Is Exercising Employee Stock Options Illegal Insider Trading? Maybe

Daniel Nathan and Brian Neil Hoffman

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Amidst the flurry of Securities and Exchange Commission (SEC) cases involving improper employee stock option backdating several years ago, many commentators opined on the potential insider trading implications of companies' issuance of stock options to officers and directors. As a result, we all now know that "spring loading" and "bullet dodging" raise securities law questions, not simply a dizzying array of mechanical mayhem. Yet the literature is surprisingly scant concerning the potential insider trading implications of an insider exercising her stock options. The time is ripe for this discussion, particularly since the SEC and Department of Justice have ambitiously prioritized insider trading enforcement of late.

Picture this: As a valued contributor to a public company, you received stock option grants over several years. You and your company have done well, and the stock price is now higher than the grant price. A bit of immediate profit sure looks attractive, particularly with your daughter bound for that pricey private university. Yet when you spoke with the company's general counsel, he confidentially informed you that the company will soon announce a massive restatement of its financial statements, likely causing the stock price to precipitously decline. The GC told you that he instituted a blackout period prohibiting transactions in the company's stock. Can you nevertheless exercise your options and sell the resulting shares?

Overview of Law

Under established law, dire consequences—including monetary sanctions, restrictions on future employment opportunities, and possible criminal prosecution—await insiders who misstep while selling their company's stock. While navigating this precipice, therefore, a review of governing principles provides a helpful tether to safety.

Insider trading is not defined by statute or regulation. Rather, case law interpreting the antifraud provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and rules adopted thereunder, establishes the basis for liability. Generally, unlawful insider trading occurs when a person:

- transacts in a security,
- while knowingly in possession of material nonpublic information,
- in breach of a duty of trust and confidence.

Courts use the breach of a duty analysis as a proxy for establishing deception, which is required by the antifraud provisions of the securities laws. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997).

Insider trading is charged under one of two theories: "classical" and "misappropriation." Under the "classical" theory, a corporate insider (such as an employee, director, or a temporary insider like an investment banker) owes a duty to his company's shareholders to refrain from trading the company's stock on the basis of the company's material non-public information. Any transactions in the company's stock based on material non-public information will benefit the company insider at the expense of other shareholders. The "misappropriation" theory applies to someone who converts material non-public information to his own use by trading ahead of an announcement in violation of a duty of trust and confidence (such as a fiduciary duty) owed to someone other than the company's shareholders.

Methods of Exercising

To understand when and how a company insider may exercise her stock options, the critical inquiry is whether an options exercise involves a purchase or sale of securities in breach of a duty.[1] As a general matter, an employee stock option is a contract between a company and an agent (an employee or director) that allows the holder, once vested, to buy a specified number of shares of the company's stock at a given price before the expiration date. There are several common ways in which an agent can pay for the exercise of stock options, and company policy might limit agents to use only certain methods:

- Cash Exercise: The option holder pays the option price per share in cash to the company in exchange for the appropriate quantity of shares. The employee then can decide to hold the shares in her portfolio, or make a separate decision to sell some or all of the shares into the market.

- Net Settled Exercise: The holder pays for the options exercise by giving enough shares back to the company (or the company retains those shares at the time of exercise) sufficient to compensate the company for the exercise price at the shares' current market value. The company may then choose to sell or retire the held-back shares.

- Broker-Assisted Cashless Exercise (also called a Same-Day Sale): At the time of exercise, some or all of the exercised shares are sold into the market and the requisite amount of the sale proceeds are used to pay the company for the exercise. The holder keeps the net proceeds and any unsold shares.

Under each method, the holder provides value, in the form of cash or stock shares, to the company directly or indirectly in exchange for the shares. The "Cash" and "Net Settled" methods involve transactions solely between the company and the holder ("intra-company"). The "Broker-Assisted Cashless" method, in contrast, involves a contemporaneous sale into the market. (Note that under all three methods, shares are also sometimes withheld for taxes).

Under each of these options exercise methods, the holder receives a benefit if the market price of the stock exceeds the cost of exercising the stock options. (Indeed, a holder typically is unlikely to exercise if the market price is below the cost of exercise, unless the time to exercise is soon expiring). If the market price increase is the result of an announcement of positive news, the holder may sell the shares, regardless of whether the exercise preceded or followed the announcement.

Conversely, if the holder exercises stock options and sells the resulting stock to the market before the announcement of negative news that decreases the market price, she will avoid losses.

Yet are these windfall profits or avoided losses improper from an insider trading perspective? The answer: it depends.

Principles and Exercise

Potential insider trading liability depends upon the method of the execution of the transaction, as well as on the timing of the transaction.

Under the first two methods (the intra-company exercises), a holder ultimately should not be held liable for insider trading based on the exercise of the stock options, even if the holder exercised while aware of yet-to-be-announced market-moving news, whether positive or negative. Why? Because any material non-public information about the company typically is known by both parties to the option exercise transaction. An intra-company exercise occurs entirely between the holder and the company and does not involve a sale to the market.

As a result, the insider does not violate a duty to the company's shareholders (or, presumably, to anybody else) by capitalizing on an informational advantage when exercising the options; there usually is no such advantage. Notably, this may not be true in all circumstances, so officers and directors should remain cautious. See *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 856-57 (2d Cir. 1968) (finding directors violated Rule 10b-5 by accepting a stock option award because they failed to disclose information about drilling results to the board or to the board's stock option committee).

Nevertheless, in many cases, the insider who is aware of non-public positive information that will move the market thus is in a position to obtain shares by exercising her stock options before the announcement, as long as she exercises those options by paying cash for them or via net settlement. On the other hand, people in possession of material non-public positive information obtained as insiders or pursuant to a duty of trust or confidence typically cannot purchase shares on the open market prior to the announcement without committing insider trading.

For example, in our hypothetical, both the holder and the company are aware of the pending restatement at the time of a cash or net settlement exercise. The holder thus likely did not deceive her counterparty (the company) by withholding information of which the company was unaware. Without deception, there is no insider trading. In a similar circumstance involving mutual fund share redemptions, the U.S. Court of Appeals for the Seventh Circuit recently noted that the classical theory of insider trading is inapplicable when there is information parity among the parties to the transaction. See Insider Trading in Mutual Funds: Do Traditional Theories Apply? Morrison & Foerster Client Alert, http://www.mofo.com/files/Uploads/Images/130808-Insider-Trading-Mutual-Funds.pdf (discussion of case in which court remanded to determine whether the misappropriation theory should apply to the case).

Importantly, a holder's subsequent decision to sell some or all of the new shares constitutes a new trading decision that is independent from the option exercise by which she obtained the shares. Once obtained, she may not sell the shares to the market while in possession of material non-public information.

In contrast, a "Broker-Assisted Cashless" exercise necessarily involves a contemporaneous sale to the market. The holder thus could be in a position to take advantage of an informational asymmetry, to the detriment of a buying member of the public. This type of exercise (and attendant sale) before the announcement of adverse market-moving information would leave a buyer with shares that will decline in value once the adverse news is announced. On the other hand, if the material non-public information involved positive news, the sale of stock to the public as part of a "Broker-Assisted Cashless" exercise would not disadvantage or deceive the buyer. To the contrary, that lucky buyer would receive an immediate windfall when the good news is announced. Of course, that timely purchase might subject the buyer to his own regulatory scrutiny.

In our hypothetical, for example, the insider should avoid a "Broker-Assisted Cashless" exercise because she could be accused of taking advantage of the higher stock price before the restatement is disclosed. The Justice Department and SEC both have pursued insider trading charges in similar instances. See, e.g., *United States v. Nacchio*, 573 F.3d 1062, 1068 (10th Cir. 2009) (insider trading charges based on options exercise involving market sales amidst accounting concerns); *SEC v. Elles*, Rel. No. 2010-252 at http://www.sec.gov/news/press/2010/2010-252.htm (insider trading charges based on options exercises and sales prior to disclosure of accounting concerns); *SEC v. Dollar General*, Rel. No. 19653 at http://www.sec.gov/litigation/litreleases/2006/lr19653.htm (insider trading charges based on options exercise involving market sale before restatement announcement).

To summarize: The safest course for an insider to exercise her stock options and avoid potential insider trading liability is through the "Cash" or "Net Settled" methods, because those transactions are conducted with the company, which likely has the same information as the insider. An exercise of stock options by an insider in a "Broker-Assisted Cashless" exercise before the announcement of unquestionably positive market-moving news may not be improper insider trading, since it would simply result in the sale of underpriced shares on the open market to a buyer, who would incur a windfall. An insider likely would not make that sale, since it would be in effect giving away value; moreover, the unusual nature of the transaction could attract regulatory scrutiny.

A "Broker-Assisted Cashless" exercise before an announcement that does or could involve negative market-moving news might well be improper insider trading because it necessarily involves a market sale to buyers who do not yet know the negative news. Finally, however employee stock options are exercised, a decision to sell the resultant shares into the market at some later time constitutes a separate trading decision that likewise is subject to insider trading principles.

What Precautions to Take?

As noted, insider trading continues to be a top priority for the Justice Department and SEC, and corporate insiders have always been subject to special scrutiny. The SEC's recent renewed focus on public company financial reporting issues creates additional risks for insiders who exercise options and/or trade before public disclosure of misstated financial statements. Public companies and their employees and directors therefore should be cognizant of the potential traps awaiting those who hold, and seek to exercise, employee stock options.

Avoiding these traps through robust policies and procedures remains the best first step. Entities should review their insider trading policies to ensure they provide comprehensive guidance to and oversight of employees. Among other things, effective policies should: define insider trading and discuss the potential ramifications for violations; enact procedures to control sensitive material non-public information; establish relevant blackout windows to restrict trading; clearly identify prohibited transactions or securities; keep track of trading in the company's stock by officers and directors; and provide an avenue for employees to ask questions about and obtain preclearance for contemplated transactions.

With respect to employee stock options, issuers should consider these additional measures that minimize temptations for insiders to engage in insider trading, and protect the firm against substantive liability for failing to take sufficient precautions against insider trading:

• Either ensure that "intra-company" exercises are carved out from insider trading policies (which is common) or adopt policies that open and close windows for "intra-company" exercises.

• Put employees on notice that sales of exercised shares are separate decisions that could subject traders to insider trading liability.

• Either prohibit "Broker-Assisted Cashless" exercises entirely, or restrict them to only be permitted during blackout windows, barring special circumstances and approvals.

• Ensure that any trade monitoring includes review of stock option exercises.

• Require employees to report transactions in the company's securities to legal or compliance personnel.

• Require senior executives and directors to obtain advanced approval of transactions in the company's securities.

• Provide periodic training on avoiding insider trading.

Moreover, insiders should consider whether to enter into Rule 10b5-1 plans, which are pre-established trading programs that specify a specific non-discretionary formula for future trades. When entered into without material nonpublic information, and if left to operate without interference, Rule 10b5-1 plans provide a defense to insider trading claims, even if the trades later happen to occur at suspicious times.

The SEC has pursued insider trading charges when plans are established while in possession of material non-public information or amended with such information. See, e.g., *SEC v. Mozilo*, Rel. No. 21068A at http://www.sec.gov/litigation/litreleases/2009/lr21068a.htm. As a result, entities and individuals should reexamine their trading plans and policies, and carefully adhere to "best practices" in this area.

In sum, the same insider trading principles apply to options exercises as to other securities transactions. Stock option exercises may create additional risks of violating the securities laws depending upon how they are exercised. Through careful advance planning and sound legal advice, stock options holders can minimize their risks of committing insider trading and reap the benefits of their stock options.

***Daniel Nathan** is a partner in Morrison & Foerster's securities litigation, enforcement and white-collar defense group; he is based in the Washington, D.C., office. **Brian Neil Hoffman** is of counsel at the firm and is based in the Denver office.*

Endnotes:

1. We will not discuss here the materiality of the non-public information, whether the transaction occurred "on the basis of" that information, and the effect of the blackout period. This article also will not discuss the ramifications of an employee's violation of company policy, including in violation of a blackout period, except to the extent that such trading amounts to a breach of duty.