

SEC Rule 10b5-1 Insider Trading Plans – Establishing a Program That Works

WHITE PAPER

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Rule 10b5-1 plans are catching up in popularity with other equity compensation programs, such as employee stock purchase plans, stock option plans and 401(k) plans. There is no doubt that Rule 10b5-1 plans are becoming standard practice for many company insiders.

This white paper provides an overview of the general requirements for Rule 10b5-1 trading plans, as well as Computershare's recommended issuer and insider best practices for initiating and managing these plans.

For more information regarding Computershare's services to support your company's Rule 10b5-1 trading plans, contact us at 609.430.7400.

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INTRODUCTION

Nobody wants to be the next Enron. One way to reduce the likelihood of your company becoming the next big scandal is through compliance with the US Securities and Exchange Commission's Rule 10b5-1, which the SEC established to address corporate governance policies and to provide more transparency for public companies.

A 10b5-1 trading plan is a contract to purchase or sell securities established by a company insider, prior to making any transactions. The plan must have been adopted in good faith and without knowledge of material, non-public information. Material, non-public information is information about a company that has not been disclosed or made generally available to the public. It is illegal to trade securities of a company using inside information.

Under Rule 10b5-1, shareholder executives and other insiders at your company can establish special trading plans that provide insiders with an affirmative defense against allegations of insider trading.

Rule 10b5-1 makes it possible for company insiders to trade company stock according to their own personal investment plan schedules, while reducing their risk of exposure to allegations of fraud or insider trading.

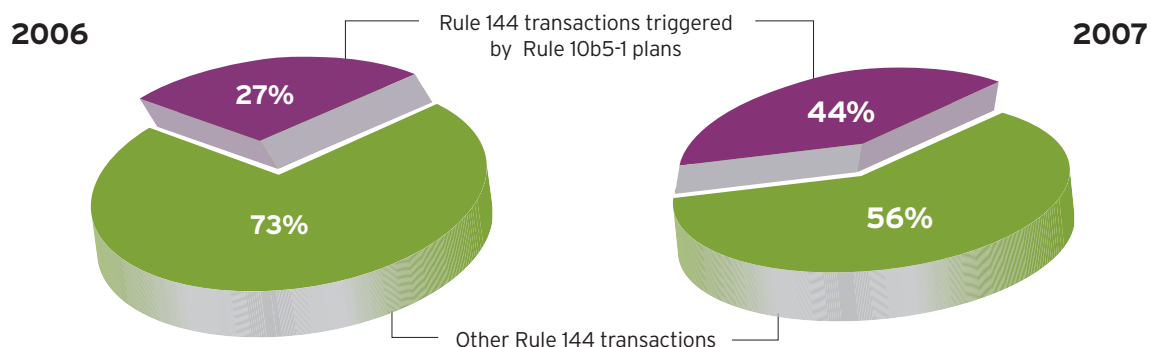
As a result, 10b5-1 plans are catching up in popularity with other equity compensation programs, such as employee stock purchase plans, stock option plans and 401(k) plans.

In December 2006, 27% of Rule 144 transactions were triggered by Rule 10b5-1 plans. By 2007, Rule 144 transactions that were triggered by Rule 10b5-1 trading plans accounted for 44% of the total market volume at year-end – the highest percentage since February 2005, according to The Washington Service.*

This white paper offers background on Rule 10b5-1 and explains how a company can set up and effectively monitor 10b5-1 plans that provide the transparency that the SEC demands, while ensuring the safety of your proprietary financial information.

*The Washington Service, *144 Market Report: December 2006*, January 5, 2007; The Washington Service, *144 Market Report: December 2008*, January 8, 2008, www.washingtonservice.com.

IN ONE YEAR, RULE 144 TRANSACTIONS TRIGGERED BY RULE 10B5-1 TRADING PLANS SIGNIFICANTLY INCREASED



Source: The Washington Service, www.washingtonservice.com

WHAT IS A RULE 10B5-1 TRADING PLAN?

Rule 10b5-1 enables a company insider to create a trading plan with a pre-existing contract that includes a set of instructions or a written plan to sell the insider's company securities. According to the rule, the plan must have been:

- > Established before the insider had material non-public information
- > Adopted in good faith

WHO SHOULD CONSIDER ESTABLISHING A 10B5-1 TRADING PLAN?

Anyone who is routinely exposed to material, non-public information that a reasonable investor would use to buy, sell or hold shares of company stock is a candidate for a 10b5-1 trading plan. This includes – but is not limited to:

- > Board members and affiliates
- > Company officers and directors
- > Shareholders who own 10% or more of the company
- > Corporate executives

In addition, many companies encourage participants, other than officers and board members, who may have possession of material, non-public information – such as attorneys and consultants – to set up 10b5-1 trading plans.

HOW SHOULD THE PLAN BE CREATED?

The plan is set up by the individual insider and executed by an investment firm.

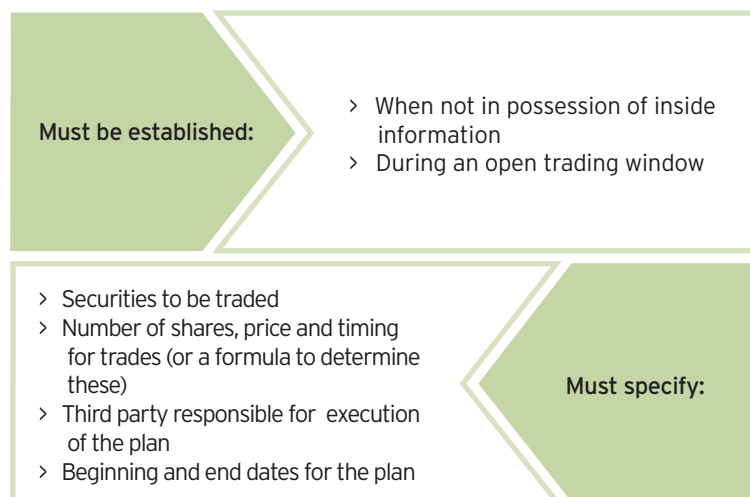
The insider must not be able to influence the investment firm once the plan has been accepted. To support this, many brokerage firms now have a special department that deals specifically with Rule 10b5-1 trading plans. When investment professionals receive plans from their clients, the plans may be sent to this department, so that the firm's individual financial advisors cannot be influenced by their insider clients.

Many companies require approval by their boards of directors in order to amend their insider trading policy to allow insiders to create 10b5-1 plans.

In addition, many companies require that insiders obtain a pre-clearance review of each plan from the company's legal counsel prior to placing the plan with an investment firm, for adherence to the company's insider trading policy.

ELEMENTS OF A RULE 10B5-1 TRADING PLAN

A binding contract for purchase or sale of a security



BASICS OF RULE 10B5-1 TRADING PLANS

BENEFITS OF TRADING PLANS

The greatest benefit of a 10b5-1 trading plan is that it offers an affirmative defense against insider trading liability, to both the company and the insider. The defense is based on two elements:

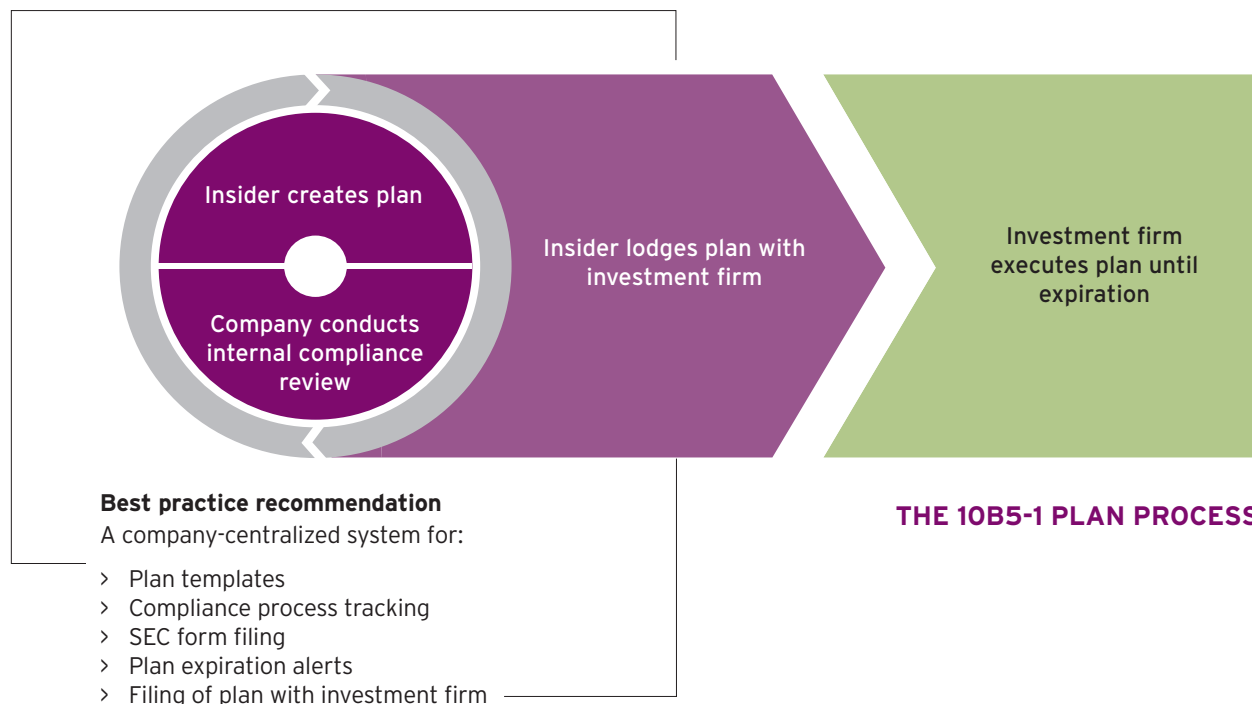
- > The plan is a binding contract that is put in place before the insider has material, non-public information.
- > Under the plan, the insider is not allowed to influence the person or entity responsible for executing the plan.

Rule 10b5-1 trading plans allow companies to manage trading by their insiders in an orderly manner and with increased transparency to the public, including the option of filing the plans with the SEC.

In addition, through a 10b5-1 plan's scheduled and rule-governed trade execution, trades can take place outside of standard trading windows and during blackout periods – enabling insiders to do more strategic personal investment planning.

HOW DOES A RULE 10B5-1 TRADING PLAN WORK?

In essence, a 10b5-1 trading plan is a document that clearly explains under what conditions the insider is allowed to buy or sell stock. The insider must not be able to exercise influence over the buying or selling of shares, except through the 10b5-1 trading plan.



Rule 10b5-1 requirements

A Rule 10b5-1 trading plan is a binding contract for the purchase or sale of the security, and must be:

- › Established when the shareholder does not possess material, non-public inside information
- › Established during an open trading window

The trading plan must also specify the following:

- › Securities to be traded
- › Either specifics for the following, or a formula or algorithm that determines:
 - › Number of shares per trade
 - › Price
 - › Timing
- › A third party responsible for the execution of the plan, to whom the insider delegates authority to execute the plan and who is not in possession of material, non-public information
- › Beginning and end dates for the trading plan

Other important considerations

Rule 10b5-1 trading plans can be modified or terminated during open windows. The plans can also be written with clauses that provide automatic termination in the event of corporate restructuring, death of the insider or the expiration of the contract.

The plans should also include language about who will handle regulatory and form filings, volume limits, etc.

All trades should be made pursuant to the plan. Insiders who deviate from their plan or seek to modify it too often may be perceived as not having entered into the plan in good faith.

SETTING UP RULE 10B5-1 INSIDER TRADING PLANS

COMPANY BEST PRACTICES

By establishing clear, consistent policies and procedures for your company and for your insiders, you can increase the likelihood that your insiders and their plans will be compliant with the rule. Here are some important steps for companies to consider in establishing a plan.

Consider mandating use of a 10b5-1 plan by insiders

Many public companies offer their insiders a variety of options, including a 10b5-1 trading plan. However, because a 10b5-1 trading plan offers an affirmative defense against insider trading, an increasing number of companies are mandating plans for their insiders.

Provide insiders with an approved plan template and guidelines

Developing a plan template used by all your company's insiders will help eliminate much of the administrative burden associated with insider tracking, negotiating and approving 10b5-1 contracts. By following pre-approved templates, plans will be consistent with your company's processes and with requirements you have established for compliance with the SEC rule.

Adopt in-house clearance procedures for plan approval

Companies generally require all insiders to submit their plans to in-house or outside counsel, to review for compliance with SEC rules and company policies, before submitting them to an investment firm.

Since a plan must be put into place during an open trading window, insiders will need to submit their plans four to eight weeks in advance to ensure proper clearance from the company's legal department. The review process will be significantly faster and simpler if all insiders are using a company-approved template.

Provide transparency by disclosing your insiders' 10b5-1 trading plans to the public

Although it is not required by the SEC, some public companies issue press releases when their insiders adopt Rule 10b5-1 trading plans. Disclosing the existence of these plans can improve investor confidence by increasing transparency to both the SEC and the public. Most companies do not disclose what percentage of their holdings insiders have included in their plans.

Use a centralized software solution to manage your plans

Some companies have added personnel, and even established a separate department, just to track and manage their Rule 10b5-1 plans.

A cost-effective alternative to increasing staff is to use software, such as Computershare's 10b5-1 Administrator™ solution, to help your company manage its 10b5-1 plans and establish a transparency mechanism for risk-management purposes.

COMPANY BEST PRACTICES

- > Consider mandating use of 10b5-1 plans
- > Provide an approved plan template and guidelines
- > Adopt clearance procedures for plan Approval
- > Publicly disclose 10b5-1 plans
- > Manage plans centrally

A specialized software solution can:

- > Keep track of all 10b5-1 plans for your insiders
- > Trigger filing of the appropriate SEC forms at the correct times
- > Remind your company and the insider of the expiration of a trading plan
- > Provide online plan templates that are easy for your insiders to use and that are consistent with company processes and requirements, simplifying the pre-clearance process

Finally, a software solution can provide a direct connection with the insider's investment firm, seamlessly automating the entire Rule 10b5-1 and SEC forms filing process.

INSIDER BEST PRACTICES

Your company's insiders are responsible for making sure their 10b5-1 plans serve the intended purpose of providing an affirmative defense against allegations of insider trading.

Write a clear, concise plan

The best plans are simple and easy to understand. The most basic and most important section of the plan document includes:

- > The specific amount of stock per trade
- > The price when each should be bought or sold
- > The dates within which the plan will be effective

If using limit orders, the 10b5-1 plan should specify:

- > Number of shares to be sold
- > Limit price
- > Dates on which to sell
- > Instructions on what to do with unfilled orders, if a limit order does not execute

Also, with limit orders, many 10b5-1 plan users find it helpful to define a recurrence pattern that instructs the investment firm to place a certain number of limit orders every month or quarter.

Companies can simplify the plan development process and help protect their insiders by providing pre-approved plan templates that incorporate these recommendations.

Allow sufficient time for pre-clearance by company attorneys

Most companies' insider trading policies require review and approval of each insider's plan before implementation. This review and approval can help protect both the company and the insider from future liability, providing documentation showing that the insider did not have inside information when creating the plan and supporting the insider's good-faith adoption of the plan.

INSIDER BEST PRACTICES

- > Adopt a clear, concise plan
- > Allow sufficient time for pre-clearance
- > Follow the plan to the letter

SETTING UP RULE 10B5-1 INSIDER TRADING PLANS

Insiders need to be aware of their company's timeline for pre-clearance and submit their proposed plans with sufficient time for review – usually one or two months in advance of the open trading window.

Follow the plan to the letter

Under Rule 10b5-1, insiders may be legally liable for insider trading if they possess or simply are aware of material, non-public information when trading stock, even if they do not actually use the information. Insiders cannot change their 10b5-1 plans when they are in possession of inside information.

Generally, this prohibits any changes to plans during company-defined "blackout" periods. Even when making plan changes during an open trading window, insiders should clear the changes with the company's legal counsel in advance. While the SEC does allow insiders to cancel their 10b5-1 plans before they expire, changes to the plan may compromise the purpose of the plan.

HISTORY OF RULE 10b5-1

Before Rule 10b5-1, the SEC standard for understanding insider trading was “knowing possession”: an insider was liable for illegal trading if he or she had knowing possession of material, non-public information. Unfortunately, some courts went by the standard of “use.” In those courts, an insider both had to have the insider information and to use it in order to be found liable.

To unify the standards used by the SEC and the courts, the SEC established Rule 10b5-1 (a), (b) and (c), which:

- > Intensified the standard of inside trading liability to “awareness,” not just “use” of information
- > Recognized that the “awareness standard” could coincide with innocent conduct, such as trading when it was clear that the information was not a factor in the decision
- > Created an affirmative defense to the insider trading liability for trades made pursuant to pre-existing contracts, instructions or written plans adopted in good faith
- > Allowed Rule 10b5-1(c) to be the exclusive defense, if there was awareness of material, non-public information at the time of trading

The legal precedence for Rule 10b5-1 includes the following cases:

- > *Radiation Dynamics, Inc. v. Goldmuntz* (2d Cir. 1972): Rule 10b-5 “imposes ‘no obligation to pull back from a commitment previously made by the buyer and accepted by the seller because of after-acquired knowledge.’”
- > *Wietschner v. Monterey Pasta Co.* (N.D. Cal. 2003), *In re Netflix Securities Litigation* (N.D. Cal. 2005): 10b5-1(c) trading plan negated inference of suspicious trading in private class action.
- > *SEC v. Lipson* (7th Cir. 2002): 10b5-1(c) creates a “safe harbor” if material, non-public information is not used in the Insider’s trading.
- > *In re Best Buy Co., Inc. Sec. Litig.* (D. Minn. Apr. 12, 2005): In considering whether stock sales in private securities class action constituted scienter, the Court noted that “the vast majority of [the defendant’s] sales are part of his apparent pattern of selling stock on a weekly basis.”
- > *Ressler v. Liz Claiborne, Inc.* (E.D.N.Y. 1998), *aff’d* (2d Cir. July 27, 1999): Defendants’ sales were not suspicious because they were pursuant to a “periodic divestment plan.”

Below are a few industry terms used in this document that may require definitions.

Blackout Period

With respect to insider trading, a blackout period is a period of more than three consecutive business days during which at least 50% of all participants under all individual account plans of an employer are unable to buy or sell employer stock held in an individual account plan.¹

Form 4

Form 4 is required by the SEC and the appropriate stock exchange to announce changes in the holdings of directors, officers, and shareholders who own 10% or more of the company's outstanding stock.²

Insider

The US Securities and Exchange Commission defines insiders as a company's officers and directors as well as any beneficial owners of more than 10% of a class of the company's equity securities registered under Section 12 of the Securities Exchange Act of 1934.³

Inside Information / Material, Non-public Information

Inside information, or material, non-public information, is information about a company that is known by the company's board of directors, management, and/or employees but not by the public.²

Rule 144

Rule 144 provides an exemption and permits the public resale of restricted or control securities if a number of conditions are met, including how long the securities are held, the way in which they are sold, and the amount that can be sold at any one time.³

¹ Cynthia Van Bogaert, "2002 Law Affects Plan Blackout Periods," BenefitsLink, <http://benefitslink.com>.

² www.investorwords.com.

³ US Securities and Exchange Commission, "Fast Facts," www.sec.gov.

ABOUT COMPUTERSHARE EXECUTIVE SERVICES

Computershare Executive Services offers software solutions for Rule 10b5-1 management, Rule 144 automation, and Forms 3, 4 and 5 compliance. Our solutions significantly reduce the time-intensive process of collecting and verifying shareholder information and automate the completion and delivery of required filings. We create audit trails and metrics throughout the process for compliance and reporting purposes. Our team includes highly skilled software engineers and business analysts focused exclusively on enhancing and supporting its solutions. We collaborate with our clients to understand their needs and to improve and support their existing business processes. For more information, visit our website at www.ces.computershare.com.

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