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Safe Harbor Rule 10b5-1 Trading Plans For Executives May Not Be "Safe" Anymore

The Safe Harbor That May Not Be Safe

All companies, directors and executives should take note of the warning made in a March 8, 2007 speech given by Linda Chatman Thomsen, Director of the SEC's Division of Enforcement. In that speech, Ms. Thomsen stated that the SEC is "looking at" trading conducted under Rule 10b5-1 plans by company executives, and looking at those trades "hard." She explained that "[w]e want to make sure that people are not doing here what they were doing with stock options. If executives are in fact trading on inside information and using a plan for cover, they should expect the 'safe harbor' to provide no defense."

Rule 10b5-1: Pre-Planned Transactions

Executives frequently have access to material, non-public information and are prohibited from acting on that information by buying or selling shares. The SEC enacted Rule 10b5-1 in 2000 to permit an executive who has possession of insider information to buy or sell securities pursuant to a previously adopted written trading plan. 17 C.F.R. §240.10b5-1. The SEC created this "safe harbor," as Ms. Thomsen explained, "to give executives regular opportunities to liquidate their stock holdings — to pay their kid's college tuition, for example — without risk of inadvertently facing an insider trading inquiry."

Specifically, Rule 10b5-1 provides an affirmative defense to the charge of insider trading if a plan is adopted *before* the executive becomes aware of the material non-public information. The 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 or to have any subsequent influence over how, when, or whether to effect purchases or sales.

The Rule also states that the affirmative defense will not apply if the person who entered into the plan altered or deviated from the 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.

The Stanford Study And Others

In December 2006, Alan D. Jagolinzer, an Assistant Professor at Stanford University's Graduate School of Business, released a study entitled "Do Insiders Trade Strategically Within The SEC Rule 10b5-1 Safe Harbor?" Professor Jagolinzer examined over 100,000 trades conducted by over 3,000 executives participating in Rule 10b5-1 plans and concluded that the trades by those executives outperformed the trades by executives who did not participate in such a plan by almost six percent.

In her March 8, 2007 remarks, Ms. Thomsen cited the Stanford Study and pointed to a *Business Week* article that discussed the results of the magazine's examination of information available on another database. Ms. Thomsen stated that the studies "suggest that . . . Rule [10b5-1] is being abused."

Academic Studies As A Trigger For The Current Stock Options Backdating Scandal

In late 2005 and early 2006, *The Wall Street Journal* noted that academic studies suggested that options backdating had occurred at a number of companies. By the end of 2006, over 140 companies were under investigation for alleged backdating of stock options, and several companies and their executives were named in high profile civil and criminal actions. Ms. Thomsen's comments raise a similar and very real issue under Rule 10b5-1 — executives who participate in Rule 10b5-1 plans could be the next high-profile targets of enforcement.

Possible SEC Examination Of 10b5-1 Plans

At least one company may already be facing this issue. On March 3, 2007, New Century Finance Corporation disclosed in filings that federal prosecutors and securities regulators are investigating, among other things, certain stock sales. As *The New York Times* reported, the company's shares have fallen more than 53 percent since the start of the year. According to the company, in a very short period in late February and March 2007, it was contacted by the regulatory arm of the New York Stock Exchange, the United States Attorney's office in Los Angeles and the SEC about trading. Vikas Bajaj and Julie Creswell, "Authorities Investigate Big Lender," *The New York Times*, March 3, 2007 at C1. Although it is unclear what stock sales investigators are looking at, a review of SEC Forms 4 indicates that, between August and November 2006, founder Edward Gotschall sold over 500,000 shares for more than $12 million under a Rule 10b5-1 plan adopted on June 15, 2006 and that founder Robert Cole sold 150,000 shares for more than $6 million under two Rule 10b5-1 plans adopted on September 15 and June 15, 2006 (although neither had sold any shares for the prior six months).

Avoiding This Problem

Ms. Thomsen's comments and the recent scrutiny of New Century Finance Corporation suggest that the next enforcement target may be Rule 10b5-1 plans, meaning that a once-safe harbor may no longer be safe. It is, therefore, critical for companies and their executives to carefully review any Rule 10b5-1 plans, as well as any trades made under those plans, particularly those made in advance of or after news releases.

For current information on SEC enforcement topics, please visit: http://www.SECactions.com.

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