Compensation Governance: Designing 10b5-1 Trading Plans

Presentation for:
Executive Compensation Webinar Series
July 14, 2016

Presented by:
Anthony J. Eppert
713.220.4276
AnthonyEppert@AndrewsKurth.com

ANDREWS KURTH

STRAIGHT TALK IS GOOD BUSINESS.®

Housekeeping: Technical Issues and Questions

- Technical issues
  - If you are having difficulty viewing this presentation, please call Cisco WebEx Tech Support toll free at 866.229.3239

- Questions during this presentation
  - We encourage questions (even though your audio lines are muted)
  - To submit a question, simply type the question in the blank field on the right-hand side of the menu bar and press return
  - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail shortly after this presentation

Housekeeping: Recording, CE Credits and Disclaimer

- Recording
  - This presentation is being recorded for internal purposes only
- Continuing education credits
  - A purpose of the webinar series is to provide FREE CE credits
  - To that end, each presentation is intended to provide 1 credit hour in the following areas:
    - CLE: 1 credit hour (Texas)
    - CPE: 1 credit hour (Texas)
    - HRCI: This activity has been approved for 1 (HR (General)) recertification credit hours toward California, GPHR, PHRi, SPHRi, PHR, and SPHR recertification through the HR Certification Institute
    - SHRM: This program is valid for 1 PDC for the SHRM-CPSM or SHRM-SCPSM
  - If you have any questions relating to CE credits, please direct them to Anthony Eppert at AnthonyEppert@AndrewsKurth.com or 713.220.4276
- Disclaimer
  - This presentation is intended for informational and educational purposes only, and cannot be relied upon as legal advice
  - Any assumptions used in this presentation are for illustrative purposes only
  - No attorney-client relationship is created due to your attending this presentation or due to your receipt of program materials

Housekeeping: About Anthony “Tony” Eppert

Anthony Eppert
Partner
Andrews Kurth LLP
Tel: +1.713.220.4276
Email: AnthonyEppert@AndrewsKurth.com

- Tony practices in the areas of executive compensation and employee benefits
- Before entering private practice, Tony:
  - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
  - Obtained his LL.M. (Taxation) from New York University
  - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
    - Editor-in-Chief, Journal of Medicine and Law
    - President, Tax and Estate Planning Society

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded companies, and involve the substantive areas of:
  - Tax,
  - Securities,
  - Accounting,
  - Governance,
  - Surveys, and
  - Human resources

- Historically, compensation issues were addressed using multiple service providers, including:
  - Tax lawyers,
  - Securities/corporate lawyers,
  - Labor & employment lawyers,
  - Accountants, and
  - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- At Andrews Kurth LLP, we have a holistic and full-service approach to compensation matters, that considers all substantive areas of compensation, including:

Housekeeping: Upcoming 2016 Webinars

- Upcoming 2016 webinars:
  - Building a Compensation Peer Group: A Step-by-Step Approach (8/11/16)
  - Preparing for the Next Proxy Season: Start Now (9/8/16)
  - Energy Companies: Compensation Governance Survey/Trends (10/13/16)
  - Identifying and Solving Pitfalls in Equity Compensation Administration (11/10/16)
  - The Importance of Miscellaneous Contractual Provisions: A Drafter's Perspective (12/8/16)

- Upcoming 2017 webinars:
  - To be announced in September
  - To suggest a topic for 2017, please e-mail Anthony Eppert

Purpose of this Presentation

- The purpose of this presentation is to discuss issues and solutions associated with 10b5-1 trading plans ("***Trading Plans***"). To that end, this presentation covers:
  - A comparison of the rules under Section 16 and Rule 10b-5,
  - The elements of a valid Trading Plan,
  - Best practices associated with Trading Plans, and
  - Certain mistakes and related solutions

Background on Section 16

- As background, Section 16 is a provision of the Securities Exchange Act of 1934 (the "***Act***") that imposes reporting requirements and trading restrictions on "insiders" of publicly-traded corporations

- A purpose of Section 16 is to deter insiders from using confidential information for personal gain. To that end, Section 16 generally requires insiders to:
  - File public reports relating to the insider's transactions with equity of the company; and
  - Disgorge profits realized on "***short-swing transactions***" (*i.e.*, any purchase and sale, or vice versa, of equity in the company within a period of less than 6 months)

- For purposes of Section 16, the term "***insider***" includes:
  - A director;
  - An officer (defined as the president, principal financial officer, principal accounting officer, any VP in charge of a principle business unit/division/function, and any other person who performs a policy-making function for the company); and
  - Any 10% beneficial owner

Background on Section 16 (cont.)

- Section 16 applies to all equity securities that are beneficially owned by an insider, including:
  - Stock, and
  - Derivative securities (defined generally as any instrument that derives its value from company stock, such as options, warrants, synthetic equity such as cash-settled RSUs and cash-settled SARs)

- Whether a person is a "***beneficial owner***" depends upon the test for which it is applied
  - For the 10% owner test, the inquiry is whether the person has voting or investment power over the equity in question
  - For all other tests under Section 16, the inquiry is whether the person has a pecuniary interest in the equity in question (*e.g.*, family holdings, trust holdings, partnership holdings, etc.)

Background on Section 16 (cont.)

- The rules governing short-swing liability are contained within Section 16(b) of the Act
  - The purpose of this rule is to deter insiders from using confidential information about the company for personal gain
  - Deterrence is effectuated by eliminating the profit element
  - The company can recover profits an insider realizes due to his/her short-swing transaction

- A short-swing transaction is any purchase and sale, or sale and purchase, of the company's equity within less than 6 months
  - Generally, a purchase or sale occurs when the insider makes an irrevocable commitment
  - Interesting is that "less than 6 months" begins on the date of the transaction and ends 2 days prior to the end of the 6 month period

- The disgorged "***profits***" is computed by matching the highest sales price to the lowest purchase price during the period, and so on, irrespective of the dates on which the transactions occurred
  - Therefore, it is possible to have a "profit" under Section 16(b) even though the transactions resulted in a net loss to the insider

Background on Section 16 (cont.)

- There are a few exemptions from Section 16(b) liability. The one most often relied upon in the equity compensation context is Rule 16b-3
  - Such is available only to directors and officers who engage in a transaction with their company

- Rule 16b-3 is a common exemption from Section 16(b) liability used by Section 16 insiders
  - Noteworthy is that, according to C&DI Question 123.01, Rule 16b-3 does not exempt a transaction by a person who is a Section 16 insider solely because they are a 10% or more beneficial owner
  - But if the Section 16 insider is a 10% or more beneficial owners AND either an officer or director, then Rule 16b-3 could apply to that individual

- To satisfy Rule 16b-3, the plan/transaction must be approved by:
  - The issuer's Board of Directors,
  - A committee of the Board of Directors comprised solely of two or more independent non-employee directors, or
  - The issuer's stockholders

Background on Rule 10b-5

- Generally, insider trading is prohibited under Rule 10b-5
- Rule 10b-5 imposes a presumption in favor of liability, such that if a person is "aware" of material non-public information at the time a security is bought or sold, such person is then presumed to be trading based upon such material non-public information
  - In practice this rule puts a lot of insiders in a difficult position because they almost always find themselves possessing material, non-public information
- But a properly designed Trading Plans would shift the focus:
  - From whether an insider had material, non-public information at the time of a trade;
  - To whether that insider had material, non-public information at the time he or she became committed to the trade

Trading Plans: Background

- Trading Plans are a common method for directors and officers to trade without incurring insider trading liability
  - It allows insiders to buy and sell their company's stock even if they are in possession of material, non-public information, but only if the trading takes place pursuant to a plan the insider entered into at a time he or she did not possess material, non-public information
  - The Trading Plan must either:
    - Specify the amount of securities to be traded and the price and date on which the stock is to be purchased or sold; or
    - Include a written formula for determining the amount, price and date of the transaction
  - A Trading Plan provides an affirmative defense against an allegation that the insider's purchase or sale was made on the basis of inside information
  - But the key is for the insider to have no future discretion over future trades
  - Plus, the existence of such a plan could preempt a perception in the market that the insider's selling is associated with a loss of confidence in the company
- Absent a Trading Plan, it is often difficult for insiders who are frequently in possession of material, non-public information to trade without incurring the risk of insider trading liability
  - Insider trading policies of companies will typically prohibit the insider from trading except during "open windows" (*e.g.*, a specified number of days immediately following the company's release of its quarterly earnings data)

Trading Plans: Reasons to Adopt

- Some of the reasons to adopt a Trading Plan include:
  - For those who often possess material non-public information, the Trading Plan provides more trading opportunities
  - Facilitates financial planning for the individual
  - Minimizes investor criticism that the trade was conducted on the basis of the individual holding material non-public information
  - Ensures the exercise of stock options that would have otherwise expired due to a lapse in the term
  - Facilitates the attainment of stock ownership guidelines

Trading Plan Requirements: Adoption

- Material non-public information cannot be a factor when setting up the trades (otherwise the affirmative defense is negated). This means that:
  - The individual cannot have material non-public information at the time of adopting the plan; and
  - Additionally, the broker (or other third party delegatee) cannot be aware of material non-public information when applying any discretion to set up the future trades
- The company's insider trading policy could help ensure compliance with the foregoing by:
  - Limiting the timing on which trading plans may be adopted to open trading windows, and
  - Prohibit any adoption of a Trading Plans during blackout periods
- And too, the person should indicate in writing at the time of the adoption of the plan that he or she does not possess material non-public information
  - In other words, the existence of an open trading window does not guarantee that the individual has no material non-public information

Trading Plan Requirements: Retain No Discretion and Good Faith

- To be clear, the affirmative defense is lost if the individual retains any discretion over the "whether," "when" and "how" to effectuate any trades
- This means the terms of the Trading Plan must:
  - Contain a written formula or algorithm that;
  - Specifies the amount (share number or dollar value), date and price of securities to be purchased/sold; and
  - The individual cannot exercise an discretion or influence over such number, date or price
- The Trading Plan must be entered into in "good faith" and not part of a plan or scheme to evade the rule
  - This good faith standard is applied using hindsight facts and circumstances
- Any change or deviation from the terms of the Trading Plan would destroy the affirmative defense
- Consider limiting the use of a broker to just one broker

Trading Plan Requirements: Waiting Period/Pre-Clearance/Other

- As a technical matter, waiting periods from the date the plan is entered into and the date the first trade is effectuated are not required (but are recommended)
  - The delay from the date of entering into the Trading Plan and conducting the first transaction should be at least 30 days
  - It is recommended that any adoption of a Trading Plan be pre-cleared under the company's pre-clearance procedures
  - Usually one person would be appointed to handle pre-clearance procedures (as opposed to multiple persons or a committee)
- Any modification to a Trading Plan is deemed to be a new Trading Plan
  - Thus, any modification must be at a time when the person has no material nonpublic information and the other requirements of the Trading Plan rules are satisfied
  - For this reason, modifications should be limited to be allowed only in extreme circumstances
- Multiple concurrent plans
  - Having a new plan take effect after an existing plan expires is an acceptable practice
  - Though multiple concurrent plans are technically permitted, such is not recommended because it could be argued that such is an attempt to evade 10b-5, thus voiding the affirmative defense otherwise provided by the Trading Plan
  - And a person should never have multiple plans covering the same shares

Rule 10b5-1 Trading Plans: Best Practices

- Important to keep in mind is that a Trading Plan is an affirmative defense, not a shield. The affirmative defense is bolstered if the company follows best practices, which can include:
  - Ensure a Trading Plan is permitted under the company's insider trading policy
  - Consider whether to voluntarily disclose the Trading Plan in a Form 8-K (*i.e.*, disclosure is not required except in a Form 4)? If yes, consider avoiding disclosure of plan details except the aggregate number of shares involved
  - Require any new Trading Plan or amendment to an existing plan to be subject to pre-clearance procedures under the company's insider trading policy
  - Only adopt the Trading Plan when the insider is not aware of material, non-public information. If the company has window periods, adopt the plan only during an open window immediately after announcement of the quarterly earnings
  - Require a lag time for the first trade (*e.g.*, 30 days). There is no legal requirement to provide a lag time, but the purpose of a lag time is to decrease public scrutiny if trading activity begins right before announcement of material news
  - Keep the Trading Plan design simple
  - Limit the length of the Trading Plan to a date between 6 and 18 months

Rule 10b5-1 Trading Plans: Best Practices

- [Cont. from prior Slide]:
  - Only allow amendments to the Trading Plan when the insider does not possess material, non-public information, subject to pre-clearance (*i.e.*, the SEC considers amendments to be the same as entering into a new plan)
  - Attempt to avoid termination of the Trading Plan in order to avoid allegations that the Trading Plan was not entered into in good faith, and alternatively, allow terminations only during an open window
  - Attempt to avoid multiple concurrent Trading Plan, especially for the same stock
  - In situations where multiple awards to multiple recipients are likely to vest at the same time (i.e., the company grants awards on the same day to all recipients pursuant to a comparable vesting schedule), consider adding a provision to the insider trading policy or pre-clearance procedures that limits sales to a percentage per day
    - Alternatively, such a provision could also be added to the grant award agreement

Rule 10b5-1 Trading Plans: Fan Fare

- In 2012, the Wall Street Journal and the New York Times published articles that speculated Trading Plans allowed insiders to gain an unfair advantage
  - The articles tend to speculate that certain executives with Trading Plans had recognized superior trading gains shortly before the underlying stock price decreased
  - Such caused the SEC and investor groups to launch their own investigations
- The Council of Institutional Investors ("CII") submitted a rulemaking petition to the SEC requesting interpretative guidance to Rule 10b5-1, and recommended:
  - That Trading Plans can only be adopted during open trading windows,
  - A prohibition on multiple Trading Plan by the same insider,
  - Require at least a 3-month wait between adoption of the Trading Plan and the effectuation of the first trade, and
  - Limit how often such Trading Plans can be modified or cancelled

Q&A No. 1 – Vest During Blackout Period

- Problem
  - Insider is awarded stock or synthetic equity that coincidentally happens to vest during a blackout period

- Thought No. 1
  - A substantial risk of forfeiture under Section 83 is automatically presumed to continue to exist to the extent that a sale of the underlying shares would subject the insider to liability under the short-swing transaction rules of Section 16(b)
  - However, NO substantial risk of forfeiture exists if the transaction is permitted under Section 16(b) but is prohibited under, for example, the company's insider trading policies

- Thought No. 2
  - Draft a provision in the award agreement that if vesting occurs during a blackout period, that the award shall continue to remain unvested until the first date of an open window
  - However, a problem with this approach is that the risk of forfeiture would also be extended

Q&A No. 1 – Vest During Blackout Period (cont.)

- Thought No. 3 – implement a net withholding (company finances withholding)
  - Such would have no open market transaction element
  - However, the company would have to finance the related cash to remit to the U.S. treasury
  - Keep in mind that some equity incentive plans do not contain liberal share counting provisions that would allow the netted out shares to return to and replenish the equity plan's share reserve
  - And at what rate should the company withhold?
    - Generally, accounting rules require that companies limit "net withholding" transactions to the minimum statutory withholding rates, otherwise, liability accounting could apply to the entire award
    - However, on October 8, 2014, FASB decided to relax such limitation by allowing for net withholding at the highest applicable margin tax rate without triggering liability classification (though a review of the equity incentive plan would be required since many are drafted to use the "minimum" language, and then, a decision would have to be made as to whether shareholder approval would be required for any implementing amendment to the equity incentive plan). There is essentially a staggered effective date, so please check with your accountants as to whether your company can withhold at this higher rate

Q&A No. 1 – Vest During Blackout Period (cont.)

- Thought No. 4 – Incorporate a Trading Plan into net withholding provision (*i.e.,* the market finances withholding)
  - Consider that the company might desire a net withholding, but might lack the cash flow to effectuate the IRS remittance
  - The market could pay the withholding dollars if:
    - The award agreement provided for such a sale in the market pursuant to a formula that otherwise satisfied the rules for a Trading Plan
    - Such could be contained within the tax withholding section of the award agreement

Q&A No. 2 – Expiring Term of Stock Option

- Problem
  - Insider is holding a stock option with a 10-year term, however, the 10-year term is expiring while the insider has material, non-public information

- Thought No. 1 – allow for exercise and hold
  - Many insider trading policies will allow the optionee to exercise using his/her own cash and then hold the resulting shares

- Thought No. 2 – Net Exercise
  - This is similar to a broker-assisted cashless exercise, except that with a net exercise there is no open market transaction
    - Instead, a portion of the exercised shares equal to the FMV of the exercise price is tendered to the company in lieu of the optionee paying the exercise price in cash
  - Much of the analysis contained within Q&A No. 1 applies equally here
  - Need to verify that the equity plan permits a net exercise so as to avoid "modification" issues (which is an issue under the ISO rules if such modification is not already permitted under the equity incentive plan)
  - ISO treatment might be lost depending upon whether tax counsel takes a conservative interpretative approach under the ISO rules
  - A problem could be that the insider trading policy of the company is too restrictive on this point and doesn't allow "any" exercise, or instead, is silent on the issue in conjunction with a conservative interpretation

Q&A No. 2 – Expiring Term of Stock Option (cont.)

- Thought No. 3 – Trading Plan was timely adopted
- Thought No. 4 – Ensure that on the front end the award agreements are drafted to require an automatic exercise, an automatic net-exercise or automatic Trading Plan-compliant open market exercise on the day immediately preceding the expiration of the 10-year life, and only if the option is in-the-money at the time

Q&A No. 3 – Exercises under ESPPs During Blackout

- Problem
  - Should a company allow (under their insider trading policy) for purchases under an ESPP during a blackout period or during a time when the individual has material, non-public information
  - Same as above, except should the company allow a change in the election under the ESPP

- Thought – Allow the purchase
  - Rationale for allowing the purchase is that the purchase could qualify for the affirmative defense under Rule 10b5-1 [*See* SEC Release No. 33-7881 (Aug. 15, 2000), at footnotes 117-121]
  - However, a conservative approach is that the initial election, and any changes thereto, should be made during an open window

Q&A No. 4 – Pledging of Stock

- Problem
  - Should a company's insider trading policies prohibit pledging of stock (including a prohibition om margin arrangements)

- Thought – prohibit pledges
  - One reason to prohibit pledges is because insider trading laws could be violated if there were a forced sale of the pledged shares at a time when the insider had material, non-public information
  - An additional reason to prohibit pledges is that ISS policies provide that it will recommend against some or all of the company's director candidates if the company allows for significant pledging by its directors or officers

Q&A No. 5 – Insider Trading Policy

- Problem
  - Whether to carveout net withholding and net exercises from the blackout periods within the company's insider trading policy

- Thought
  - To avoid disputes, the issue should be addressed, including any pre-clearance procedures associated with the same
  - Generally, tax withholding and net exercises are not viewed as transactions involving material, non-public information, especially since there is no open market transaction
  - But it always could, and for this reason, some companies choose to specifically prohibit or limit the practice
  - In any event, failing to address the issue within the insider trading policy is not recommended (but is often the case)

Q&A No. 6 – Insider Trading Policy

- Problem
  - Whether to include an exception within the insider trading policy to allow for trades pursuant to a Trading Plan
- Thought
  - Trading Plans are not subject to the prohibitions associated with trading on material, non-public information
  - Such should specifically be addressed within the insider trading policy (though detailed guidelines might be addressed in separate guidelines outside of the insider trading policy)

Don’t Forget Next Month’s Webinar

- Title:
  – Building a Compensation Peer Group: A Step-by-Step Approach

- When:
  – 10:00 am to 11:00 am Central
  – August 11, 2016

Andrews Kurth Locations

AUSTIN
111 Congress Avenue
Suite 1700
Austin, Texas 78701
Phone: +1.512.320.9200
Fax: +1.512.320.9292

BEIJING
Room 2007, Capital Mansion
No. 6 Xin Yuan Nan Lu,
Chao Yang District
Beijing, China 100004
Phone: +86.10.8486.2699
Fax: +86.10.8486.8565

DALLAS
1717 Main Street
Suite 3700
Dallas, Texas 75201
Phone: +1.214.659.4400
Fax: +1.214.659.4401

DUBAI
Andrews Kurth (Middle East) DMCC
45th Floor
Mazaya Business Avenue, BB2
Jumeirah Lakes Towers
P.O. Box 118273
Dubai, UAE
Phone: +971.4.567.0767
Fax: +971.4.567.0768

HOUSTON
600 Travis Street
Suite 4200
Houston, Texas 77002
Phone: +1.713.220.4200
Fax: +1.713.220.4285

LONDON
Andrews Kurth (UK) LLP
16 Old Bailey
London EC4M 7EG
United Kingdom
Phone: +44.20.3053.8300
Fax: +44.20.3053.8299

NEW YORK
450 Lexington Avenue
New York, New York 10017
Phone: +1.212.850.2800
Fax: +1.212.850.2929

RESEARCH TRIANGLE PARK
4505 Emperor Boulevard
Suite 330
Durham, North Carolina 27703
Phone: +1.919.864.7200

THE WOODLANDS
Waterway Plaza Two
10001 Woodloch Forest Drive
Suite 200
The Woodlands, Texas 77380
Phone: +1.713.220.4800
Fax: +1.713.220.4815

WASHINGTON, DC
1350 I Street, NW
Suite 1100
Washington, DC 20005
Phone: +1.202.662.2700
Fax: +1.202.662.2739

Copyright © 2015 Andrews Kurth LLP. Andrews Kurth, the Andrews Kurth logo and Straight Talk Is Good Business are registered service marks of Andrews Kurth LLP. All Rights Reserved. This brochure has been prepared for informational purposes only and does not constitute legal counsel. This information is not intended to create (and receipt of it does not constitute) an attorney-client relationship. Readers should not act on this information without seeking professional counsel. A past performance or prior result is no guarantee of a similar future result in another case or matter. Andrews Kurth LLP is a Texas limited liability partnership. Andrews Kurth (UK) LLP is authorized and regulated by the Solicitors Regulation Authority of England and Wales (SRA Registration No.598542). Andrews Kurth (Middle East) DMCC is registered and licensed as a Free Zone company under the rules and regulations of DMCCA. Attorney Advertising.

ANDREWS KURTH