their portfolios or dispose of stock for other reasons when they may come into possession of material nonpublic information at a time when they would otherwise want to trade.¹

Because the defenses provided by the rule are narrow and appear to be intended by the SEC to be the exclusive defenses to a charge of unlawful insider trading in certain circumstances, it is essential that those who intend to avail themselves of the rule clearly understand and scrupulously adhere to it. This summary is intended to promote an understanding of the basic concepts of Rule 10b5-1 and its utility. Because neither the SEC nor the courts have had occasion to interpret Rule 10b5-1, there are some areas of uncertainty. Moreover, many of the subjects addressed by this summary are presented in general terms; careful attention should be exercised when taking advantage of Rule 10b5-1, especially where it interacts with other SEC rules, such as Rule 144 and Rule 13d-1.

Background

Q. What is the prohibition on insider trading?

A. Prohibited insider trading is not defined in any statute or regulation. The courts have established the principal elements of the prohibition. Stated very generally, a corporate insider may not trade in that corporation’s securities on the basis of material nonpublic information about the corporation, that is, significant information that has not been publicly disclosed. Nor may a person trade on the basis of material nonpublic information about any company where the information has been misappropriated from someone in breach of a duty. Further, one who receives material nonpublic information from an insider or a misappropriator — called a “tippee” — may not trade on the basis of that information if he knew or should have known that it was provided to him in breach of a duty to the original source of the information.²

Q. What concern gave rise to the rule?

A. While the leading cases delineating what constitutes unlawful trading generally spoke in terms of the prohibition on trading “on the basis of” material nonpublic information, it was not clear what that meant. In particular, there was no definitive authority whether liability could be based on trading while in mere possession of material nonpublic information or whether the SEC in an enforcement action, for example, had to establish that the defendant actually made use of the material nonpublic information in deciding to trade. There were other gray areas, including the situation where a person reached a decision to make a particular trade without any awareness of material nonpublic information but then came into possession of such information before the trade was executed.³

Q. What was the SEC’s resolution of this issue?

A. The SEC concluded that a “knowing possession” standard for a violation better accomplishes the goals of the prohibition on insider trading than a “use” test. At the same time, the SEC recognized that in some respects a strictly applied knowing possession standard could be overbroad. Therefore, the SEC adopted an “awareness” test with specific affirmative defenses that, in its view, “cover situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision.”⁴ Rule 10b5-1 sets forth both the test and the defenses.

Rule 10b5-1

Q. What is the gist of Rule 10b5-1?

A. According to the SEC, one element of a Rule 10b-5 violation is trading with an awareness of material nonpublic information. Rule 10b5-1 specifies when the decision is made without that awareness.

Q. Are the defenses provided in Rule 10b5-1 exclusive?

A. The SEC rejected suggestions that there be a general “non-use” defense or that the defenses be non-exclusive safe harbors, on the grounds that that approach “would effectively negate the clarity and certainty that the rule attempts to provide.”⁵ This might be construed as meaning

that the SEC intended the rule's defenses to be exclusive. For this reason, strict adherence to the elements of a defense is advisable unless and until it becomes clear that the SEC did not so intend or a court determines that the SEC has overstepped its authority by too narrowly interpreting Section 10(b) of the Securities Exchange Act and Rule 10b-5 itself.

Some may refer to these defenses as "safe harbors," which they are. This characterization should not obscure the fact that while some safe harbors apply where other facts and circumstances may nevertheless give rise to protection under the underlying statute, that may *not* have been the SEC's intention here.

Q. What is the benefit of the rule?

A. The rule has two obvious benefits.

First, it provides significant guidance on how to structure securities transactions to avoid trading on the basis of material nonpublic information. This makes it possible, for example, for an insider to engage in a regular liquidation program to pay recurring expenses (*e.g.*, college tuition) or to diversify an investment portfolio without having to suspend or terminate that program if the insider becomes aware of material nonpublic information.

Second, where transactions are carried out in accordance with one or more of the defenses a corporate executive will be able to explain to the public that purchases or sales of his company's stock were not based on any material nonpublic information. This may have the collateral benefit of dampening volatility in the stock price based on speculation about why insider transactions occurred.

Q. Under Rule 10b5-1, what constitutes trading "on the basis of" material nonpublic information?

A. The rule defines trading "on the basis of" material nonpublic information to mean that "the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale" unless an affirmative defense applies. Rule 10b5-1(b).

Q. Does Rule 10b5-1 define what it means to be "aware" of information?

A. The SEC defined "aware" to mean "having knowledge; conscious; cognizant,"⁶ although this definition does not appear in the rule itself. Proof of awareness in litigated

cases will often depend on circumstantial evidence, just as proof of "possession" or "use" has in prior cases.

The Affirmative Defenses

Q. When does an affirmative defense afforded by Rule 10b5-1 apply?

A. An affirmative defense applies when the provisions of the defense are satisfied so long as the action taken to establish the defense was "in good faith and not as part of a plan or scheme to evade the prohibitions" of Section 10(b). Rule 10b5-1(c)(1)(ii).

Q. What are the affirmative defenses?

A. The rule deems a purchase or sale to be not "on the basis of" material nonpublic information if — *before becoming "aware" of material nonpublic information* — the person had

- entered into a binding contract to purchase or sell the security — or
- instructed another person to purchase or sell the security for the instructing person's account — or
- adopted a written plan for trading securities. Rule 10b5-1(c)(1)(i)(A).

Q. Does Rule 10b5-1 state what is meant by a contract, instruction or plan?

A. Yes. The contract, instruction or plan must

- specify the amount of securities to be purchased or sold *and* the price at which *and* the date on which the securities are to be purchased or sold — or
- include 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 are to be purchased or sold — or
- not permit the person to exercise *any* subsequent influence over how, when or whether to effect purchases or sales, provided that any other person who, pursuant to the contract, instruction or plan, did exercise such influence must not himself have been aware of material nonpublic information when doing so.

Further, the transaction must be executed pursuant to the contract, instruction or plan. Rule 10b5-1(c)(1)(i)(B).

Q. What does the rule mean by “amount of securities”?

A. “Amount” means either a specified number of securities (such as shares of common stock) or a specified dollar value of securities. Rule 10b5-1(c)(1)(i)(C)(iii)(A).

Q. What does the rule mean by “price” of securities?

A. “Price” means the market price on a particular date, a limit price or a particular dollar price. Rule 10b5-1(c)(1)(i)(C)(iii)(B). Thus, an order to sell “at the market” on a particular day satisfies the rule.

Q. What does the rule mean by “date”?

A. In the context of a sale at the market price, “date” means the specific day of the year on which the order is to be executed, or as soon thereafter as practicable under ordinary principles of best execution of a securities transaction. In the case of a limit order, “date” means a day of the year on which the limit order is in force. Rule 10b5-1(c)(1)(i)(C)(iii)(C). For example, if a limit order is “good ‘til canceled,” “date” means the time between when the order is placed and when it is executed in accordance with its terms, is canceled or expires under the broker’s rules that provide for automatic expiration of such an order. Any cancellation must be in accordance with the parameters set forth in the contract, instruction or plan that is in compliance with the rule.

Q. Does this mean that in order to satisfy the affirmative defense a person must place an order to sell a specific amount of securities — either in terms of number of securities or total value of securities — at the market on a specified future date or pursuant to a limit order effective for a specific period?

A. No. There are several ways to establish an affirmative defense. Rule 10b5-1 also allows orders to be placed pursuant to a *written* formula or computer program that will generate the timing and price of the transaction *independent* of any further instructions of the person making the trade, so long as the formula or program was put into place when the person was not aware of material nonpublic information.

Q. Must a contract under Rule 10b5-1 be in writing?

A. No, the contract need not be in writing. Only a formula, algorithm or computer program need be in writing.⁷

Q. Is a Rule 10b5-1 plan subject to approval by the issuer of the securities that are the subject of the plan?

A. No, there is no legal requirement for issuer approval. Some companies may impose that requirement to assure that the terms of any plan for an officer or director conform to the company’s securities trading policy. For example, the company policy may prohibit trading at a time when a trade would otherwise be executed in compliance with the trading plan. In that event either the plan should conform to the company’s blackout restrictions or it may be appropriate to amend company policies to permit trades during “blackout periods” so long as the trade is in compliance with Rule 10b5-1. In any event, out of an abundance of caution an officer or director should submit the plan to company counsel for approval or comment.

Q. More generally, what impact does Rule 10b5-1 have on quarterly blackout periods that issuers impose on some or all company personnel?

A. The purpose of a blackout period, usually surrounding the announcement of quarterly earnings, is to minimize the chance that someone will engage in an improper or suspect transaction. Compliance with a blanket prohibition such as a blackout eliminates the risk that someone will exercise faulty judgment in trading, *e.g.*, erroneously believing that the nonpublic information they have is not material.

In concept, the availability of the affirmative defenses under Rule 10b5-1 should make it possible to except from the blackout those who establish a Rule 10b5-1 contract, instruction or plan when they are not aware of material nonpublic information. Therefore, a public company could provide that the blackout does *not* apply to those who have a Rule 10b5-1 compliant contract, instruction or plan in place, *e.g.*, one that has been approved by the company. Lifting the blackout generally to accommodate Rule 10b5-1-protected transactions, however, diminishes the simplicity and the prophylactic effect of the absolute blackout, where the company cannot reasonably scrutinize each individual contract, instruction or plan to determine if it is compliant or cannot police trading to assure that it is conducted in all cases in conformity with the contract, instruction or plan.

This concern can be alleviated if exclusion from the blackout is permitted only where the person implements a trading plan that is in a form pre-approved or prescribed by the company or the person provides the company with documentary evidence of granting another person complete control over trading decisions.

Alternatively, the company could retain the blackout and mandate that the terms of the blackout be included in any covered person's Rule 10b5-1 contract, instruction or plan, so that there would be no purchases during the blackout period even where the contract, instruction or plan would otherwise call for a transaction.

In situations where a blackout is imposed for special purposes, *e.g.*, in anticipation of announcing a major corporate development, the company has the same option: it can except from the blackout transactions that are in accordance with a pre-existing Rule 10b5-1 arrangement or can require that any contract, instruction or plan provide that it be suspended upon implementation of a blackout.

Q. Can a person, such as a corporate executive of a publicly traded company, simply turn over to another person authority to trade for the executive?

A. Yes. The rule provides a defense where a person delegates full authority to a second person, such as an investment manager, to trade for the account of the first person. This defense will be successful, however, only if the delegation of authority was clear, the executive exercised no authority whatsoever over the timing or other aspects of the actual trading decision made by the second person, and the executed transaction was in accordance with the terms of the authority that was granted. Moreover, the delegation should be to someone who will not himself become aware of material nonpublic information about the securities in question. If the person to whom authority was delegated does become aware of such information, the trade will have to independently satisfy one of the other affirmative defenses (*e.g.*, that the trade was executed in accordance with a written formula that was established before the person effecting the trade became aware of the information).

Q. Must this delegation of authority be in writing?

A. Rule 10b5-1 does not require that the delegation of trading authority be in writing in order to sustain the defense.⁸ A written delegation of authority is strongly recommended, however, because it provides clear evidence of the fact of the delegation as well as the terms

of the delegation, including some degree of proof that the person making the delegation did not retain any influence over how, when or whether to effect a trade. Moreover, other regulations under the securities laws may require that certain grants of investment discretion be in writing.

Q. Can the written program be based on a formula that tracks a market index, market segment or group of securities, for example, providing for purchases or sales of stock in an executive's company based on movements of a group of stocks in the same industry?

A. Yes, as long as the concept is clearly defined. While the final form of Rule 10b5-1 did not expressly include such a defense, which had been in the rule as first proposed, the SEC stated that the final rule encompassed that approach.⁹

Q. Did the SEC place any qualifications on the requirement that the actual transaction be in accordance with the contract, instruction or plan?

A. Yes. A transaction is deemed *not* to have been made pursuant to the contract, instruction or plan if the person who entered into the contract, instruction or plan "altered or deviated from the contract, instruction, or plan . . . 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." Rule 10b5-1(c)(1)(i)(C).

Q. Is there any other affirmative defense?

A. Yes. A further affirmative defense was provided for entities, essentially codifying the information barrier defense on which financial institutions have relied for many years. Rule 10b5-1(c)(2).

A transaction by a non-natural person is not "on the basis of" material nonpublic information if two criteria are satisfied:

- The natural person who made the actual investment decision for the entity was not aware of the material nonpublic information when that person made the decision to trade — and
- The entity had implemented reasonable policies and procedures to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information, including policies and procedures that

restrict such individuals from becoming aware of material nonpublic information.

The existence of effective information barriers thus affords an additional defense for entities. Entities also can avail themselves of the other affirmative defenses afforded by Rule 10b5-1.

Q. If a person makes a trade while aware of material nonpublic information but does not use that information in deciding to trade, is that unlawful?

A. In the view of the SEC, that transaction would be unlawful even if the information was not used in making the decision — unless one of the affirmative defenses in the rule can be established. The SEC adhered to its analysis that “a trader who is aware of inside information when making a trading decision inevitably makes use of the information.”¹⁰ As stated earlier, there may be challenges to the SEC’s power to define exhaustively what is and what is not a violation of Section 10(b), pursuant to which Rule 10b-5 was promulgated in the first place. Obviously, the best course is for persons who may come into possession of (and thus become aware of) material nonpublic information to conduct their transactions in compliance with Rule 10b5-1.

Q. The Supreme Court has held that proof of scienter — generally defined as an intent to deceive or reckless conduct — is necessary in order to establish a violation of Rule 10b-5. Does Rule 10b5-1 change this?

A. When it issued the rule, the SEC expressly stated that Rule 10b5-1 deals only with the possession/use issue, that no other aspect of the law of insider trading is affected and that the scienter requirement remains intact.¹¹

Applications of Rule 10b5-1

Q. If a person simply delegates authority to another person to handle all trading, similar to a blind trust, will that satisfy the affirmative defense if a trade occurs when the person who delegated the authority was aware of material nonpublic information at the time of the trade?

A. Yes. Indeed, when the SEC first proposed Rule 10b5-1 it said that true blind trusts do not need the protection of the rule at all because trading by a blind trust does not

create difficulties under existing insider trading law.¹² Rule 10b5-1 underscores that trading under this approach is permissible. However, as noted above, it is best that any delegation of authority be in writing and that the delegation be to someone who is not likely to become aware of material nonpublic information and thus be disabled from directing the trading.

Q. Does Rule 10b5-1 also apply to an investment vehicle in which an insider has an interest?

A. Yes. For example, if an insider is an investor in a partnership that holds securities of the insider’s company and that insider has a decision-making role in the partnership, a transaction by that partnership could pose an insider trading problem if it occurred when the insider-partner was aware of material nonpublic information. If the partnership complies with Rule 10b5-1 when trading in the securities of the insider’s company — using either a contract, instruction or plan defense or the information barrier defense — the partnership and the partners should be protected.

Q. Is there any particular time when a trading plan should be put in place?

A. The only requirement under Rule 10b5-1 is that the plan can be put in place only when the person is not aware of material nonpublic information about the issuer of the stock that is the subject of the plan. An ideal time to put a plan in place is during a “window” period under a company’s securities trading policy; this is the time when insiders are allowed to trade, which typically is shortly after the company has made a comprehensive disclosure, such as on Form 10-K or Form 10-Q.

Q. Once a Rule 10b5-1 trading plan is put in place, can it be changed?

A. Yes, so long as the change is made in good faith and *at a time when the person is not aware of material nonpublic information*. (This concept also applies to canceling the plan, discussed in the following answer.) Any subsequent transaction made in accordance with a revised plan that complies with the rule will be protected. Good faith, however, may be questioned if the trader makes frequent changes in the trading plan. A plan that is often adjusted might be argued not to be a complying plan at all, but merely a succession of individual trading decisions that would not qualify for any of the defenses.

Q. Can a plan or program be cancelled, rescinded or abandoned?

A. The rule does not prohibit canceling, rescinding or abandoning a program. A company or an insider ought to be able to call a halt to a program at any time, even if the company or the insider has become aware of material nonpublic information. Cancellation, rescission or abandonment of a program does not result in a purchase or sale of a security that can be questioned under Rule 10b-5. At the same time, purchases or sales pursuant to a program that occurred prior to cancellation, rescission or abandonment of a particular program might be questioned if the act of halting the program occurs at a time when the person effecting the halt is aware of material nonpublic information, on the grounds that such cancellation, rescission or abandonment should be regarded as evidence of bad faith and a “scheme” to evade the strictures of Section 10(b).

Several points bear emphasis in this connection.

- It is inherent in the concept of the defenses that the initiator of a program may exercise no influence over the manner in which the program is carried out. That is, the person may not override a contract or implementation pricing formula on a case-by-case basis, although programs can be amended consistent with the requirements of the rule. As already noted, a frequently amended plan might not qualify under Rule 10b5-1, with the result that each transaction would have to satisfy the requirements of Rule 10b-5 independently.
- The affirmative defense may be used for a single transaction, such as an order to a broker to buy or sell a specified number of shares at the market or pursuant to a limit order, so long as the order was placed when the person was not aware of material nonpublic information. The placement of the order and its terms should be documented when it is placed.¹³
- Only a purchase or sale on the basis of material nonpublic information violates Rule 10b-5. A decision *not* to sell or buy does not violate that rule. Therefore, if a person who has put in place a regular selling program that complies with Rule 10b5-1 later comes into favorable material nonpublic information and thus decides he does not want to sell the stock can terminate the program, unless the contract, instruction or plan is constructed in a way that precludes termination. Such termination, by itself, would not violate the law, even if termination, and the right to terminate, were held to undermine compliance Rule

10b5-1.¹⁴ That is, the affirmative defense is not needed if there is no consummated transaction to defend. It bears repeating that *a program that is frequently cancelled and restarted may not qualify to protect a transaction because the program may be found not to have been established in good faith.*¹⁵

- Cancellation of an established program may be a (true or false) signal to those aware of the cancellation that material nonpublic information has motivated the cancellation, when the insider has been required to disclose or otherwise has taken the affirmative step of announcing his trading plan in advance — e.g., to defuse speculation about the reasons for his transactions if they are later revealed or required to be reported.

Q. Can a corporation use Rule 10b5-1 in connection with repurchases of its own stock?

A. Yes. The SEC dealt specifically with this issue:

“[A]n issuer could adopt a written plan, when it is not aware of material 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.”¹⁶

Either a written plan or a delegation of authority should conform to SEC Rule 10b-18, regarding issuer repurchases of equity securities, in order to take advantage of that safe harbor from liability for manipulation under Section 9(a)(2) of the Securities Exchange Act and Rule 10b-5. In this connection it is important to note that Rule 10b-18 encompasses not only repurchases by or on behalf of the issuer but also repurchases by an “affiliated purchaser” (Rule 10b-18(a)(3) and (b)), and so that an issuer’s transactions that are intended to be protected by the manipulation safe harbor must take into account, among other transactions, an affiliated purchaser’s transactions that are executed unbeknownst to the affiliated purchaser pursuant to a pre-existing Rule 10b5-1 plan. Issuer repurchases should be reported as summarized in Preliminary note 2 to Rule 10b-18 as amended effective in December 2003. Delegation of discretion should be to an entity that itself either is unlikely to become aware of material nonpublic information regarding the issuer or, at the very least, can qualify for the information barrier

defense provided by Rule 10b5-1(c)(2), so that those who would be making the trading decisions for the issuer's repurchase program would be isolated from others in the entity who might become aware of such information. Alternatively, an issuer itself can also take advantage of the entity defense in Rule 10b5-1(c)(2).¹⁷

Q. Employees, including non-executives, may become aware of material nonpublic information at a time when they would otherwise pay the exercise price of stock options by selling stock or buy stock in an employee benefit plan, such as a 401(k) plan. Does the rule afford any protection in these situations?

A. Yes. An employee can adopt a written plan with a formula for determining the specified percentage of her vested options to be exercised and selling sufficient shares to pay the exercise price. In the case of a stock purchase or 401(k) plan, the employee can instruct the plan administrator to purchase stock pursuant to a predetermined plan or formula.¹⁸ The instructions should be in writing that complies with the rule.

Q. Do any special rules apply to trading in a self-directed benefit plan pursuant to a Rule 10b5-1 plan?

A. Yes. Under Section 306 of the Sarbanes-Oxley Act of 2002 it is unlawful for a director or executive officer of a public company to trade in the stock of the company during a blackout period applicable to that security, where "blackout period" means a suspension of or restriction on trading activity in a benefit plan for a period of more than three consecutive business days. SEC Regulation BTR as well as rules of the Department of Labor have implemented this prohibition. During such a blackout a transaction that is in compliance with Rule 10b5-1(c) is exempt from this prohibition, so long as the person did not enter into or modify the contract, instruction or written plan during the blackout period or while aware of the actual or approximate beginning and ending dates of the blackout period.¹⁹

Q. Can a person exercise a standardized call or put option, i.e., one that was purchased on one of the options exchanges, while aware of material nonpublic information regarding the issuer of the underlying stock without having to satisfy one of the affirmative defenses?

A. Not according to the SEC.²⁰ This may be one of the more controversial aspects of Rule 10b5-1. The SEC takes

the position that the exercise of the option — even though it is the exercise of a pre-existing contractual right where the writer of the option has no choice but to honor an exercise notice — is an investment decision by the holder of the option in which material nonpublic information can be exploited in violation of Rule 10b-5. Therefore, if a person is aware of material nonpublic information, under the SEC's interpretation he cannot exercise the option unless the transaction is covered by one of the affirmative defenses. Compliance with the defense could, however, be accomplished through a program of exercises pursuant to a written protocol — adopted when the person did not have such information — that specified the dates of exercise, series of options to be exercised where there was more than one series owned and the number of options to be exercised, or specified a formula for exercising.²¹

Q. Does the same principle apply to an over-the-counter option?

A. The SEC's analysis described in answer to the preceding question would apply equally to the holder of an over-the-counter option. A violation could be avoided by the holder who wishes to exercise the option in that situation by disclosing the material nonpublic information to the counterparty pursuant to a confidentiality agreement that precludes the counterparty from disclosing or trading on the basis of the information. This entirely private transaction, *i.e.*, one not conducted on an exchange, should not then pose any Rule 10b-5 problem for the option holder-exerciser. Of course, this solution is not available in the case of standardized options because the option holder and option writer are strangers — there is no means by which the exerciser can make a limited disclosure to the writer in order to avoid what the SEC believes is a Rule 10b-5 violation. In both cases, at the time the option is acquired and when the holder was not aware of material nonpublic information, the option holder could provide for exercise of the option at expiration if it is in-the-money at that time (and has not been closed out) — an instruction that would comply with the new rule.

This also raises a point that may have been overlooked by the SEC when commenting on the propriety of developing a plan for selling stock in order to exercise company stock options, noted above. Even under the SEC's broad theory that the exercise of an option when in possession of material nonpublic information can violate Rule 10b-5, there would ordinarily be no problem in exercising a company-issued option, because the company presumably has that same nonpublic information. This principle would not apply, however, if the optionee had misappropriated

information from a third party that favorably reflected on the company that issued the option but which was not (yet) known to the company, e.g., that a customer was about to place a major order. Under the SEC's broad theory, the option holder could not exercise the option without making disclosure to the issuer. Many complex unresolved issues remain regarding the interplay of options and Rule 10b5-1.

Q. How does Rule 10b5-1 affect hedging transactions?

A. As already noted, a purchase or sale is not pursuant to a contract, instruction or plan in compliance with the rule if the person who entered into the arrangement also entered into or altered a corresponding or hedging transaction or position with respect to the securities *after* establishing the contract, instruction or plan. Rule 10b5-1(c)(1)(i)(C). Because it is permissible to change the contract, instruction or plan at any time before one becomes aware of material nonpublic information, one ought to be able to enter into or alter the hedge or other position so long as that, too, occurred before becoming aware of the material nonpublic information. For example, certain hedges expire by their terms; it should be possible to reestablish such a hedge as part of the Rule 10b5-1 plan. Nevertheless, because the SEC has not expressly provided for that, this aspect of hedging should be viewed as an unresolved issue.

The SEC interprets Rule 10b5-1 not to permit dynamic hedging by institutions that seek to rely on the information barrier affirmative defense where the individual who manages the hedge at the trading desk is aware of material nonpublic information.²² This problem can be avoided either by segregating personnel so that those who manage the hedge are not made aware of the information or by establishing a formula for the hedge before the entity becomes aware of material nonpublic information. This underscores that entities are not limited to the information barrier defense.

Q. How does Rule 10b5-1 apply in the context of selling securities that have been pledged by someone who comes into possession of adverse material nonpublic information?

A. Generally speaking, if a person has pledged securities, e.g., for a bank loan or a margin loan, at a time when the person was not aware of material nonpublic information regarding the issuer of the securities and the loan then comes due or a margin call is issued when the person is aware of such information, a sale of the collateral in the open market will not be protected by Rule 10b5-1; in each

case the pledgor had the right to pay the loan and his decision not to pay reflects control over the sale that is inconsistent with Rule 10b5-1. A limited exception to this principle is when the broker did not give notice to the pledgor before selling the stock and the broker itself did not have material nonpublic information.²³

Q. Does Rule 10b5-1 have any effect on Section 16 of the Securities Exchange Act or the rules under Section 16?

A. Section 16 and its rules, which deal with transactions by certain officers, directors and owners of 10% of the equity securities of a public company, are unaffected by Rule 10b5-1. The SEC has drafted the affirmative defenses "so that their conditions should not conflict with the conditions of Section 16 exemptive rules."²⁴ Thus, if a programmed trade resulted in a transaction reportable under Section 16(a), a Form 4 should be filed as it would be for any such transaction, and if programmed trades resulted in a short-swing profit, no matter how unintended, the profit would have to be paid to the issuer under Section 16(b). Thus, special care must be exercised to establish a protocol for compliance with Section 16.

Q. Does Rule 10b5-1 have any effect on Rule 144 for sales of securities of restricted stock or sales by affiliates of the issuer?

A. Rule 10b5-1 has no direct effect on Rule 144. However, anyone selling securities covered by Rule 144 must be sure that any contract, instruction or plan is consistent with Rule 144 and that any required filing of Form 144 is made in anticipation of possible sales triggered by implementation of the contract, instruction or plan. In other words, even though the owner is not in control of when the sales are made, Rule 144 and the filing requirements with respect to Form 144 must nevertheless be complied with.²⁵

Form 144 contains a certification that the seller "does not know any material adverse information in regard to the current and prospective operations of the Issuer of the securities to be sold which has not been publicly disclosed." Because the timing of a sale under a Rule 10b5-1 plan, and thus the timing of filing a Form 144, is inherently outside the control of the seller, the SEC staff permits modification of Form 144 to make the representation as of the date the Rule 10b5-1 plan is adopted or the Rule 10b5-1 compliant instructions are given, specifying that date.²⁶

Rule 10b5-1 may be of particular use to persons subject to Rule 144. A person may not be able to sell securities until her holding period expires under Rule 144. While waiting for the period to expire, however, she may become aware of material nonpublic information that would preclude a sale when the holding period later expires. Before becoming aware of material nonpublic information she should put a Rule 10b5-1 sale program into effect that will be implemented upon expiration of the holding period. This will permit sales after the holding period expires even if by then she has learned material nonpublic information. At the same time, special problems may arise if the person seeking to use Rule 144 is one whose transactions are aggregated with an affiliate of that person for purposes of determining compliance with the transaction volume limitations of Rule 144(e).²⁷

Q. Does Rule 10b5-1 have any effect on Schedule 13D filing requirements?

A. Any person subject to Schedule 13D requirements, which apply where the person is the beneficial owner of more than 5% of a class of equity security registered under the Exchange Act, must comply with those requirements with respect to any trades made pursuant to a Rule 10b5-1 program. For example, if purchases under the program result in the acquisition of a material additional amount of securities (1% being deemed material for these purposes²⁸), an amended Schedule 13D must be filed. Likewise, if sales pursuant to a Rule 10b5-1 program result in ownership falling to 5% or below, an amended Schedule 13D should be filed. Members of a “group” filing a Schedule 13D, one of more of whom may have independent Rule 10b5-1 programs in effect, must exchange information to assure that timely amendments are filed.

In addition, Item 4(a) of Schedule 13D requires disclosure of “any plans . . . which relate to or would result in [t]he acquisition . . . of additional securities of the issuer, or the disposition of the securities of the issuer.” This requires disclosure of any Rule 10b5-1 contract, instruction or plan, and an amendment to the Schedule 13D to reflect any change in a previously disclosed Rule 10b5-1 contract, instruction or plan.

Q. Does Rule 10b5-1 have any effect on Regulation M when the issuer with which the person is affiliated is engaged in a distribution of securities?

A. Any transaction entered into pursuant to a Rule 10b5-1 compliant contract, instruction or plan that would otherwise be prohibited by Regulation M would still be prohibited by that regulation. Therefore, the Rule 10b5-1 plan must have a built in trigger so that it is suspended in the event that a transaction pursuant to the plan would violate Regulation M.

Q. Are there other circumstances that should give rise to an automatic suspension or termination of a Rule 10b5-1 plan?

A. Yes. Rule 10b5-1 provides a defense only to a claim of a violation of Rule 10b-5. There is also a prohibition on insider trading — buying or selling — in Rule 14e-3, when a person is in possession of material nonpublic information regarding a tender offer. Because Rule 10b5-1 does not expressly provide a defense in the event that the person who establishes a trading plan comes into possession of material nonpublic information regarding a tender offer, the plan should provide for cancellation when the person comes into possession of that kind of information. Of course, to be effective, the person needs to communicate that fact, on a confidential basis, to the entity that is implementing the plan. Alternatively, the person whose plan does not include that automatic termination clause should unilaterally terminate the plan upon learning of the information regarding the tender offer. Rule 14e-3(b), however, contains a defense for an entity comparable to Rule 10b5-1(c)(2).

Q. Is there any requirement to disclose existence of a Rule 10b5-1 plan?

A. At the present time there is no requirement to disclose the existence of a Rule 10b5-1 plan unless disclosure is required under some other statute or rule, such as under Section 13(d) as discussed above. Some companies have made voluntary disclosure.²⁹ In April 2002 the SEC proposed to amend Form 8-K by adding what was then identified as proposed Item 10(b), which would require disclosure regarding any Rule 10b5-1 plan of any director or executive officer of the registrant.³⁰ The proposal has neither been adopted nor withdrawn.³¹

Q. Can a person who has a Rule 10b5-1 plan or instruction in place engage in a transaction in the same securities independently of the plan?

A. Yes. As a general matter the better rule appears to be that existence of a plan or instruction does not preclude another transaction, so long as it is not otherwise in violation of Rule 10b-5 and is not a prohibited hedging transaction. If shares that are the subject of the plan are sold or options that are subject to the plan are exercised, that may be deemed to be a modification of the plan, however, which would have to comply with Rule 10b5-1.

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¹ The rule was proposed in SEC Release 34-42259 (Dec. 20, 1999), available at <http://www.sec.gov/rules/proposed/34-42259.htm> (“Proposing Release”). The rule was adopted in SEC Release 33-7881 (Aug. 15, 2000), available at <http://www.sec.gov/rules/final/33-7781.htm> (“Adopting Release”), which also contains the text of the rule. The rule became effective October 23, 2000.

² See generally *Dirks v. SEC*, 463 U.S. 646 (1983); *United States v. O’Hagan*, 421 U.S. 642 (1997).

³ See generally Donna M. Nagy, “The ‘Possession vs. Use’ Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never be Golden,” 67 U. Cin. L. Rev. 1129 (1999); Allan Horwich, “Possession versus Use: Is there a Causation Element in the Prohibition on Insider Trading?,” 52 Bus. Law. 1235 (1997).

⁴ Adopting Release at text at note 115.

⁵ Adopting Release at III.A.1.

⁶ Adopting Release at note 105.

⁷ SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fourth Supplement (May 30, 2001), available at <http://www.sec.gov/interps/telephone/phonesupplement4.htm>. (“Telephone Interp.”), Rule 10b5-1, Question 17.

⁸ Telephone Interp., Rule 10b5-1, Question 17.

⁹ Adopting Release at note 110.

¹⁰ Adopting Release at text at note 104.

¹¹ Adopting Release at III.A.1.

¹² Proposing Release at note 91.

¹³ Examples of compliant and non-compliant limit orders are addressed at Telephone Interp., Rule 10b5-1, Questions 11.

¹⁴ As a general matter, Rule 10b-5 prohibits certain transactions only in connection with a consummated purchase or sale. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). See Telephone Interp., Rule 10b5-1, Question 15(a).

¹⁵ See, e.g., Telephone Interp., Rule 10b5-1, Question 15(b).

¹⁶ Adopting Release at text at note 116.

¹⁷ Telephone Interp., Rule 10b5-1, Question 18.

¹⁸ Telephone Interp., Rule 10b5-1, Question 16.

¹⁹ Regulation BTR, Section 101(c)(2).

²⁰ Adopting Release at note 115. See also Telephone Interp., Rule 10b5-1, Question 5.

²¹ See, e.g., Telephone Interp., Rule 10b5-1, Question 6.

²² Adopting Release at note 125.

²³ Telephone Interp., Rule 10b5-1, Questions 8-9.

²⁴ Adopting Release at text at note 123.

²⁵ Telephone Interp., Rule 10b5-1, Question 1.

²⁶ Telephone Interp., Rule 10b5-1, Question 2.

²⁷ Telephone Interp., Rule 10b5-1, Questions 3-4, 12.

²⁸ SEC Rule 13d-2(a).

²⁹ See, e.g., Form 8-K filed by JDS Uniphase Corporation dated February 28, 2001, available at <http://www.sec.gov/Archives/edgar/data/912093/000089161801500085/f70044e8-k.txt>.

³⁰ SEC Release 33-8090 (April 12, 2002), available at <http://www.sec.gov/rules/proposed/33-8090.htm>.

³¹ See SEC Release 34-46313, text at note 16 (Aug. 6, 2002), available at <http://www.sec.gov/rules/other/34-46313.htm>.