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EXECUTIVE BRIEFING SERIES

Rule 10b5-1 Plans

The Corporate Executive's Trading Tool

CANACCORD Genuity

More corporate executives are using 10b5-1 plans to turn their risk into reward with respect to trading company stock. Rule 10b5-1 plans allow corporate insiders to preclude insider trading liability and more easily access their personal wealth held in company stock.

Canaccord Genuity has been helping its clients to structure, adopt, and implement 10b5-1 trading plans since the rule's inception in 2000.

Reason for the Rule

"Insider trading" was a loosely defined buzzword within our court system in the mid-to-late 90s. Some courts defined insider trading as the *use* of material nonpublic information, and others defined it as trading while in the *possession* of material non-public information. Corporate executives and directors were repeatedly accused of the misdeed, only to have their fate rest merely with the whim of the court and a slew of conflicting legal precedents. In October 2000, the Securities and Exchange Commission (SEC) put into effect Rule 10b5-1, which replaced the conflicting "use" and "possession" standards with a new "awareness" standard. The rule states, "A trade is on the basis of material nonpublic information if the trader was *aware* of the material nonpublic information when the person made the purchase or sale."

Although Rule 10b5-1 placed a broader "awareness" definition around insider trading, the rule, in part, was designed to give corporate executives and directors, who are often *aware* of material nonpublic information, greater flexibility when trading their company's stock. In fact, the SEC describes Rule 10b5-1 as an "affirmative defense" against charges of illegal insider trading. The rule allows corporate insiders to structure a trading plan at a time when they are not aware of material nonpublic information. Under the trading plan, the insider can buy or sell company stock at predetermined quantities, prices, and dates in the future even if they later become aware of material nonpublic information. In effect, the rule allows corporate executives and directors an exemption to certain restrictions imposed by insider trading laws.

How to Adopt a Plan

Most public companies permit the use of 10b5-1 plans for corporate executives and other senior officials; however, we strongly recommend consulting your employee-trading officer or company counsel before pursuing the enactment of a plan. The process begins by finding an open trading window (i.e., a period of time that does not constitute a blackout period due to earnings release or pending announcement of other material nonpublic information) during which the plan can be developed and made effective. Then we guide the interested party through the necessary components of a 10b5-1 contract and how we can assist them in devising a plan to meet their specific needs and interests. A Rule 10b5-1 plan must be in writing and must be entered into before the insider becomes aware of material nonpublic information. In addition, the plan must contain the following information:

- 1) Number of shares to be bought or sold: This can be designated as a specific number, as a percentage of the person's holdings, or as a number of shares needed to produce a specific dollar amount.
- 2) Price at which the shares will be bought or sold: This can be designated as a specific dollar price, a limit order price, or as the prevailing market price.
- 3) Date/time of the purchase or sale: This can be designated as a specific date or time, or as the time at which a specific event occurs.

The 10b5-1 contract can specifically state the amount, price, and date/time of the stock purchase or sale, or it can provide a written formula or algorithm for determining the stock amount, price, and date/time of purchase or sale.

How to Personalize Your Plan

The requirements of a Rule 10b5-1 plan are actually quite simple and lend corporate executives and directors much flexibility in developing a self-tailored plan. You can create a plan to sell a certain number of shares per week, per month, or all in one block, or you can create a plan to sell a certain number of shares when the price hits a certain dollar value.

Canaccord Genuity identifies the following “best practice” guidelines to follow in developing most 10b5-1 plans:

- 1) Enter into a plan during an open trading window.
- 2) Enter into a plan with a broker who does not handle the majority of your other trading activities (do not want record of frequent contact with your 10b5-1 broker after the plan has been executed).
- 3) Limit your plan durations to one year or less, keeping in mind that there are several variables that could alter your interests - option increases, job security, financial needs.
- 4) Allow a reasonable period of time to pass before you execute your first trade off of the plan (length of time dependent on how the plan is structured, but we typically recommend at least 30 days).
- 5) Review your plan every six to nine months to ensure that your strategies and objectives are consistent with your current situation (remembering that a plan is difficult to change, but it can always be canceled).
- 6) Execute plans against 20-25% of your holdings or a certain dollar amount that you will want/need to obtain over the life of the plan.
- 7) Keep it simple: Identify your primary goals for purchasing or selling stock and tailor your plan to meet those goals (e.g., if your goal is to use sale proceeds to pay for your child's education, then consider timing your sale dates in advance of each college tuition payment)

10b5-1 Plan Benefits

The primary benefit of Rule 10b5-1 intended by regulators was to provide corporate executives, directors, employees, and shareholders “affirmative defense” in litigation over insider trading. In effect, the rule has led to several other benefits:

- 1) Greater access to wealth: A properly structured plan can allow executives to buy or sell stock at times when they would otherwise be restricted (e.g., blackout periods).
- 2) Increased visibility in structuring securities transactions: 10b5-1 plans can be structured to buy or sell stock at certain prices, dates, events, intervals, or in specific amounts, thus aiding in wealth transfer and management.
- 3) Shareholder confidence: When a corporate officer's purchase or sale of stock is disclosed as a 10b5-1 event*, or even if the officer is known to have a 10b5-1 plan, shareholders tend to perceive this insider trading activity less negatively than if it were an “unplanned” event.
- 4) Alleviates burden of deciding the materiality of nonpublic information: Rule 10b5-1 plans relieve employee-trading officers and company counsel from the responsibility of having to decide the materiality of nonpublic information at each trade.

* Rule 10b5-1 does not require public disclosure of a plan or trades resulting from a plan.

How to Amend a Plan

The SEC has clearly stated that a 10b5-1 plan can be terminated at any time, essentially, because it is not against the law to *not* trade based upon inside information. However, it does begin to look suspicious if a corporate executive executes and terminates plans on a frequent basis. We recommend considering possible termination triggers, such as an M&A transaction or termination of employment, before entering into a 10b5-1 plan so that these events can be structured into the plan as automatic termination triggers.

Corporate executives can also modify their plan, but, like the execution of a new plan, they must do so without the possession of material non-public information and in good faith. In order to resist calling into question the good faith requirement, we recommend limiting your modifications to only those instances in which you can point to an external event that necessitates the change (e.g. the purchase of a new house). We also recommend modifying your plan during an open trading window and waiting until the next open trading window to execute your first trade.

Summary

10b5-1 plans have become a growing trend among corporate officers and directors both as a way to preclude insider trading liability and as a means of accessing personal wealth held in company stock. Canaccord Genuity has been helping its clients to structure, adopt, and implement 10b5-1 plans since the rule's inception in 2000. In addition, Canaccord Genuity has a proprietary method of organizing and tracking 10b5-1 trades so as not to miss an event or foil the execution of a plan.

We support our clients with extensive equity trading expertise and repeated performance success in trading large volumes of stock on a daily basis. Canaccord Genuity focuses exclusively on institutional small- to mid-cap securities and knows where to find the potential buyers and sellers of these stocks. Typically, we can find the natural buyers and sellers of a stock in the marketplace, thus minimizing the impact on price and achieving best execution standards.

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