Advantages of SEC Rule 10B5-1 for Corporate Insiders

By: Shane Merritt

Ken Lay, Jeff Skilling, Lee Fastow, Richard Scrushi, Bernie Ebbers and Martha Stewart. What do these people have in common? It's not just a love for home décor, but rather a common failure to ingratiate themselves with the US Securities Exchange Commission.

While for the most part, the aforementioned were -- and in some cases, debatably still are -- extremely successful executives, their problems stem from greed and poor ethics. As a result of these and other fiascos, today's Corporate Executive is under more scrutiny than ever.

Many have found the Icarus Paradox to be true in the sense that, as they reach the apex of their career and begin to carry more responsibility for their corporate decisions, their income and personal risk of loss also reach their peaks. In order to keep old customers, obtain new ones, meet competition and justify his profits, the businessman must constantly seek to raise quality, reduce costs (and prices), increase production and improve all facets of his business. He must accept the fact that he will always be faced with problems that exist only to be solved in the most efficient manner possible. For this to occur, he must be intensely focused on both the problem and the solution; everything else is just noise.

Jim Collins points out in his book, *Good To Great*, that top CEOs from what his team found to be "great" companies, had a maniacal focus on building their companies and were "infected with an incurable need to produce sustained results…" While there are a few extraordinary executives who are able to manage both their careers and their portfolios successfully, they are more the exception than the rule. Most are focused on doing what they do best and hiring experts for everything else.

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The Equity-Based Compensation Dilemma

Normally, a large component of executive income is derived from equity-based compensation, which can be both a blessing and a curse. The blessings are that they are able to profit as their companies grow and that the equity at some point is convertible to real money. The curse is that aside from potential phantom tax issues and market volatility, a plethora of other concerns remain. One concern for corporate officers is the potential accusation of "insider trading".

The US Securities Exchange Commission ("SEC") Rules make it illegal for a person to buy or sell a security based on material non-public information. This means simply, that one cannot buy or sell securities if he or she has knowledge not available to the public that is significant enough to cause the stock (or bond) to move in one direction or the other if the public were in possession of the same information. All stock and bond markets operate on the premise of transparency – that all market participants learn about material events at about the same time. Under this arrangement, theoretically no one should get an unfair advantage.

It is also important to note that the status of "Insider" is not limited to corporate officers. It can also include major shareholders, accountants, lawyers, bankers, analysts,

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secretaries and printers.

Another concern is the public's perception when insiders sell their shares. It is generally one of suspicion, a belief that the insider is selling ahead of some pending disaster in the company.

To reduce corporate liability, most companies have implemented restricted trade or "Blackout" periods and trading policies that determine when officers and employees are allowed to trade their security. Restricted periods are typically placed before and after announcement of corporate operating results and pension funding. They also begin when insider becomes aware of information that is both material and non-public, which can be quite often among higher ranking officers.

Internal policies also generally prohibit public disclosure of certain restricted period dates.

Finally, the last and most often overlooked risk that executives face, is having so much of one's livelihood tied to one company through their earnings and investments.

Recently, I was having a conversation with an officer whose company is going through a fairly significant patent infringement case. The company stock has been under pressure and currently more than ninety percent of his investable assets are being decimated.

The move scared him enough to make the commitment to unwind the majority of his stock options after the company's legal woes pass.

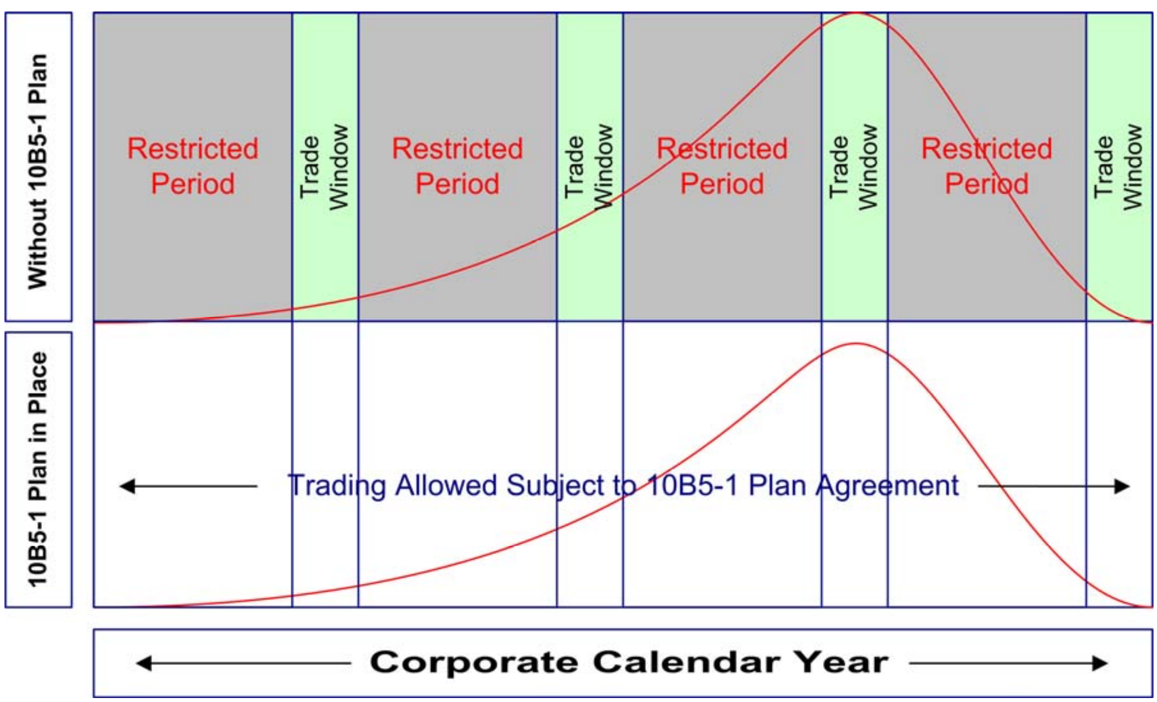
Gaining Liquidity and Divsersifying Investments

So how can an executive reap the benefits of his position and mitigate the risk involved with equity-based compensation?

In answer to all of these concerns, the SEC has made provision for insiders to implement what is known as a 10B5-1 plan. The plan allows insiders and advisors to structure an approach that will help them gain liquidity and further diversify their investments.

A properly structured plan can help insiders sell their company stock in situations where they previously may have been restricted.

Functionality of a 10b5-1



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Since the plan is created once and sales are pre-determined in advance to be transacted on future dates, the status of 'trading while in possession of material non-public information' does not apply to the insider

for the purposes of his or her specific plan and can act as a safe harbor for executives against allegations of insider trading (*Wieschner v. Monterey Pasta Co*., *status also validated by more than five top law firms.)* This rule can also be used by issuers to act as a safe harbor for corporate stock repurchase plans. In both instances, the plans must be entered into in good faith, and not as a method to evade or scheme as outlined in SEC Rule 10B5-1 Para (c)(1)(ii).

To begin a plan, an insider must not be in possession of "inside information" at the time of agreement and the plan must be implemented before the insider comes into contact with such information.

As a best practice, most corporate compliance departments will consult their legal counsel prior to initiating a plan, upon which their counsel affirms that the aforementioned is not in possession of material non-public information. Some companies use the pre-trade clearance procedures that are used in absence of a plan prior to implementation.

A properly structured plan must provide clear written instructions and include:

1.) A specific number or formula for calculating the number of shares to be bought or sold (or options that represent a specific number of shares).

2.) The price at which to buy or sell, which can either be a market or limit order.

3.) A schedule of dates on which the transactions should occur.

To help ensure safe harbor status, the plan should not permit the insider on whose behalf the transaction occurs to exercise any subsequent influence over the transactions after the plan is established.

The plan should also consider future option grant dates if known to avoid a violation of the short-swing profit rule (Section 16b), which occurs when an individual either buys or sells the same security within a six-month timeframe and realizes a profit on the transaction. Under this scenario, all profits must be disgorged and the transactions would provide very little value.

After the plan is drafted, it should be reviewed by the officer's corporate counsel or compliance department before implementation. We've seen instances where drafted plans met the SEC requirements but were changed by corporate compliance to exclude trading during company imposed blackout periods. Further, though they are permissible, some companies in a desire to avoid potential inquiries by the SEC and perhaps not fully understanding Rule 10B5-1, offer no provision for their use whatsoever.

Issuers and insiders should also be aware that they must comply with standard regulatory reporting requirements, which may include Form 144, Form 4, Schedule 13D and or 13G. A good firm should typically handle this for their clients as a matter of practice.

10B5-1 plans can also be modified and terminated, but only at a time when the insider is not in possession of inside information. If the plan is repeatedly modified or terminated multiple times, there

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is the risk that the SEC will view the plan as inconsistent with Rule 10B5-1 or consider the change a trading scheme. Therefore, executives should contact their legal counsel prior to terminating or amending an agreement.

Leveraging the Knowledge of other Insiders

With this plan in place, we have now established a systematic method for liquidity and have mitigated some of the systematic risk of having too much invested in a single company. What next? There are as many different investment strategies as there are people, which is the beauty of Wall Street. As in business, there are winners and losers and to the victor goes the spoils.

In managing the assets of many executives, a strategy that we have found to be successful over time, involves Exchange Traded Funds and Individual Equities. We call the model the "CFO Strategy" because our primary screen is based on the open market purchases made by Chief Financial Officers. We know that insiders sell for many reasons: liquidity, risk reduction, to capture profits, etc… They typically buy for one reason- because they know their company's stock is well positioned and believe that it will be very profitable.

Insider trading rules were established because the US Securities Exchange Commission recognized the value of the information that insiders have which the public does not have and the advantage it gives to the insider over the private investor. These rules allow for the purchase and sale of corporate stock by insiders, but as a matter of compliance require the filing of certain forms to announce their transaction; these filings have been very useful to us.

Even those employees outside of management have valuable insight as to the health and general well-being of their companies. Aside from the obvious insights gleaned from various VP's and department managers, the general mood and buzz is readily assessable by virtually anyone inside the company who is paying attention.

While this is all good information, the real intelligence the Wall Street Analyst wishes he had is held by the Chief Financial Officer. A fairly homogenous group of individuals seldom taken in by the showmanship of the CEO, CFOs tend to be realists with a focus on the true health of the company. The CFO is privy to:

1. Accounts Payable and Receivable.
2. The Reality of the Balance Sheet and Off-Balance Sheet Transactions.
3. Potential Mergers & Acquisitions.
4. Planned Changes in Corporate Strategy.
5. Potential Benefits or Harm as a result of Micro or Macro economic changes.
6. The real book value of their company.

Most importantly, CFOs are responsible for sales forecasting on a quarterly basis for the CEO. In other words, their "guess" is a much better guess than an outside analyst- notwithstanding our most recent education on some of historical schemes and conflicts of interest that have been found among some analysts. The fact that the CFO has his finger on the pulse of the company and knows the status of off-balance sheet transactions and LLCs owned by the corporation give further credence to our belief that our strategy is the ultimate Wall Street Lie-Detector. It is also interesting to note that, prior to their demise, the CFOs of WorldCom and Enron never made a single open market purchase.

There are many other reasons for filtering equity purchases based on those made on the open market by CFOs, but the general concept should make sense to corporate insiders.

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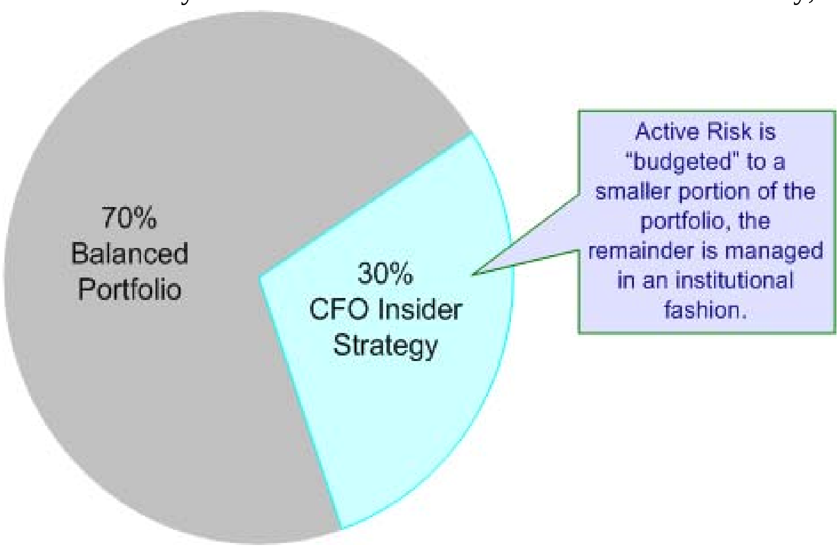
Currently, our clients know one company very well- their own. This is a way to leverage the knowledge held by their peers and contemporaries while not violating SEC rules. There is much more to both our buy and sell discipline, but the general idea beyond the initial screen is not dissimilar to the approach that other equity managers take. While with any investment strategy, there are no guarantees, we believe the chances of one finding a more intelligent strategy on Wall Street to be very slim.



Typically, the overall portfolio that we're diversifying into, depending on the client's risk tolerance, objective, and time horizon, will offer a blend that is 70% Balanced in a manner consistent to institutional investments and 30% in our CFO Strategy.

The method is known as "Risk Budgeting" and helps to reduce volatility in your portfolio. The CFO strategy serves as the performance driver for the rest of the portfolio and we believe the buy discipline offers a good way to manage the risk of owning a portfolio of individual equities.

In speaking to clients and potential clients, we have heard remarks such as, "Our company is going to soar, this is going to make me rich," "I'm not selling until it hits $500 a share," though admittedly less often since the crash of the dot-coms. Multiple studies have been done on single stock ownership and the associated risks, with a net summation that inevitably, the investor is far better to diversify for asset growth and protection purposes.

A brilliant Roman statesman once remarked that "Good advice is often given, but seldom prospered from."

We've outlined some of the risks that corporate executives assume in receiving equity-based compensation and a method that will not only help reduce that risk, but also help diversify their investments in an intelligent manner. Either part of this advice, if taken, will benefit the executive greatly and allow him or her to spend time focusing on what it is that makes them successful. America needs great businessmen and women, so focus on what you do best.

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