RESPONSE

TILTING AT INSIDER TRADING WINDMILLS

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In response to Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. Pa. L. Rev. 801 (2014).

INTRODUCTION

In *Insider Trading via the Corporation*,[1] Professor Jesse M. Fried expresses his frustration that "when insiders are subject to strict trade-disclosure requirements and firms are not, insiders have a strong incentive to exploit the relatively lax trade-disclosure rules that apply to firms in order to engage in *indirect* insider trading."[2] Professor Fried divides insider trading into so-called "direct" and "indirect" styles.[3] His Article does not concern the former—that is, the well-worn world of insiders trading their own shares.[4] Instead, it examines a more circuitous brand—where corporate

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1 Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PA. L. REV. 801 (2014).

2 *Id.* at 804.

3 *Id.* at 804-06.

4 *See, e.g.*, Jie Hu & Thomas H. Noe, *The Insider Trading Debate*, FED. RES. BANK ATLANTA ECON. REV., Fourth Quarter 1997, at 34, 34 (noting that "trading by officers, directors and other key employees of corporations who have access to private information has generated some of the most sensational scandals in the popular business press"); Audrey Strauss, *Recent Insider Trading Jury Charges: 'Possession' vs. 'Use,'* 246 N.Y. L.J. 5, 5 (2011) (observing that "[i]nsider trading

insiders maneuver the levers of the corporation to buy and sell shares at favorable prices and, in turn, boost the value of their own equity. Professor Fried views indirect insider trading as both costly to public investors and deleterious to the firm's economic value.[5] The Article also proposes to reduce these costs through the imposition of trade-disclosure rules which more closely mirror those applied to insiders themselves.

This short Response aims to lend new insight and perspective to this topic, the importance of which cannot be overstated given the demonstrable increase in the number of corporate buybacks in recent years.[6] The Response proceeds in four parts. Part I simply recaps the Article, offering a synopsis of its main insights. Here, no improvement is sought. Instead, a summary and prioritization of the Article's observations is the goal.[7]

Part II asserts that the problem of insider trading via the corporation is overstated. As a foundational matter, incentive does not behavior make. More particularly, any personal benefit obtainable through indirect insider trading is significantly diluted, with an offender unlikely to hold a sufficiently sizeable portion of the firm to make such behavior as desirable as the Article suggests. Additionally, the Article fails to address meaningfully the full cost of any iniquitous behavior when measured by the professional, legal, and reputational risk to which it subjects an unmasked offender.

Part III focuses attention on the more benign (and more likely) rationale supporting firms' stock issuance and repurchase choices. Regulatory and market distortions inspire corporate decisions surrounding open market repurchases (OMRs) and at the money sales (ATMs) of shares. In particular, the various accounting and corporate finance considerations described in this Part of the Response frequently encourage these transactions. Further, most often, decisions can be defended because they are in a firm's interest, and therefore consistent with corporate insiders' fiduciary duties. Regulation of corporate repurchases is also far more robust than the Article concedes. As this Part suggests, any firm employing a responsible model of corporate governance routinely considers many concerns beyond those

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prosecutions have been back in the spotlight recently, with multiple trials and even more guilty pleas occurring over the last year in the Southern District of New York").

[5] Fried, *supra* note 1, at 805, 826-33 (asserting that indirect insider trading "secretly redistributes value from public investors to insiders" and leads "insiders to waste economic resources").

[6] *See, e.g.*, Jason Zweig, *Will Stock Buybacks Bite Back?*, WALL ST. J. (Mar. 21, 2014, 5:19 PM), http://blogs.wsj.com/moneybeat/2014/03/21/will-stock-buybacks-bite-back/tab/print, *archived at* http://perma.cc/BF2-UJ9N (observing that corporations in the Russell 3000 repurchased $567.6 billion worth of stock in 2013, representing a twenty-one percent increase over 2012).

[7] Admittedly, such an effort might not result in the same emphasis that Professor Fried would choose himself.

mentioned by Professor Fried. The final section of the Response offers a brief conclusion, positing that Professor Fried's analysis rests on the tenuous assumption that the corporation and its officers are somehow inherently prone to malevolent action and self-dealing.

I. PROFESSOR FRIED'S ARGUMENT AGAINST INDIRECT INSIDER TRADING

Professor Fried objects to the frequency with which U.S. firms trade in their own shares while the trade disclosure requirements governing such transactions remain "minimal."[8] And though the Article highlights the relative laxity of the trade disclosure requirements imposed on U.S. firms compared to their overseas counterparts, its principal objection concerns the leniency of the rules that firms face in light of "those [rules] imposed on *insiders* of those firms."[9]

After applauding the long tradition of barring a corporation's insiders from profiting freely as a result of their access to inside information about a firm,[10] the Article questions whether regulations have failed to enforce similarly effective oversight on firms themselves (and on insiders acting through such firms).[11] In Professor Fried's judgment, "U.S. policymakers have failed to grasp that when insiders are subject to strict trade-disclosure requirements and firms are not, insiders have a strong incentive to exploit the relatively lax trade-disclosure rules that apply to firms in order to engage in *indirect* insider trading."[12]

In celebrating the regime that effectively holds insiders to account for their *direct* transactions, Professor Fried focuses on the requirements of (i) Rule 10b-5[13] and (ii) Section 16(a)[14] of the Securities and Exchange Act of 1934 ("Exchange Act").[15] Rule 10b-5—one of the foundational parts of the federal securities laws[16]—requires certain persons who possess material nonpublic information about a firm to either (i) disclose that information or

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8 Fried, *supra* note 1, at 803.
9 *Id.* at 803.
10 *Id.* at 806-11.
11 *Id.* at 812-17, 822-26.
12 *Id.* at 804.
13 17 C.F.R. § 240.10b-5 (2014).
14 15 U.S.C. § 78p(a) (2012).
15 Fried, *supra* note 1, at 808-11, 813-15.
16 *See, e.g.*, LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES REGULATION 398 (4th ed. 1999) (noting that "Rule 10b-5 clearly occupies the preeminent position among the anti-fraud provisions in the securities laws"); *see also* Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (describing Rule 10b-5 as "a judicial oak which has grown from little more than a legislative acorn").

(ii) refrain from trading in the firm's shares.[17] And Section 16(a) requires corporate officers, directors, and persons owning more than ten percent of a public company to disclose publicly the details of each purchase and sale of the firm's shares within two business days.[18]

With respect to Rule 10b-5, Professor Fried offers a two-part critique. First, he argues that the materiality limitation ensures that economic waste and unfair advantage will result from the rule's inability to capture scenarios where inside information simply falls below that threshold.[19] Second, he posits that deterrence is "far from perfect" where the Securities and Exchange Commission (SEC) has limited resources and, as a result, must pick its fights.[20] The Article likewise criticizes Section 16(a) with the assertion that "insiders can trade secretly for two days without facing any price adjustment due to trade disclosure."[21] Yet, without Section 16(a)'s disclosure requirements—however imperfect—Professor Fried concedes that "insiders' ability to profit from trading on inside information would be far greater."[22]

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[17] *See* 17 C.F.R. § 240.10b-5 (barring insiders from failing "to state a material fact necessary in order to make the statements made [in a trade] . . . not misleading," and forbidding inside trades that would "operate as a fraud or deceit upon any person"); Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (establishing the disclose-or-abstain rule); *see also* United States v. O'Hagan, 521 U.S. 642, 652 (1997) (holding that an insider's fiduciary duty "gives rise to a duty to disclose or to abstain from trading" (internal quotation marks omitted)); Fried, *supra* note 1, at 813 (commenting that Rule 10b-5 requires insiders to "disclose any material nonpublic information that they possess or abstain from trading in the firm's shares").

[18] 15 U.S.C. § 78p(a).

[19] Fried, *supra* note 1, at 808-09, 814 ("[T]he courts' high materiality threshold permits trading on many types of important but sub-material information."). Federal securities laws do not define the term "material," but instead, rely on case law. Information is said to be material if "there is a substantial likelihood that a reasonable shareholder would consider it important in [making an investment decision]" and it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[20] Fried, *supra* note 1, at 809-810. For a discussion of this principle in a larger context, see Michael C. Macchiarola, *"Hallowed By History, but Not by Reason": Judge Rakoff's Critique of the Securities and Exchange Commission's Consent Judgment Practice*, 16 CUNY L. REV. 51, 67-81 (2012).

[21] Fried, *supra* note 1, at 811.

[22] *Id.* Disappointingly, aside from a passing mention, the Article fails to discuss the "short-swing profits rule" of Section 16(b) of the Exchange Act, one of the most important deterrents for company insiders transacting in firm shares. *See id.* at 830 (noting that Section 16(b) prohibits insiders from making short-swing profits by "buy[ing] and sell[ing] stock within a six-month period [when] the purchase price is lower than the sale price"). Section 16(b) thus is designed to prevent the unfair use of insider information by those most likely to regularly possess it, and provides for the automatic recapture of profits occurring within a period of less than six months. 15 U.S.C. § 78p(b). In addition, Professor Fried fails to mention the ban on short sales by insiders, embodied in Section 16(c) of the Exchange Act. *See* 15 U.S.C. § 78p(c) (barring insider sales when the insider "does not own the security sold" or fails to deliver the sold security promptly).

Professor Fried is even less impressed with the regulation of firms dealing in their own shares, viewing the applicable requirements as far too lenient. The Article examines the buying and selling activities of public corporations and concludes that "[t]here is overwhelming evidence that insiders use private information to have firms secretly buy and sell their own shares at favorable prices."[23] With respect to both OMRs and ATMs, Professor Fried identifies three types of regulations applicable to firms transacting in their own shares: (1) pre-transaction disclosure requirements, (2) a prohibition on trading while in possession of material nonpublic information, and (3) post-transaction disclosure requirements.[24] The Article objects to these regulations as being both too lenient and imprudent in their timing.[25] Professor Fried further complains that the pre-transaction announcement is at risk of subsequent amendment—because actual purchase or sale amounts are ultimately subject to change based on market conditions.[26] Also, the Article laments that the post-transaction disclosure requirements do not obligate firms to describe certain important trade details and do not apply until months after a trade.[27]

Professor Fried's prescription and the Article's *raison d'etre* is a proposed two-day disclosure rule (similar to the disclosures imposed on insiders through Section 16(a)) for firms trading in their own stock.[28] The efficacy of this proposal, and of the analysis that undergirds the proposal, is examined below.

II. Indirect Insider Trading: An Overstated Problem

The Article fails to emphasize adequately the disincentive that counterbalances any potential personal gain to an indirect insider trader. In fact, any such advantage is diluted by the percentage of the firm that such an indirect insider trader does not own. As a result, the Article overstates the temptation for any self-interested insider to manipulate the corporate levers in the manner Professor Fried fears. In fact, acknowledging shares not owned by an insider (and, in turn, fairly applying the resulting discount to any potential benefits of indirect insider trading) seriously curtails the desirability of an indirect insider trading scheme. In addition, when the potential legal liability is measured against any budding benefit, the indirect form of

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23 Fried, *supra* note 1, at 839. *But see* Zweig, *supra* note 6 (noting that "companies tend to exhibit the same perverse timing—buying high and selling low—as individual and institutional investors").

24 Fried, *supra* note 1, at 812-15, 822-24.

25 *Id.*

26 *Id.* at 813, 822.

27 *Id.* at 814-15, 823-24.

28 *Id.* at 834-39.

insider trading seems far less appealing than the direct version.[29] Applying simple risk–reward analysis reveals that the potential reward for direct insider trading far exceeds the comparable potential prize available from its indirect cousin. Further, comments about the differing reporting cycles notwithstanding, the legal risk remains the same in each case.[30] Finally, too little consideration is paid to the contentions that (i) any benefit earned on the back of a selling shareholder is shared with all the firm's remaining shareholders and (ii) incentives of this sort might not overcome the vigilance with which corporate insiders tend to perform their role as firm stewards.[31]

A critical review of the very example that Professor Fried offers reveals the strained analysis required to equate indirect insider trading with direct insider trading, where an insider acts alone in the sale of his or her own shares. To support the claim that "insiders have an incentive to engage in bargain repurchases," the Article constructs a scenario whereby a "bargain repurchase shifts value from public shareholders as a group to [the] Insider."[32] In the simple hypothetical case presented, six shareholders each hold a single share of the corporation.[33] The six shares represent all of the firm's shares

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[29] Professor Fried attempts to dismiss this concern in a very brief discussion toward the end of his Article. His analysis, limited to a paragraph, holds that an insider would prefer to act in the indirect manner because he could likely hide behind the liability of the corporation: "From an insider's perspective, it is one thing for the corporation to be charged with a violation of the securities laws; it is quite another for the insider himself to be a defendant in an insider trading case." *Id.* at 830. *But cf.* Robert H. Friedman, Jonathan H. Deblinger & Kenneth S. Mantel, *Navigating Public Company Equity Buybacks*, INSIGHTS, Dec. 2011, at 1, 1-2 (outlining the serious nature with which boards approach these transactions, because if they are handled poorly, they can "subject an issuer and its board to investor criticism, and, potentially, litigation").

[30] Professor Fried draws attention to the fact that "a firm buying its own shares in the market is subject to much less stringent trade-disclosure requirements than a firm insider who personally buys those shares." Fried, *supra* note 1, at 815. In particular, Professor Fried is concerned that insiders must report specific trade details within two days while firms "need to report only aggregate monthly or quarterly trading activity, and can wait for months after this activity to do so." *Id.* at 839. Such analysis fails to acknowledge the fact that, in practice, the SEC, the Department of Justice and the Financial Industry Regulatory Authority (FINRA) will easily gain access to any trading details that they wish to review. And the methods by which those trades are fully disclosed to other market participants is of little concern when it comes to the regulators' mission to deter bad behavior.

[31] *See, e.g.*, Friedman, Deblinger, & Mantel, *supra* note 29, at 1 (noting that "[b]efore establishing a buyback program, the underlying goals with respect to the program should be identified by the issuer's management and board of directors and discussed at the board level"). The Article and this Response do not discuss issues of corporate or personal income taxation which, depending on individual facts and circumstances, would likely be significant considerations for any offending shareholder.

[32] Fried, *supra* note 1, at 817.

[33] *Id.* at 816.

outstanding and a single shareholder is deemed an insider.[34] As the hypothetical scenario unfolds, the firm repurchases its shares at a discounted price versus actual value.[35] The insider does not participate as a selling shareholder "because he is aware that the stock is underpriced."[36] Following the repurchase (and because of the discount), Professor Fried asserts that stock value shifts from public shareholders as a group to the insider.

The most significant issue with this hypothetical scenario is not that it is an overly simplistic example designed to prove a point. Nor is it the troubling leap embedded in the assumption that an insider has the wherewithal to identify and act upon an underpriced stock—all the while managing to skillfully manipulate the firm's levers and manage the layers of checks and balances at the management and board levels of the firm.[37] Instead, the scenario's undoing is found in its expression of benefit, which seems little more than a sleight of hand. While the hypothetical insider enjoys a benefit from the offending discounted purchase, that *very same benefit* is available to every single member of the nonselling class of shareholders.[38] So, while a selling shareholder in the example is hoodwinked into selling his stock too cheaply, it is the insider *and all of the other nonselling shareholders* who benefit from the scheme.

By failing to highlight the fact that any benefit to a malevolent insider is substantially diluted by other nonsellers who ride the schemer's coattails, Professor Fried overstates the insider's incentive to engage in indirect insider trading. In fact, in the hypothetical Professor Fried presents, a full eighty percent of the economic benefit is enjoyed by shareholders other than the offending insider. Professor Fried also downplays the notion that

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[34] *Id.*

[35] *Id.*

[36] *Id.* at 817. This statement is itself troubling because the concept of being "aware" of an underpriced security is at odds with the efficient market hypothesis's central assertion that financial markets are "informationally efficient" and that, as a result, a security's price impounds all available information. *See generally* Eugene F. Fama, *Random Walks in Stock Market Prices*, FIN. ANALYSTS J., Sept.–Oct. 1965, at 55, 56, *reprinted in* FIN. ANALYSTS J., Jan.–Feb. 1995, at 75, 76 ("An 'efficient' market is defined as a market where there are large numbers of rational, profit-maximizers actively competing, with each trying to predict future market values of individual securities, and where important current information is almost freely available to all participants."). For a description of the efficient market hypothesis and its limitations and applications, see Michael C. Macchiarola, *Beware of Risk Everywhere: An Important Lesson from the Current Credit Crisis*, 5 HASTINGS BUS. L.J. 267, 281-83 (2009).

[37] *See supra* note 31 and accompanying text.

[38] Professor Fried does present the insider's benefit in Table 1 of the Article. Fried, *supra* note 1, at 817 tbl.1. In the Article's text, however, he draws little attention to the facts that (i) the ill-gotten benefit is spread among multiple selling shareholders and (ii) little of the benefit is enjoyed by the hypothetical malevolent actor. The objection here is against the Article's emphasis.

any purchase of cheap stock or sale of overvalued stock significantly benefits the firm's balance sheet and is thus wholly consistent with an insider's fiduciary duty to protect the corporation's interest.[39]

Finally, if civil or criminal penalties and sanctions indeed represent the "menu of prices" that Jeremy Bentham long ago suggested, the indirect version of insider trading would seem a rather curious choice over the direct version for an insider opting to cross the insider trading Rubicon.[40] Just how enticing is an indirect version of insider trading that requires an expenditure of insiders' corporate political capital, all to manipulate the firm's levers in favor of a purchase plan designed to shift value from unwitting selling shareholders to insiders? Besides, as the example illustrates, even if successful, any personal benefit derived from such a scheme arrives discounted by a significant dilutive tax, paid to other nonselling shareholders, which would not apply to the (much easier to accomplish) direct form of insider trading.[41] Perhaps the indirect offender simply possesses a more pronounced instinct to share his ill-gotten gains with others.

III. ALTERNATIVE FACTORS AFFECTING FIRMS' STOCK ISSUANCE AND REPURCHASE CHOICES

Professor Fried's Article advances a narrative that OMRs systematically begin in the cunning mind of a self-interested insider and result in disadvantage for an unwitting selling shareholder. As a result, the Article underappreciates the far more benign reasons that firms regularly (and tactically) seek to purchase cheap stock.[42] Most often, a corporation engages in repurchase activity to signal to the market that its shares are undervalued

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[39] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (explaining that "the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise").

[40] *See generally* BERNARD E. HARCOURT, THE ILLUSION OF FREE MARKETS 105 (2011) (describing Jeremy Bentham's philosophy, which extended "the economic rationality of pricing to the field of crime and punishment" and viewed "the penal code as a grand menu of prices"). Bentham saw humans engaged in a constant effort to weigh potential gains of any behavior against the pain likely to be imposed. Any rational punishment system must, under these assumptions, be graduated to allow for punishment to more closely match the crime. In this context, indirect insider trading's lesser benefit, coupled with its similar potential punishment, makes it far less appealing than direct insider trading.

[41] Admittedly, this comparison assumes that the direct personal trade would be beyond the recapture of the short-swing profits rule. *See supra* note 22.

[42] The corollary holds true for ATMs. OMRs, however, are the focus of this section of the Response.

and represent a good investment.[43] In fact, corporations seek routinely to improve the market's perception of their earnings power by retiring shares, thereby improving the firm's much-watched earnings per share ratio through the corresponding reduction of its outstanding share count.[44] This benefit remains the most compelling reason for the corporation and its shareholders (including any shareholder-officers) to repurchase shares.[45] Corporations also engage in share repurchases (i) to minimize the dilutive effects of acquisitions or employee stock options, (ii) to distribute cash to shareholders in a tax-advantageous manner, (iii) to provide a measure of liquidity to minority investors, and (iv) to reduce the number of holders of record.[46] That insiders might enjoy the spoils of these corporate benefits by virtue of their equity holdings is best understood as a secondary consequence.[47]

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[43] *See, e.g.*, David R. Fried, *What to Look for in a Stock Repurchase Program*, AAII J., May 1998, at 21, 22 (suggesting that companies use stock repurchase programs to signal to stockholders that "the stock is too cheap due to temporary conditions").

[44] *See* STEVEN MARK LEVY, REGULATION OF SECURITIES: SEC ANSWER BOOK 11-41 (3d ed. Supp. 2011) ("When a company buys back its shares, fewer shares are left in circulation, causing the amount of earnings per share to rise and (it is hoped) boosting the share price."); Patti Domm, *Buybacks Boost Earnings, as Valuations Rise, Profits Lag*, CNBC.COM (Nov. 5, 2013, 12:47 PM), http://www.cnbc.com/id/101160650, *archived at* http://perma.cc/Z735-HTFP ("A smaller float means less stock to divide the company's net income by, resulting in higher earnings per share."). Of course, as the name implies, the earnings per share ratio is determined from dividing the firm's earnings by the number of shares outstanding. Less obvious is the fact that the corporate transaction by itself does nothing to affect the firm's actual results. Often, however, investors are more impressed by perception than reality. *See generally* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 77-78 (11th ed. 2014) (discussing the earnings per share ratio and its inputs).

[45] *See, e.g.*, Victoria Dickinson, Paul Kimmel & Terry Warfield, *The Accounting and Market Consequences of Accelerated Share Repurchases*, 17 REV. ACCT. STUD. 41, 42 (May 2010) (attributing the significant growth in accelerated share repurchases to the fact that "current accounting for these transactions . . . results in a more immediate . . . boost to reported earnings per share"); Jia Lynn Yang, *Companies Turning Again to Stock Buybacks to Reward Shareholders*, WASH. POST (Dec. 15, 2013), http://www.washingtonpost.com/business/economy/companies-turning-again-to-stock-buybacks-to-reward-shareholders/2013/12/15/58a2e99c-4aef-11e3-9890-a1e0997fb0c0_story.html, *archived at* http://perma.cc/WY4L-BSP9 ("When the number of shares outstanding falls, the value of each one goes up, instantly rewarding shareholders.").

[46] *See generally* Friedman, Deblinger & Mantel, *supra* note 29, at 2 (articulating the various reasons for share repurchases).

[47] One practitioner expounds on the myriad alternative reasons for corporations' stock repurchases:

> Corporations engage in stock repurchase programs for a variety of other legitimate reasons, including using the stock to meet the needs of employee benefit programs and the exercise of stock options; sending a message to the investment community that the stock is undervalued and a good investment; putting excess cash to use when there are no better investment alternatives; or reducing the cost of capital by substituting relatively cheaper debt for more expensive equity.

The Article's greatest flaw is that its discussion about the *regulation* of OMRs is far from complete. Further, the description of the applicable regulations as "minimal"[48] is incorrect. In presenting the appropriate considerations of a firm in connection with a share repurchase or secondary issuance, Professor Fried omits several key elements. In particular, the Article fails to articulate fully (i) the scope of the board deliberations predating such a transaction, (ii) the substantial and detailed restrictions about the time, place, and manner of share repurchases, and (iii) the full scope of disclosures before, during, and after these transactions. Absent a presentation of the broad panoply of checks and balances on the repurchasing corporation and its officers, the Article's readers are more likely to overestimate the likelihood that the indirect brand of insider trading occurs with any frequency.

First and foremost, the Article provides nary a mention of the internal governance and board deliberations and approvals that customarily accompany any corporate activity involving the firm's shares. Corporations, as a matter of course, seek the advice and counsel of expert advisers, including bankers, lawyers, and accountants, to ensure that the best interests of shareholders are considered and that the board's fiduciary duty is properly discharged in connection with any repurchase program.[49] Among the factors that boards consider is "the impact of the repurchase on the cash position of the company . . . and whether there is a better alternative use of the company's cash surplus."[50]

As a matter of regular practice, prior to approving any repurchase of firm shares, a responsible board would generally consider: (i) the relevant law of the firm's state of incorporation, (ii) the firm's organizational documents (including certificate of incorporation and bylaws), (iii) any existing agreements that limit the firm's ability to repurchase (or sell) its securities, (iv) any

LEVY, *supra* note 44, at 11-41; *see also* Peter Atkins, *Questions Surrounding Share Repurchases*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 14, 2013, 9:35 AM), http://blogs.law.harvard.edu/corpgov/2013/03/14/questions-surrounding-share-repurchases, *archived at* http://perma.cc/K54T-B7Y6 (naming "returning capital to shareholders in a more tax-efficient manner than declaring dividends" and "offsetting the dilutive effect of merger and acquisition activity and exercises of employee stock options" as additional motivations for companies repurchasing shares).

48 Fried, *supra* note 1, at 803.

49 *See* Atkins, *supra* note 47 ("The board should discuss and document the goal of the repurchase. By doing so, the board can demonstrate that it properly considered its shareholders' best interests and that it properly discharged its fiduciary duties.").

50 *Id.* Often, such considerations are required by the corporate laws in the firm's state of incorporation. *See, e.g.*, DEL. CODE ANN. tit. 8, § 160(a)(1) (West, Westlaw through 2010 legislation) (prohibiting a corporation from dealing in its own shares "when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation").

relevant stock exchange rules,[51] and (v) the tax and accounting treatment of the proposed transaction(s).[52] In addition, boards typically memorialize and document the nature and scope of their deliberations with care.[53]

Immediately following a board's decision to engage in a share repurchase program, the company's attention turns to the public disclosure of the plan prior to its commencement. As a general matter, a public announcement intends to insulate the firm from potential liability and to inform the public about (i) the estimated time period of the program, (ii) the maximum number of shares to be purchased, (iii) the plan's objective, and (iv) the manner in which the shares are expected to be purchased.[54]

Because repurchase programs can influence the value of the stock, there exists significant potential to run afoul of the antimanipulation provisions of the federal securities laws.[55] In particular, both Section 9(a) and Section 10(b) of the Exchange Act prohibit fraudulent and manipulative practices in connection with an issuer's purchase and sale of its securities.[56]

In an effort to avoid potential liability under the Exchange Act, companies regularly conduct the purchase and sale of their securities in accordance with the prophylactic Rule 10b-18, which provides a nonexclusive safe harbor against allegations of market manipulation when the market activities of the firm respect the time, manner, volume, and price conditions of the

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[51] In fairness, the Article does briefly consider NASDAQ Rule 5250(b)(1). *See* Fried, *supra* note 1, at 813 n.52.

[52] Atkins, *supra* note 47.

[53] *See generally supra* note 49 and accompanying text (highlighting how boards must document their deliberations to show that they have appropriately discharged their fiduciary duties).

[54] Atkins, *supra* note 47. This disclosure is typically achieved through a press release, or on Form 10-Q, Form 10-K, or Form 8-K. *Id.* Also, that a firm does commit to actually buying shares may be fueled less by a desire to manipulate purchases than a need to retain the flexibility to manage its fiduciary obligations to shareholders.

[55] LEVY, *supra* note 44, at 11-41.

[56] In pertinent part, Section 9(a)(2) makes it unlawful for any person

> [t]o effect, alone or with 1 or more other persons, a series of transactions in any security registered on a national securities exchange . . . creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

15 U.S.C. § 78i(a)(2) (2012).

And Section 10(b) makes it unlawful for any person

> [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. § 78j(b).

Rule.[57] The Article's analysis fails to account for the full effect of this Rule's application on the activities of firms and their insiders. In fact, companies expend significant time and resources to ensure that transactions in firm shares fall within the Rule's safe harbor, often entering "into an arrangement with a broker or dealer that agrees to implement the repurchase program according to the companies' instructions and in accordance with the requirements of Rule 10b-18."[58] Moreover, because the Rule aggregates firm purchases with those of affiliated purchasers, it invites additional corporate scrutiny of the personal purchases and sales of insiders.[59] Again, the Article simply fails to recognize this reality.

In 2000, the SEC was concerned about disparate rulings regarding the appropriate standard for a Rule 10b-5 violation[60] and adopted Rule 10b5-1 to facilitate lawful trading by corporate insiders.[61] The Rule provided that "knowing possession" of inside information rather than actual "use" of the information was grounds for an insider trading violation.[62] At the same time, Rule 10b5-1 provided two separate affirmative defenses against liability for an insider buying or selling securities. The first defense applies both to individuals and entities buying or selling securities, and requires that the person asserting the defense prove the following three factors:

> (A) Before becoming aware of the inside information, the person had
>
> (1) Entered into a binding contract to purchase or sell the security,
>
> (2) Instructed another to purchase or sell the security for the instructing person's account, or
>
> (3) Adopted a written plan for trading the securities;
>
> (B) The [relevant] contract, instruction, or plan . . .
>
> (1) Specified the [securities' amount, price, and date];

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[57] Atkins, *supra* note 47.

[58] *Id.*

[59] *See id*. ("It is . . . in a company's best interest to be aware of its affiliated purchasers' activities. . . . Even if a repurchase is made in accordance with Rule 10b-18, a company is not protected against other types of violations of the Exchange Act, such as [direct insider trading] violations . . . .").

[60] *See generally* Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913, 914-915 (2007) (identifying Rule 10b5-1 as one of three rules the SEC adopted in 2000 "to address issues that arise in connection with the potential misuse of material nonpublic information in transactions in the stock of public companies").

[61] 17 C.F.R. § 240.10b5-1 (2014); *see id.* § 240.10b5-a(c) (listing affirmative defenses insiders can potentially use to avoid liability for insider trading).

[62] *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000) (explaining how Rule 10b5-1 deals with "the issue of when insider trading arises in connection with a trader's 'use' or 'knowing possession' of material nonpublic information" by making an insider liable when he "purchases or sells *while aware* of the information" (emphasis added)).

(2) Included a written formula or algorithm for determining the [securities' amount, price, and date]; or

(3) Did not permit . . . subsequent influence over how, when, or whether to effect purchases or sales . . . ; and

(C) The purchase or sale that occurred was pursuant to the contract, instruction, or plan.[63]

Rule 10b5-1's second affirmative defense is available only to entities that buy or sell securities, and provides that an entity may establish that its transaction is not "on the basis of" material nonpublic information if

(1) The individual making the investment decision [for the entity] was not aware of the information; and

(2) The [entity] had implemented reasonable policies and procedures . . . to ensure that individuals making investment decisions would not violate [insider trading] laws.[64]

Since Rule 10b5-1's passage, the Rule has generally been lauded "for providing a workable mechanism for insiders to diversify their portfolios without running afoul of the prohibition on trading on the basis of material nonpublic information."[65] Although corporations routinely manage transactions in firm shares to avail themselves of the Rule's affirmative defenses, the Article makes no mention of Rule 10b5-1 plans.

In large measure, Sections 9(a) and 10(b) of the Exchange Act and Rules 10b-18 and 10b5-1 are familiar ground for those firms and insiders dealing in company shares, as they represent a large portion of the legal landscape that must be responsibly and carefully navigated. And, although their requirements might seem daunting, together they garner little mention in *Insider Trading via the Corporation*. Moreover, virtually no attention is paid to the significant expense of time, energy, and monies routinely borne by responsible firms and their insiders endeavoring to purchase and sell firm shares properly.[66] Against such a backdrop, the Article's proposed two-day disclosure rule for firms seems of little consequence.

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[63] 17 C.F.R. § 240.10b5-1(c)(1); *see also* LEVY, *supra* note 44, at 11-23 (summarizing the requirements of the first affirmative defense).

[64] 17 C.F.R. § 240.10b5-1(c)(2); *see also* LEVY, *supra* note 44, at 11-24 (summarizing the requirements of the second affirmative defense).

[65] Horwich, *supra* note 60, at 914-915.

[66] The Article's omissions grow more significant when one considers that the Article does not address accelerated share repurchase programs, Regulation M, and the self-tender rules—all of which are beyond the scope of this Response.

CONCLUSION

In the end, Professor Fried's *Insider Trading via the Corporation* is tilting at windmills,[67] seeking to solve a problem that is far from apparent. Along the way, the Article glosses over the panoply of regulation and best practices that typically provide checks on a firm's purchase or sale of its own shares. Moreover, the Article is the product of an equally unfortunate and unwarranted skepticism concerning the nature of the corporation and its gatekeepers. While the Article does succeed in calling attention to an issue worthy of further monitoring, one only hopes that any ongoing reform efforts will carefully consider the more complete context and begin with a less jaded view of human nature.

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[67] For an exegesis of the phrase "tilting at windmills," see *Tilting at Windmills*, THE PHRASE FINDER, http://www.phrases.org.uk/meanings/tilting-at-windmills.html (last visited Sept. 10, 2014), *archived at* http://perma.cc/3FZD-8AXS.