WASHINGTON TRUST
Wealth Management®

Making the Most of Equity-Based Compensation: Adopting a Rule 10b5-1 Trading Plan

Making the Most of Equity-Based Compensation: Adopting a Rule 10b5-1 Trading Plan

Stock is often a meaningful part of an executive's total compensation. However, while stock grants can be lucrative, restrictions may apply for those in possession of material non-public information (MNPI), such as executives and directors, even if stock trades are not based on that information. As indicated below, establishing an individual stock trading plan, known as a Rule 10b5-1 plan, can help.

Executives with the greatest exposure to and reliance upon a company's equity grants are often subject to frequent trading restrictions. These restrictions and blackout periods were established to protect investors from insiders opportunistically trading on MNPI. Blackout periods may occur before key events that could impact stock price, such as earnings announcements or mergers and acquisitions. They also may be imposed periodically on stock sales and purchases for employees of a company, such as a pharmaceutical company seeking FDA approval for a drug, greatly reducing the stock trading windows. These restrictions often result in a lack of liquidity and increased exposure, narrowing the opportunity to diversify and raise cash through selling shares. The inability to trade can result in a highly concentrated stock position in the very company the executive relies on for income.

How can an executive, insider, or restricted employee sell stock without running afoul of insider trading rules? The Securities and Exchange Commission (SEC) Rule 10b5-1 may help. Rule 10b5-1 plans allow corporate insiders and others subject to trading restrictions to purchase and sell securities while avoiding accusations of impropriety. When structured correctly by legal counsel that follows the guidelines of Rule 10b5-1, a transaction plan may offer an affirmative defense against insider trading by providing pre-determined and clear instructions to a broker about when to sell (or buy) shares of the restricted security.

Building the Plan

Trading plans are established on an individual basis by the executive, key employee, or director holding company stock or grants. A trading plan should be created when the insider does not have MNPI, preferably during an open trading window. And the plan must contain enough information for the broker to execute the trades without any additional instruction, information, or discretion from the insider.

The 10b5-1 trading plan must be in writing and contain the following specific elements:

1. Specification of the number of securities to be purchased/sold, the price, and the date; or

2. A written formula, algorithm, or computer program to be used for determining amounts, prices, and dates for purchases or sales; or

3. Restriction that does not permit the person to exercise any subsequent influence over how, when, or whether purchases or sales are effected

A trading plan provision concerning price can include a market or limit order. Market orders are executed regardless of price, and limit orders are triggered when a designated price is reached. A trading plan provision regarding dates need not be month and day specific. The transactions are usually set at a regular cadence, monthly or quarterly. Plans may include more than one target price to improve the chances of being executed. Examples of acceptable plan provisions may include:

- Sell 100 shares per month with a limit price of $50
- Sell 10% of shares every quarter
- Sell 200 shares at $100 and another 300 shares at $110 every month

Setting the Price

One of the most difficult decisions to make about a 10b5-1 plan is determining how to set the target sale price.

A mathematical equation like the Black-Scholes model for pricing derivatives (that Myron Scholes and Robert Merton won the Nobel Prize for in 1997) can be used to inform this decision. The Black-Scholes model uses five variables: strike price, current stock price, time to expiration, risk-free rate, and stock volatility to attempt to estimate the full value of a stock option. Mathematical models, like Black-Scholes, help determine how much theoretical upside is available, how much potential risk there is in waiting, and how to balance that risk/reward with your personal financial goals. And calculations can be done using an online calculator.

Another way to set a target sales price is to consider the funds needed for a specific financial goal, such as college tuition, a tax bill, or a home purchase. You can tailor your plan to sell enough stock to fund a specific goal at a designated time, particularly if the plan is updated each year. For example, if you know you will need $75,000 for college tuition this year, you can set a number of shares with a price that is low enough to likely be executed. While this may not guarantee that you get the highest sale price possible, it will likely raise enough to cover the tuition expense. You can set an additional, higher price tranche to capture gains above the amount earmarked for the specific goal.

Filing Your Plan

Many companies already have 10b5-1 plans, with standard rules, forms, and adoption agreements in place, that you can use to establish your plan. We would recommend checking with your Human Resources Department first to determine whether standard plan documents and forms exist. Then, you can follow them to identify the designated prices, dates, and amounts or formulas. Otherwise, you would need to receive guidance from legal counsel with expertise in this area to create your own plan and file it with your company.

Once a plan is created, most companies require a cooling off or waiting period between filing the plan and executing a trade to ensure the insider is sufficiently removed from access to MNPI. This period is generally 30 to 60 days. While there is no expiration on 10b5-1 plans, the plan duration should be long enough to avoid the appearance of acting on insider information, but short enough to achieve your financial goals and avoid the need to amend or cancel. As a result, many 10b5-1plans are effective for one year, which allows for any needed updates and for the inclusion of newly vesting grants in the plan.

Equity-based compensation can be a valuable and important part of your wealth story, but you may need help to maximize its flexibility, manage its liquidity, and control its exposure due to trading restrictions. Asking your company about adopting their standard 10b5-1 plan or working with a qualified attorney to create your own can help. If you have questions or want more information, please contact your Washington Trust Wealth Advisor.

Will the Rules Be Amended?

Rule 10b5-1 plans can be abused and have come under scrutiny. In December 2021, the SEC proposed amending the current rules to include:

A mandatory 30-day cooling-off period after adoption or modification of the plan;

A requirement that officers and directors certify that they are not aware of MNPI when adopting a new or modified plan;

The affirmative defense won't apply to multiple overlapping plans for open market trades in the same class of securities;

Plans adopted to execute a single trade would be limited to one per 12-month period;

10b5-1 plans must be entered into and operated in good faith.

The proposal also requires enhanced disclosure regarding Rule 10b5-1 trading plans, option grants, and issuer insider trading policies and procedures.

Even if this proposal is not enacted, once a 10b5-1 plan is established, best practices can help maintain the affirmative defense. Some best practices guidelines include:

- Only have one plan at a time
- Don't trade outside of the plan
- Use a cooling-off period before 10b5-1 trading begins
- Use a pre-approved template
- Avoid cancelling or modifying the plan
- If a plan must be cancelled or modified, avoid doing so while in possession of NMPI
- Employ a steady approach, selling or buying a similar amount at regular intervals
- Do not use a plan to execute a one-time trade or large irregular trades
- Planned trades that result in large profits at suspect times increase scrutiny of the plan

WASHINGTON TRUST

Wealth Management®