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Good Corporate Hygiene: Share Trading and Repurchases

Part 1 of 2 of the Good Corporate Hygiene Series

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Agenda

- Rule 10b5-1 and 10b5-1 trading plans
- Anticipated changes to the rule
- Company stock repurchase plans and Rule 10b-18
- Buyback alternatives
- Proposals to address share repurchases
- Corporate controls related to share trading

Rule 10b5-1 and 10b5-1 Plans

Rule 10b5-1

- Rule 10b5-1 specifies that a sale constitutes trading on the basis of material non-public information (MNPI) when the person making the sale was aware of MNPI at the time the sale was made
- Rule 10b5-1, adopted in August 2000, codifies the position of the Securities and Exchange Commission (SEC) that awareness, not use, of MNPI is sufficient to establish liability in insider trading cases
- The rule creates a mechanism whereby any person or entity can enter into a trading plan that will provide an affirmative defense to a claim that a trade occurred "on the basis of" MNPI

Rule 10b5-1

Available to persons and entities: Provides that trades made pursuant to trading plans established in compliance with Rule 10b5-1 are deemed not to have been made on the basis of MNPI

Available to entities: Provides that an entity will not be liable if it demonstrates that the person making an investment decision on behalf of the entity was not aware of MNPI and that the entity had implemented reasonable policies and procedures to prevent insider trading

- *An issuer may also rely on 10b5-1 for itself*: An issuer should indicate that it is not in possession of MNPI when, for example, it enters into a stock repurchase program, an accelerated share repurchase program, etc.

- A **Rule 10b5-1 plan** is a trading program designed to comply with Rule 10b5-1(c) of the Securities Exchange Act of 1934, as amended (Exchange Act)
- Rule 10b5-1 plans allow "insiders" of public companies (or others) to establish a trading plan to purchase or sell predetermined amounts of securities at predetermined times

Elements of a Rule 10b5-1 Plan

- To benefit from the protections of the affirmative defense, a 10b5-1 plan must:
  - Specify the amount, price, and date of the purchases or sales;
  - Include a written formula for determining the amount, price, and date of the purchases or sales; or
  - Not permit the person to exercise any subsequent influence over how, when, or whether to effect the purchases or sales
- Alteration or deviation from the plan disqualifies the plan from the protection of the Rule
- The plan must be entered into in ***good faith*** and not as part of a strategy or scheme to evade the prohibitions on insider trading
- Anyone other than the person adopting the 10b5-1 plan may execute trades; A 10b5-1 plan is typically an arrangement between a company insider and that person's broker, wherein the broker executes trades according to the plan's specifications

Benefits of a Rule 10b5-1 Plan

- Aside from the affirmative defense, other benefits associated with a trading plan include:
  - A higher level of certainty for insiders planning securities transactions
  - More opportunities for insiders to sell their securities, especially if an issuer's trading policy allows for trading during a blackout period under the plan
  - Less negative publicity associated with insiders' sales
  - Decreased burden on counsel/compliance officers who otherwise would need to make individual determinations about the availability of possession of MNPI every time an insider seeks to move on a securities transaction

Scrutiny of 10b5-1 Plans

Former SEC Chair Clayton's views

- In a letter to Congressman Brad Sherman, former SEC Chair Clayton noted the importance of a strong control environment, especially in times of heightened market volatility and uncertainty, such as during the COVID-19 pandemic
- Clayton outlined specific issues that could be revisited, in order to promote market integrity and investor confidence, and demonstrate a commitment to "good corporate hygiene," including:
  - Insider trading policies for senior executives and board members
  - Terms and administration of Rule 10b5-1 plans
  - Issuing and pricing stock options

Former SEC Chair Clayton's views

Insider Trading Policies for Senior Executives and Board Members

- Insider trading policies must have controls in place in order to prevent senior executives/board members from trading if a company is in possession of MNPI, even if the individual did not personally have knowledge of the information
- How can this be enforced?
  - Require a time period between the occurrence of an event and the required disclosure of the event to the public

Former SEC Chair Clayton's views

Terms and Administration of Rule 10b5-1 Plans

- Companies should require that all Rule 10b5-1 plans for senior executives/board members include mandatory waiting periods for trading after adoption, amendment, or termination of a trading plan
  - Required waiting periods can help to demonstrate that a plan was executed in good faith and serve to reinforce investor confidence in public companies' management, thus contributing to strengthening market integrity

How can companies demonstrate "good corporate hygiene" when it comes to Rule 10b5-1 plans?

SEC Director of Division of Corporation Finance, William Hinman

- Rule 10b5-1 plans should be designed to eliminate any inference of impropriety, contributing to good corporate governance; ill-constructed plans lead to questions, regardless of securities laws compliance
- Companies should consider demonstrating that Rule 10b5-1 plans are executed in good faith by requiring mandatory waiting periods
- Boards and compensation committees should consider the relationship between company share repurchase plans and trading activity by directors/senior executives when approving, amending, or terminating Rule 10b5-1 plans
- Companies should consider whether it is appropriate to issue stock/other equity compensation to executives while the company is in possession of MNPI
  - Issues arise if a company grants an award based on fair market value or their stock's trading price if the market is not in possession of material information

Rule 10b5-1 plans scrutinized by Congress

- Earlier this year, Congress [Warren, Brown, and Van Hollen] addressed a letter to SEC Acting Chair Lee urging review and reform of SEC policies related to 10b5-1 plans, especially focusing on plans' lack of transparency
- The letter suggested there was evidence (especially from the healthcare industry) that 10b5-1 plans were being abused "at the expense of ordinary investors"
  - Congress specifically noted that misuse of these plans "create significant disadvantages for investors," and often involve setting "trigger prices" prompting large stock sales on days where company announcements bring "good news"
- Congress recommended implementing former SEC Chair Clayton's four to six month cooling off period between adoption/amendment of 10b5-1 plans before trading begins/recommences

What does Congress suggest?

- Content of 10b5-1 plans and trades made pursuant to plans should be disclosed to the SEC and the public so other shareholders can factor in the degree to which stock prices are influenced by corporate executives' plans
- The SEC should enforce existing filing deadlines to ensure that the public is aware of when executives' trades are made
- Congress also suggested that the SEC should better align executives' incentives with those of the shareholders and the public by enforcing penalties when executives benefit from short-term windfalls that do not turn into long-term gains

Congress' request for information

- The letter concluded with questions:
  - What actions does the SEC currently take to ensure that 10b5-1 plans are compliant with the Commission's current rules and requirements?
  - How many enforcement actions has the agency taken with regard to 10b5-1 plans in the past five years? Please provide a list and summary of all such actions.
  - Has the SEC taken action to require a "cooling off period" between the adoption or amendment of any 10b5-1 plan and any stock sales under that plan?
  - Does the agency intend to require that 10b5-1 plans are disclosed publicly and posted online in advance of any trades made under that plan?
  - Has the SEC considered or evaluated modifications of regulations to ensure that 10b5-1 adequately covers "short-swing" purchases?
  - What other actions has the SEC taken or are under consideration to prevent the abuse of 10b5-1 plans?

SEC's response to Congress

- Acknowledging that Rule 10b5-1 has not been significantly revamped since its adoption in 2000, Former Acting Chair Lee responded in agreement; there were improvements to be made in the space, wherein she explained her instruction to SEC Staff to consider Congress' suggestions

- The response letter also gave a list of pending and settled enforcement actions which mentioned violation of Rule 10b5-1 where the public was pressing charges, as Congress inquired

  - Former Acting Chair Lee confirmed that the SEC's Division of Enforcement would continue to take 10b5-1 plans seriously in their investigations

So, what does SEC Chair Gensler say?

- There's "freshening up" to be undertaken with respect to Rule 10b5-1 plans…
- Concerns include:
  - With no required cooling off period when making a trade prior to insiders adopting a 10b5-1 plan, bad actors could perceive this as a loophole to participate in insider trading
  - With no limitations on when 10b5-1 plans can be cancelled, insiders can cancel plans while in possession of MNPI, thus undermining investor confidence
  - There are no disclosure requirements
  - There are no limits on the number of 10b5-1 plans insiders can adopt
    - Ability to enter into multiple plans (and potentially cancel plans) gives appearance to insiders that they have "free option" to choose amongst favorable plans at any time
- Chair Gensler asked the SEC Staff to consider recommendations to strengthen the Rule

"In my view, these plans have led to real cracks in our insider trading regime."

SEC Chair Gary Gensler at the 2021 CFO Network Summit

Academic Research

Academic Studies

- A study conducted by Stanford University professors, "*Gaming the System: Three 'Red Flags' of Potential 10b5-1 Abuse*," suggests that researchers, regulators, and shareholders have limited understanding of how 10b5-1 plans are used in practice.
  - **Study sample**: All sales reported on Forms 144 between January 2016 and May 2020 and the adoption date of any corresponding 10b5-1 plans
    - **Total**: 20,595 plans, covering trading activity by 10,123 executives at 2,140 firms
- Three "red flags" identified:
  1. Plans with a short cooling off period
  2. Plans that entail only a single trade
  3. Plans adopted in a given quarter that begin trading before that quarter's earnings announcement

The Stanford study

- **Study finding**: The shorter the cooling off period, the more likely it appears the plan is being used opportunistically; versus longer cooling off periods where this concern diminishes
- **Study recommendation**: Require four to six month cooling off period (as suggested by Clayton); at a minimum, trading on the same day should not be permitted
  - The data found that trades made after a four to six month cooling off period (post-adoption) do not systematically anticipate stock price declines
- **Study finding**: (1) Single-trade plans are inconsistent with traditional financial advice for exiting a concentrated equity position over time and (2) the original expectation that Rule 10b5-1 would govern trades made "under a regular, pre-established program"
- **Study recommendation**: Disallow single-trade 10b5-1 plans, requiring multiple transactions spread over a certain time period instead
  - This would allow a plan to qualify for the affirmative defense

The Stanford study

- **Study finding**: Senior executives are aware of corporate performance between quarter-end and earnings announcements, so it is unlikely they can enter a plan during this period without having MNPI. Companies may have blackout periods to prevent this, but the study data shows that some executives use 10b5-1 plans to circumvent the purpose of blackout periods, adopting plans during periods when they are almost surely in possession of MNPI
- **Study recommendation**: Remove the affirmative defense of Rule 10b5-1 for plans that are adopted and for plans that start sales before earnings announcements

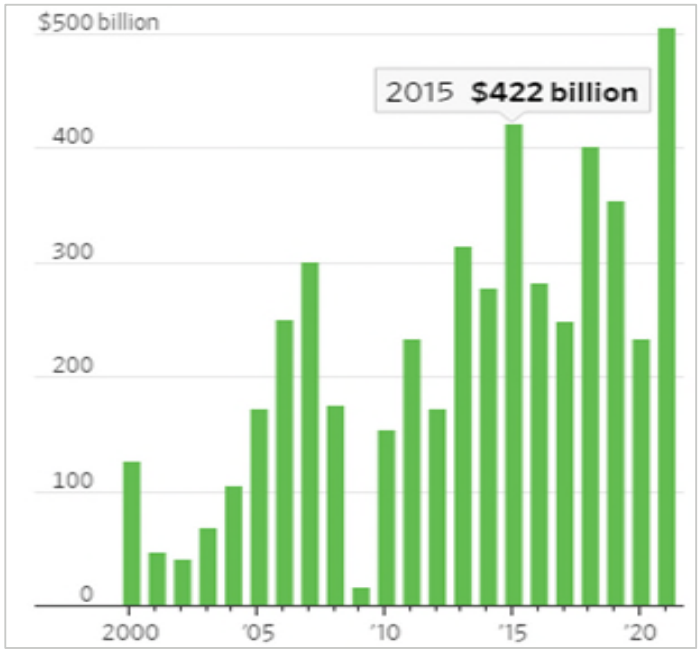
The Stanford study
Other recommendations for disclosure policies

- The study suggests that the SEC should consider requiring:
  - Disclosure of 10b5-1 plans; or, *at a minimum*, disclosure of the adoption, modification, suspension, or termination of a plan, and the maximum number of shares scheduled to be sold under a 10b5-1 plan
  - That filers indicate on Form 4 whether the reported transaction is made pursuant to a 10b5-1 plan and, if so, the date of plan adoption or modification
  - Electronic EDGAR reporting of Form 144 [already being considered]
- The study also recommends that companies consider requiring general counsel approval of 10b5-1 plans and disallow plan adoption inside trading blackout periods

Company Stock Repurchases

Stock Repurchase Authorizations

Repurchase authorizations through May 7 of each year



Source: Goldman Sachs

Buyback Methods

- Open market purchases
- Accelerated share repurchase programs (ASRs)
- Privately-negotiated repurchases
- Issuer tender offers

Initial Buyback Considerations

- Company repurchases during blackouts
  - Are the company's blackout periods the appropriate length?
- During window period should the company consider
  - Rule 10b-18 purchases
  - Rule 10b5-1 plan
  - MNPI

Initial Buyback Considerations *(cont'd)*

- Business judgment/liquidity issues
  - Borrowing or other funding of buybacks
  - Use of proceeds
- Disclosure issues/public perceptions
- Proxy advisory firms
- Stockholder demands

Rule 10b-18 Basics

Rule 10b-18

- A non-exclusive safe harbor from liability under market manipulation rules
- Manner of purchase
  - Single day, single broker-dealer
- Timing condition
  - Limits periods during which an issuer may bid for or buy its common stock
  - Purchase by the issuer cannot be the opening transaction reported on the consolidated quotation system
  - Where the purchase is effected for a security that has an ADTV of $1 million or more and a public float of $150 million or more, the purchase cannot be effected during the ten minutes before the scheduled close of the primary trading session in the principal market for the security, and the last 10 minutes before the scheduled closed of the primary trading session in the market where the purchase is effected

Rule 10b-18 *(cont'd)*

  - For all other securities, purchases cannot be effected during the 30 minutes before the scheduled close of the primary trading session in the principal market for the security and the 30 minutes before the scheduled close of the primary trading session in the market where the purchase is effected
  - Under certain conditions, an issuer purchase can be effected following the close of the primary trading session in the principal market until the termination of the period in which the last sales prices are reported in the consolidated system
- Price condition: repurchases must be made at a price not exceeding the highest independent bid or last transaction price, whichever is higher, if during trading hours the security is: reported on the CQS, displayed and disseminated on any national securities exchange or quoted on any interdealer quotation system that displays at least two price quotes

Rule 10b-18 *(cont'd)*

- Volume condition: The purchases must satisfy certain volume limits – usually purchases on a single day cannot exceed 25% of the ADTV in the preceding four weeks
- The non-exclusive safe harbor is available for common stock (or the equivalent) but not for preferred stock, warrants, convertible debt, etc.
- Purchases by an affiliated purchaser may under certain circumstances be attributable to the issuer under Rule 10b-18
- Rule 10b-18 does NOT provide safe harbor from the anti-fraud and anti-manipulation provisions of the Exchange Act
- The company should assess whether it has MNPI
  - Availability of Rule 10b5-1
  - Insider purchases and sales

Rule 10b-18 Program Documentation

- Selecting a broker
- Documenting the repurchase plan
- Trading windows or reliance on Rule 10b5-1
- Designee(s) to monitor repurchases
- Notifications to insiders and compliance procedures
- Monitoring other ongoing or proposed corporate transactions

State Law Considerations

- For a Delaware corporation, Section 160 of the DGCL allows a company to purchase or redeem its shares from stockholders, so long as its capital is not and would not become impaired
- The board's determination of "surplus" should be sufficient
- The board also should consider whether the repurchase would cause the company to become insolvent

Other Buyback Considerations

- Charter and by-law considerations
- Contractual restrictions
- Legal or regulatory restrictions
  - Conditions on receiving aid
  - Capital requirements
  - Court order or judgement
- Accounting or tax issues
- Stock exchange requirements
- Regulation M distributions

Disclosure Considerations

- Stock exchange will require disclosure
  - Press release
  - Issuer may file an Item 7.01 Form 8-K
  - Disclosure may be made as to repurchase authorization generally
- Announcement often at time of authorization
  - In any event before any repurchase is made
- Issuer will be required to disclose repurchases in its Exchange Act filings
- SEC may propose additional disclosures

Controls to Implement

- Controls relating to repurchases and communications with the appointed broker
- Process in place to address suspensions of repurchases securities offering undertaken
- Determine how to respond to questions that may arise following the announcement of a repurchase program
- Process for regularly reporting repurchases

Share Repurchase Structures

Repurchase Options

	Open Market	Prepaid/Accelerated Share Repurchase	Tender Offer
Advantages	• Continued stock support • "At-market" repurchase • Maximum flexibility • Lowest cost • Can be executed as a 10b5-1 program or opportunistically	• Optional upfront share count reduction • "At-market" repurchase • Potential tax efficiencies • Strong signal • Economic protection/discount available	• Speed of repurchase completion near current valuation • Strongest signal • Liquidity event for investors • Rapid share count reduction
Disadvantages	• Limited by daily volume • Exposed to market price over time • Share count reduction over time • Weaker signal • No guarantee of completion	• Exposed to market price over time • Fully funded upfront • Commits issuer to complete repurchase	• Requires premium to current price • Investors determine success of tender • Higher transaction costs • No ongoing stock support
Mechanics	• Issuer purchases shares in the open market over time • Can buy back stock during blackout period via 10b5-1 program	• Bank sells the block to Issuer upfront • Bank repurchases stock in the open market over time • True-up payment and/or additional shares delivered at completion of cover period	• Issuer specifies a number of shares to be repurchased within a defined price range or at specific fixed price • Shareholders decide whether they would like to participate in the offer • Tender offer open for a minimum of 20 days
Documentation	• Short form appointment letter • No public documentation	• Master confirmation • No public documentation	• Schedule Tender Offer (Schedule TO) filed with SEC
Applications	• Desire to maintain flexibility including ability to stop	• Minimum value of shares Issuer desires to purchase	• Repurchase large block of stock in a short period of time

Accelerated Share Repurchases

What is an ASR?

- An **accelerated share repurchase**, or ASR, is a structured, privately negotiated transaction, usually documented as a "forward" contract, in which a dealer agrees to sell a pre-defined amount of stock to a company at a price per share that is based on the VWAP during the relevant period
- A dealer acts as the "seller" of company shares in an ASR, and the company acts as the "purchaser" in buying back its own shares
- Numerous dealers have engaged in ASRs with their corporate clients
- Although ASRs are now commoditized to a significant extent, they do entail legal considerations that require review by counsel

Rationale for ASRs

- Efficiency
  - Permits buybacks at less than the VWAP
- Immediacy
  - Immediate share count reduction
- Certainty
  - Timing and quantity of buyback are known upfront
- Signal to market
  - Strong signal through commitment (often announced in press release) to repurchase shares
- Possible accounting advantages
  - Immediate EPS benefit and "equity treatment" for transaction, so mark-to-market may not hit income statement

Rationale for ASRs *(cont'd)*

- However, ASRs have been criticized for
  - Potential liability concerns
  - Unusual pre-transaction stock activity in certain cases
  - Lack of full and accurate disclosures
  - Inferior risk/reward compared with alternatives, including simple Rule 10b-18 programs

How does an ASR work?

- **At the beginning of the ASR**:
  - The company pays a pre-defined dollar amount to the dealer
  - The dealer borrows stock from current holders of the equity (stock lenders)
  - The dealer delivers these shares to the company (typically 80% of the underlying shares)
- **Over time**:
  - The dealer buys stock in the market to cover the shares it borrowed
  - The dealer typically has the option to complete the ASR at any time during a pre-agreed period
  - This option and its associated option value generates a discounted repurchase price for the company
- **At final settlement**:
  - The total number of shares purchased by the company equals the ASR dollar size divided by the discounted average price
  - If the dealer did not deliver enough stock upfront, it delivers incremental shares to the company at the end of the ASR
  - If the dealer delivered too many shares, the company will owe the dealer (and can typically settle in cash or in shares)

Structured Alternatives in ASRs

- Alternatives to vanilla “VWAP minus” structure?
  - Large majority of ASRs are now based on straightforward VWAP minus structure
  - However, it is possible to set a maximum and minimum (a collared structure) or, alternatively, either a maximum or minimum, on the number of shares to be repurchased
  - Can also structure for
    - Fixed dollar or fixed shares;
    - Upfront or delayed share delivery; and
    - Knock-out days or other bespoke features
  - Structural complexities may raise additional securities law concerns, especially during a hedging period when collar levels are being established

Collared ASR

- In many respects similar to a basic ASR:
  - Issuer executes an accelerated share repurchase program to repurchase shares at a discount to the average 10b-18 VWAP over the term
  - Issuer spends a fixed dollar amount to repurchase stock
    - Total number of shares repurchased equals:
      - Upfront payment divided by [Average Daily 10b-18 VWAP-discount], subject to a minimum and maximum number of shares
      - Total repurchase cost fixed upfront
      - Shares repurchased at a discount to average daily 10b-18 VWAP
- However, collar protects issuer if stock price appreciates and allows issuer to participate in price depreciation up to the minimum repurchase price

Collared Forward Share Repurchase

- Issuer pays a fixed aggregate purchase price
- Dealer delivers a variable number of shares determined on a per-share purchase price equal to the average price that is subject to a collar
  - Cap on average price equals strike price of a call option purchased by the issuer on its own stock
  - Floor on average price represents strike price of a put option purchased by the dealer on the stock
- Permits issuer to retire the minimum number of shares at inception of trade (boosts EPS)
- Lets issuer repurchase shares at average price over term, minimizing volatility

Section 9 and Section 10 of the Exchange Act

- **Section 9(a)(2)** — Cannot effect any transaction or series of transactions in any security that creates actual or apparent active trading in that security, or raises or depresses its price, for the purpose of inducing the purchase or sale of the security
- **Section 10(b)** — Cannot employ any manipulative or deceptive device or contrivance in connection with the purchase or sale of a security
- **Rule 10b-5** — Cannot employ any device, scheme or artifice to defraud, make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, or engage in any act, practice or course of business that operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security
  - The potential for 10b-5 liability can be minimized by structuring the ASR as a Rule 10b5-1 trading plan and conforming the ASR to Rule 10b5-1's requirements, thus enabling the assertion of defenses to 10b-5 claims
  - This means that the company will not have any influence over how, when or whether the dealer will effect purchases of stock in connection with the ASR

Proposals to Address Share Repurchases

SEC Proposals

- SEC regulatory agenda lists Rule 10b5-1 in proposal stage, targeting October 2021
  - Chair Gensler has asked the SEC to consider the intersection of Rule 10b5-1 and share buybacks

- SEC regulatory agenda lists share repurchase modernization in proposal stage, targeting April 2022

Various Proposals Raised in Recent Years

- Prohibiting public companies from repurchasing their shares on the open market
- Prohibiting buybacks unless company pays all workers at least $15/hour and offers certain healthcare, sick leave and retirement benefits
- Restricting ability of directors and officers to sell shares or pledge shares for five years following receipt or for three years following a Rule 10b-18 share repurchase
- Banning bans on buybacks by companies receiving Federal assistance
- Directing SEC Staff to study and report on possible revisions to regulations regarding Rule 10b5-1 trading plans

Corporate Controls Related to Share Trading

Corporate Controls Related to Share Trading

- Insider trading
  - Insider trading policy
  - Insider sales of company stock in proximity to corporate repurchases
- Handling MNPI
  - Regulation Fair Disclosure (Regulation FD)
  - Stock option or other equity grants while the company is in possession of MNPI

Corporate Controls Related to Share Trading

- Practicing good corporate hygiene:
  - Proactive, informed consideration of the issue
  - Policies to guide conduct
  - Tone at the top
  - Policies reviewed periodically to determine whether they are working as designed or whether they need to be revised
  - Training administered on a periodic basis
  - Disclosure of company policies

Insider Trading Policy

- Insider trading is prohibited by the federal securities laws
- Although not required, most companies have an insider trading policy
  - Minimize the likelihood of insider trading
  - Help a company establish a defense against controlling person liability
  - Procedures can help with Section 16 compliance
- Generally applies to directors, officers, employees, consultants

Insider Trading Policy

- Typical insider trading policy controls:
  - Quarterly blackouts and/or trading windows
  - Event specific blackouts
  - Pre-clearance procedures
  - Hedging, pledging, short sale prohibitions
  - Exception for transactions under a Rule 10b5-1 plan
    - Initiation, revocation or modification of a plan may be restricted transactions
  - Post-termination transactions
- Preventing trading once the company is in possession of MNPI, including the time period between an event and the required disclosure of that event

Insider Sales in Proximity to Corporate Repurchases

- Not prohibited, but may give the appearance of impropriety
- If sales by the insider under a 10b5-1 plan could be MNPI, the company should not repurchase while in possession of MNPI
- Insider trading policy could address this issue
  - Require pre-clearance of such insider sales
  - Impose an event-specific blackout during company repurchases
- The company might address this issue in another policy
  - Conflict of interest
  - Code of ethics

Handling MNPI

- Regulation FD
- Stock option or other equity grants while the company is in possession of MNPI

Regulation FD

- **Background**
  - SEC considers "selective disclosure" by public companies to be a form of insider trading
  - Regulation FD is designed to "level the playing field" and protect market integrity and investor confidence
- **Summary**
  - *If* a public company, or person acting on its behalf, discloses MNPI to certain types of recipients,
  - *Then* the company must publicly disclose the information:
    - Simultaneously, if disclosure was intentional, or
    - Promptly, if disclosure was not intentional

Regulation FD *(cont'd)*

- A disclosure is "intentional" if the person making it either knows, or is reckless in not knowing, that the information they are communicating is both
  1. Material, and
  2. Nonpublic
- Intentional disclosures of material, nonpublic information to covered recipients require simultaneous public dissemination
- Where a company unintentionally discloses material, nonpublic information, the company must publicly disseminate the information promptly
  - Promptly means "as soon as reasonably practicable" but in no event after the later of:
    - 24 hours, or
    - The opening of trading on the next business day, … after a senior official learns of an unintentional violation

Regulation FD Speakers

- Regulation FD applies only to certain types of speakers at a public company:
  - "Senior officials" of the company
    - Directors and executive officers
    - Investor and public relations officers
    - Other persons with similar functions
  - Other persons directed to make disclosure (by senior officials)
  - Any other officer, employee or agent of the company who regularly communicates with market professionals (described below) or security holders

Regulation FD Speakers *(cont'd)*

- Speakers *not* covered by Regulation FD:
  - Those who make disclosure in violation of their duty to the company
  - Persons (other than senior officers) who communicate with market professionals or security holders on occasion, but not regularly (they remain subject to insider trading laws)

Regulation FD Recipients

- Regulation FD applies only to certain types of recipients, or listeners (generally shareholders and market professionals):
  - Security holders, where the company should foresee that the recipient will buy or sell on the basis of the information
  - Brokers, dealers and their associated persons (including sell-side analysts)
  - Investment companies, hedge funds and their affiliated persons (including buy-side analysts)
  - Investment advisers, institutional investment managers and their associated persons

Regulation FD Recipients *(cont'd)*

- Recipients *not* covered by Regulation FD (and who face insider trading liability if they trade or tip):
  - An issuer's officers, directors and other employees are persons owing a duty of trust or confidence to the company
    - Includes "temporary insiders," such as attorneys, investment bankers and accountants
  - Persons who have expressly agreed to maintain the confidentiality of the information
  - Persons receiving information in connection with certain registered public offerings where the disclosure is made by the registration statement.

Regulation FD

- Regulation FD applies to material, nonpublic information
- Particularly troublesome areas identified by the SEC include:
  - One-on-one sessions
  - Review of analyst reports
  - Reaffirmation or commenting upon previous earning/revenue guidance
  - Responding to inquiries about rumors

Regulation FD Materiality

- The SEC will utilize the materiality tests that have been developed by the courts over the years:
  - Substantial likelihood that a reasonable investor would consider the information important in making an investment decision
  - Substantial likelihood that the information would have been viewed by a reasonable investor as having significantly altered the total mix of information
  - Information that could reasonably be expected to have a substantial effect on the price of the securities

Regulation FD Method of Public Disclosure

- Method must be reasonably designed to provide broad, non-exclusionary distribution of information to the public. The SEC suggests one or more of:
  - Press releases distributed through a widely circulated news or wire service
  - Filings made with the SEC
  - Press conferences or telephonic conferences that members of the public may access (after receiving adequate notice that the conference will be held)
  - Other methods that are reasonably designed to provide broad, non-exclusionary distribution of the information to the public

Regulation FD/Public Disclosure Policy

- Not required, but many companies have a Regulation FD policy
- Safeguard against selective disclosure of MNPI
- The SEC will consider existence of a formal policy when deciding whether a selective disclosure was intentional
- Policy should limit and define the people who are authorized to speak for the company
- Consider having a disclosure team to make materiality judgments
- Regulation FD policy should be coordinated with other aspects of the company's disclosure controls and procedures

Stock Option Grants while Company is in Possession of MNPI

- Stock options are typically granted with an exercise price equal to the "fair market value" of the stock on the grant date. If the company has MNPI, the value of the stock would not reflect that information and may not be "fair market value"
- "Spring-loaded" options
- Such grants are not prohibited by the federal securities laws
- Disclosure may be required by executive compensation rules
  - Regulation S-K, Item 402(b)(2)(iv) requires disclosure, if material, of "[H]ow the determination is made as to when awards are granted, including awards of equity-based compensation such as options"

Stock Option Grants while Company is in Possession of MNPI *(cont'd)*

- Concerns raised by former SEC Chair Clayton and former Director Hinman:
  - Shareholder approved equity plans require stock options with exercise prices at or above fair market value
  - Grants made when the company has MNPI do not have exercise price at "fair market value"
  - The grant may be inconsistent with the terms of the equity plan
  - The grant may be inconsistent with accounting rules if the trading price is not a good indicator of fair market value
  - Grants that start out well in-the-money dilute the recipient's incentive
  - "Spring-loaded" grants lead to loss of market confidence in management and the Board
- Eastman Kodak Company example

Stock Option Grants while Company is in Possession of MNPI *(cont'd)*

- Countervailing considerations:
  - Companies typically award grants on a regular, annual cycle
  - Timing of Board and committee meetings
  - May be tax or other regulatory constraints for holding meetings at a certain time
  - Stock option and other equity grants often have vesting restrictions
    - ISS Equity Plan Scorecard requires a minimum vesting period of one year

Stock Option Grants while Company is in Possession of MNPI *(cont'd)*

- Practicing good corporate hygiene:
  - Fully inform Board and committee of legal framework and potential optics concerns
  - Consider whether to wait to make stock option or other equity grants until MNPI is publicly disclosed
  - Disclose plan or practice of timing grants in coordination with the release of MNPI
  - Consider minimum vesting requirement of at least one year
  - Plan ahead – For regular annual grants, schedule Board meetings to occur after earnings have been released

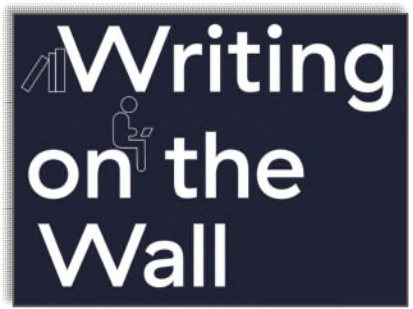
Additional Resources

Read:

- *What's the Deal?:* Rule 10b-18
- *What's the Deal?:* Rule 10b5-1

Watch:

- MB Microtalk: Regulation Fair Disclosure



Visit our illustrated securities glossary: *Writing on the Wall*

Sources

- SEC Director Hinman on Corporate Finance Regulation
- SEC Chair Clayton's Letter to Chairman Sherman
- Congress' Letter to SEC Acting Chair Allison Herren Lee
- Stanford paper: Stanford University Study: "Gaming the System: Three 'Red Flags' of Potential 10b5-1 Abuse"