10B5-1 PLANS: FURTHER OBSCURING THE "SMOKING GUN" AND PROPOSALS FOR CHANGE

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In recognition of insiders' legitimate need to transact in their company's stock from time to time, the SEC promulgated Rule 10b5-1 in 2000. Under the rule, an insider may point to participation in a plan whereby stock purchase prices, dates, and volumes are determined in advance to rebut a charge of insider trading. In the years since the creation of these 10b5-1 plans, however, it has become clear that insiders may be exploiting loopholes in the system to engage in increased levels of insider trading. This Article details the development of 10b5-1 plans, explains the ambiguities leading to abuse of the plans, and recommends proposals for change.

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INTRODUCTION

Prior to 2000, the state of the law regarding the scienter requirement for insider trading was unsettled. With the promulgation of Rule 10b5-1, however, the SEC clarified that knowing possession of material, nonpublic information accompanied by a trade satisfied the scienter component of a Rule 10b-5 violation.[1] In its Adopting Release for Rule 10b5-1, the SEC also provided for an affirmative defense whereby insiders could enter into a transaction agreement with a broker prior to coming into possession of material, nonpublic information.[2] The 10b5-1 plan was intended to rebut an allegation of insider trading if trades were executed within the plan and in compliance with several factors outlined by the SEC.[3] In creating the affirmative defense, the SEC acknowledged that insiders are often in possession of material, nonpublic information but often have a need to transact in their companies' securities for legitimate reasons, including liquidity and diversification.[4]

Over a decade after the birth of Rule 10b5-1 and the affirmative defense, it is increasingly apparent that 10b5-1 plans are doing little to avert insider trading. In fact, both academic research and a number of high-profile cases support the proposition that executives commonly are manipulating the plans to provide cover for illegal trading activity.[5] A

1. *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716 (Aug. 24, 2000).
2. *Id*. at 51,726-29.
3. *Id*.
4. *See, e.g*., Linda Chatman Thomsen, Dir., SEC Div. of Enforcement, Speech by SEC Staff: Opening Remarks Before the 15th Annual NASPP Conference (Oct. 10, 2007), http://www.sec.gov/news/speech/2007/spch101007lct.htm#9 ("The idea was to give executives opportunities to diversify or become more liquid through the use of plans with prearranged trades without facing the prospect of an insider trading investigation.").
5. *See, e.g*., part III, *infra* pp. 955-962 (discussing ways in which the plans have been

watershed moment in the history of 10b5-1 plans occurred in November 2012, when the *Wall Street Journal* published an exposé highlighting a number of instances in which executives fortuitously avoided significant losses by selling company stock in advance of negative news events.[6] In each case, transactions occurred ostensibly within the bounds of a 10b5-1 plan. In response, the SEC appears to be interested in amending the Rule and institutional investors have begun calling for changes. While the ultimate form the plans will take is uncertain, it is clear that modification is necessary for the plans to fulfill their intended purpose.

I. BACKGROUND

Prior to exploring (1) the requirements of the 10b5-1 affirmative defense, (2) the loopholes that executives are abusing, and (3) proposed changes to the plans, it is necessary to discuss the background of Rule 10b-5 and the common law development of the scienter requirement for insider trading.

A. *The Common Law Split On Insider Trading*

Prior to the enactment of the Securities and Exchange Act of 1934 ("'34 Act") and the promulgation of Rule 10b-5, two distinct schools of thought regarding classical insider trading developed.[7] Both viewpoints

manipulated).

6. Susan Pulliam & Rob Barry, *Dark Markets: Executives' Good Luck in Trading Own Stock*, WALL ST. J., Nov. 28, 2012, at A1 [hereinafter Pulliam & Barry, *Executives' Good Luck*].

7. The following discussion regarding the two distinct schools of thought is in reference to classically conceived insider trading, where a corporate director or officer engages in trades involving his or her own company's stock. Classically conceived insider trading has been described as "liability [that] occurs when a person, who stands in a fiduciary relationship with a market participant trades shares with this participant while in possession of material, non-public information." Marcy G. Dworkin, *The Misappropriation Theory As A Corollary to the Classic Insider Trading Theory*, 1996 ANN. SURV. AM. L. 315, 318 (1996) (internal footnotes omitted).

That description, as we will see, was up for debate under common law standards. Classically conceived insider trading stands in contrast to the misappropriation theory of insider trading, which commonly involves a party who is not a corporate officer or director, but is someone who comes into possession of material nonpublic information and uses it to his or her advantage. Under the misappropriation theory of insider trading, a fiduciary duty does not exist between the insider and the party who trades. *Misappropriation Theory of Insider Trading*, 111 HARV. L. REV. 410, 410 (1997). Rather, it focuses on the duty owed by the insider to the source of the misappropriated information. *Id.* The misappropriation theory of insider trading was first endorsed by the Supreme Court in *United States v. O'Hagan*, 521 U.S. 642 (1997).

turned on whether a fiduciary duty extends from corporate insiders to stockholders in their individual capacity.[8] If it does, then insiders had a duty to disclose material facts prior to engaging in trades with that individual; if not, then no such obligation existed. Under the affirmative view, the proposition flowed naturally from the principle that directors were obligated to pursue profit through the corporation.[9] Given the inseparability of corporate profit and stock price, director fiduciary duties must attach to both.[10] Under the negative view, buying and selling of corporate stock involved stockholders in their individual capacity (separate and apart from the corporate form), and directors owed no special duties in this regard.[11]

Although scholars have described the pro-finding of fiduciary duty between corporate insiders and individual stockholders as the minority view,[12] it nonetheless appeared to have garnered the support of significant numbers of courts.[13] The Supreme Court of Georgia aptly articulated the position in the 1903 case of *Oliver v. Oliver*,[14] when it argued that:

> [T]he fact that [a director] is trustee for all is not to be perverted into holding that he is under no obligation to each [stockholder]. The fact that he must serve the company does not warrant him in becoming the active and successful opponent of an individual stockholder with reference to the latter's undivided interest in the very property committed to the director's care.[15]

According to the court, neglecting to find a fiduciary relationship extending

8. *See* Clarence D. Laylin, *The Duty of a Director Purchasing Shares of Stock*, 27 YALE L.J. 731, 739 (1918) ("The assumption seems correct that some such fiduciary relation must be established . . . . Without it, there would be no more foundation for the duty to disclose unsolicited information to a stockholder than there would be for such a duty on the part of a director selling his own shares to an outsider.").

9. *Id*. at 738.

10. *Id*.

11. *Id*. at 734.

12. Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1302 (1998).

13. *See e.g*., Beck v. Fishel, 36 Ohio C.C. 616, 622 (Ohio Ct. App. June 7, 1909) ("Ordinarily the officer of a corporation is bound to account to his stockholders for the avails of any sale made by him, as any other trustee is bound to account to his beneficiary for the avails of sales made by him"); Stewart v. Harris, 77 P. 277, 279-80 (Kan. 1904) ("Since the stockholders own these shares, and since the value thereof . . . are affected by the conduct of the directors, a trust relation plainly exists between the stockholders and the directors . . . . From it arise the fiduciary duties of the directors towards the stockholders"); McManus v. Durant, 168 A.D. 643, 663-64 (N.Y. App. Div. 1915) ("This devolution of unlimited power imposes on a single holder of the majority of the stock a correlative duty, the duty of a fiduciary or agent, to the holders of the minority of the stock . . . .").

14. 45 S.E. 232 (Ga. 1903).

15. *Id*. at 233.

to individual stockholders that would proscribe insider trading was downright paradoxical: It would "inevitably lead[ ] to the conclusion that, while a director is bound to serve stockholders en masse, he may antagonize them one by one; that he is an officer of the company, but may be the foe of each private in the ranks."[16]

In contrast with *Oliver*, the so-called majority view of insider trading under common law did not think corporate insiders owed a duty to individual stockholders to disclose material information about the company prior to engaging in trades with them. Indeed, as one scholar described it in a 1919 article, if an individual seller knows that the buyer, by virtue of his position, may know more about the value than the seller, then "there is nothing morally or legally wrong, according to present-day standards, in laying upon [the seller] the burden of making inquiry of the buyer, and in declaring that he assumes the risk involved in [the buyer's] own silence."[17]

One of the earliest cases to hold that corporate fiduciary duties do not extend to situations involving insider trading is *Carpenter v. Danforth*.[18] In *Carpenter*, defendant Danforth, a director of The National Bank Note Company, purchased 136 shares of his corporation's stock from plaintiff for $60 per share, or $10 per share above par.[19] Danforth's motive, both for purchasing the stock and for paying a premium, appears to have been gaining control of the corporation at a point when it was poised to take advantage of lucrative government contracts.[20] The work did indeed come through as hoped, and Danforth profited handsomely by receiving the corporation's first-ever dividend[21] of 310 percent within five months of his stock purchase, as well as another 200 percent dividend eight months thereafter.[22]

In spite of the air of bad faith surrounding the transaction, which was further supported by the fact that Danforth purchased the stock from the

16. *Id.* at 235.

17. Laylin, *supra* note 8, at 739-40.

18. 52 Barb. 581 (N.Y. Sup. Ct. 1868).

19. *Id.* at 582.

20. *Id.* at 588. The lucrative contracts, described as "work done for the government on the postage currency," *id.*, were possibly related to the ongoing monetary crisis arising from the Civil War. The U.S. Government, facing difficulties in paying for the war, issued new bonds, notes, and currency, financial instruments that revolutionized the U.S. monetary system. *Dancing the "Legal Tender Polka": Public Reaction to Changes in Government Securities during the Civil War*, BUREAU OF ENGRAVING AND PRINTING, U.S. DEP'T OF THE TREASURY, *available at* http://www.moneyfactory.gov/wdclincolnexhibit3.html. The issuance of these new securities preceded the signing of the Legal Tender Act by President Abraham Lincoln on February 25, 1862, and the signing of the Fractional Currency Act later that year. *Id.*

21. *Carpenter*, 52 Barb. at 590.

22. Dawson v. Nat'l Life Ins. Co. of United States, 157 N.W. 929, 933 (Iowa 1916).

executor of a family friend's estate "under the guise of friendship,"[23] the court stated that any duties Danforth owed to plaintiff did not extend to the stock itself.[24] The court noted that although there was a trust relationship between Danforth and the plaintiff, the relationship "extended only to the management of the general affairs of the corporation, with a view to dividends of profits; and . . . [it] extended no farther."[25] Therefore, the court held, Danforth owed the plaintiff nothing more than the duty not to engage in actual fraud.[26] In the absence of fraudulent misrepresentation or concealment of a material fact, Danforth was not liable to the plaintiff.[27]

Many courts continued to hew to the majority view regarding insider trading for at least the next fifty years.[28] In the 1933 case of *Goodwin v. Agassiz*,[29] plaintiffs sold several hundred shares of Cliff Mining Company on the Boston Stock Exchange after reading in a newspaper that the company was ceasing exploratory operations for copper land it owned in Northern Michigan.[30] Defendants, who served as executives of the company, believed, based on a geologist's theory (unbeknownst to plaintiffs), that valuable copper deposits did exist in the area—failed exploratory operations notwithstanding. Defendants consequently purchased plaintiff's stock in a blind transaction and, after the geologist's theory came to light, plaintiffs sued.[31] The Massachusetts Supreme Court, in affirming the trial court's decision, held that while the executives did owe fiduciary duties to stockholders, they had no duty regarding disclosure when buying and selling in an impersonal market.[32]

Though the majority view might seem to have produced some unpalatable results, courts mitigated its harshness in two ways: liability still attached to insiders who engaged in fraud, and the courts sometimes recognized the existence of a duty to disclose if the insider was in

23. *Id*.
24. *Carpenter*, 52 Barb. at 584.
25. *Id*.
26. *Id*. at 586-87.
27. *Id*. at 587.
28. *See, e.g.*, The Board of Comm'rs of Tippecanoe Co. v. Reynolds, 44 Ind. 509, 524 (1873) (railroad company president not required to disclose that the stock he was purchasing from a stockholder was significantly undervalued where his acts were found not to relate to the "property or to the business of the corporation"); Crowell v. Jackson, 23 A. 426, 427 (N.J. 1891) (stating that "[a] director or the treasurer of a corporation is not, because of his office, in duty bound to disclose to an individual stockholder, before purchasing his stock, that which he may know as to the real condition of the corporation affecting the value of that stock.").
29. 186 N.E. 659 (Mass. 1933).
30. *Id*. at 659-60.
31. *Id*. at 660.
32. *Id*. at 661.

possession of "special facts." In the context of securities trading, common law fraud includes: (1) "misrepresentation made for the purpose of inducing reliance upon [a] false statement,"[33] as well as (2) fraudulent concealment of a material fact.[34] Thus, the Supreme Court of New Jersey found in *Judson v. Peoples Bank & Trust Co*.[35] that defendants were liable for devising a fraudulent plan between a bank and a company president to engage in a leveraged buy-out without disclosing material facts to the selling shareholder.[36]

There was also an exception to the common law rule in the case of "special facts." The Supreme Court recognized the special facts doctrine in *Strong v. Repide*.[37] In *Strong*, the plaintiff's broker had sold eight hundred shares of the Philippine Sugar Estates Development Company to a broker acting on behalf of defendant.[38] Plaintiff's agent was unaware of defendant's identity (and indeed, defendant's broker was likewise unaware, because he had been employed by an acquaintance of the defendant and not by the defendant directly).[39] The defendant, who owned three-fourths of the company's stock and who served as director, also knew the value of the shares would multiply shortly thereafter, on account of an impending sale of the company's land to the U.S. Government for an attractive premium.[40] The Supreme Court, in finding the defendant liable, held that a director in possession of "special facts" regarding the value of the stock was under a duty to disclose those facts to the shareholder prior to trading the stock.[41] Liability attached to the defendant, therefore, not "simply [because of] his character as a director, but because, in consideration of all the existing circumstances . . . it became the duty of the defendant, acting in good faith, to state the facts before making the purchase."[42]

B. Rule 10b-5 is Promulgated to Unify Securities Trading Laws

As the forgoing discussion illustrates, the state of the law regarding liability for classical insider trading prior to the Great Depression was

33. Chiarella v. United States, 445 U.S. 222, 227-28 (1980); *see also* Carpenter v. Danforth, 52 Barb. 581, 587 (N.Y. Sup. Ct. 1868) (defining fraud as a misrepresentation of a material fact between a buyer and a seller).
34. *Carpenter*, 52 Barb. at 587.
35. 134 A.2d 761 (N.J. 1957).
36. *Id*. at 772.
37. 213 U.S. 419 (1909).
38. *Id*. at 425.
39. *Id*.
40. *Id*. at 424-25.
41. *Id*. at 431.
42. *Id*.

incongruous at best. It seems unsurprising, therefore, that a number of "flagrant abuse[s] of inside information" were discovered in hearings preceding the enactment of the Securities Act of 1933 ("'33 Act") and the '34 Act.[43] In an attempt to more uniformly regulate securities markets in general, Congress, therefore, enacted the '33 and '34 Acts.[44] In passing the '34 Act, Congress did not attempt to enumerate an exhaustive list of acts that would amount to securities law violations; rather, it sought to draft a "catch-all" provision "intended to cover the full range of fraudulent conduct that human ingenuity might devise."[45]

Specifically, Section 10(b) provides that it is:

> [U]nlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance . . . ."[46]

To implement Section 10(b), the SEC promulgated Rule 10b-5, which makes it unlawful to (a) defraud third parties, (b) make false statements of material fact or fail to provide material information in order to correct misleading statements, or (c) engage in any course of action that is, or would constitute, fraud or deceit respecting the purchase or sale of any security.[47]

Courts have construed insider trading to be an instance of fraudulent conduct that falls within the broad ambit of Rule 10b-5.[48] Though "insider

43. Freeman v. Decio, 584 F.2d 186, 190 (7th Cir. 1978).

44. Eric C. Chaffee, *Standing Under Section 10(b) and Rule 10b-5: The Continued Validity of the Forced Seller Exception to the Purchaser-Seller Requirement*, 11 U. PA. J. BUS. L. 843, 851 (2009).

45. United States v. Lang, 766 F. Supp. 389, 400 (D. Md. 1991) (internal citation omitted); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (noting that Section 10(b) "was described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices'") (internal citation omitted). *But see* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 430 (1990) (explaining that the '34 Act as a whole was passed for the protection of investors, while Section 10(b) specifically sought to make certain activities illegal that had been closely associated with speculative trading).

46. 15 U.S.C. § 78j (2012).

47. 17 C.F.R. § 240.10b–5 (2012).

48. Note, however, that rule 10b-5 is not the only securities law that prohibits insider trading. Section 16(b) of the '34 Act requires an insider to disgorge gains from a purchase followed by sale (or the reverse, a sale followed by purchase) within a six-month period, inferring insider trading from the mere existence of such paired transactions. Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2089-90, 2126 (1994). Additionally, Rule 14a-9 is designed to prohibit insider abuse with regard to proxy materials, Rule 13e-3(b) regulates

trading" is not specifically defined in federal securities laws, it is widely understood to mean securities trading based on, or while in possession of, material, nonpublic information.[49] *In re Cady, Roberts & Co*. was one of the first cases to take this position when it imposed liability on a broker who sold a corporation's stock on behalf of clients upon receiving advance word that the corporation was cutting its quarterly dividend.[50] The broker, Gintel, had learned of the dividend cut after one of his fellow employees, who also happened to be on the board of the corporation cutting the dividend, telephoned Gintel with the news promptly upon the board's decision, nearly an hour before it went public.[51]

The rationale for imposing liability in these situations is that to allow an insider to take advantage of material nonpublic information is to allow fraud upon the public. In other words, insider trading is but one of the "infinite variety of devices by which undue advantage may be taken of investors and others."[52] SEC Commissioner William Cary noted in *Cady, Roberts* that the insider may avoid committing this particular variety of fraud by disclosing the pertinent information prior to trading or, if releasing the information first were not practicable, by abstaining from the transaction altogether.[53]

Cady, Roberts did not attempt to define the term "insider." However, it did note that the class extended beyond just executives of the company. After remarking that the duty not to engage in insider trading traditionally applied to "officers, directors and controlling stockholders," Commissioner Cary explained that the list was not exhaustive, but that the class could best be demarcated by looking at: (1) the existence of a relationship giving an individual access to material, nonpublic information by virtue of his

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insider trading in going-private transactions, and Regulation M-A, Item 1011(b) controls in mergers and acquisitions. Dale A. Oesterle, *The Overused and Under-Defined Notion of "Material" in Securities Law*, 14 U. PA. J. BUS. L. 167, 170 (2011). Section 17(a) of the '33 Act and 15(c)(1) of the '34 Act also provide avenues of policing insider trading. *Freeman*, 584 F.2d 186, 190 (7th Cir. 1978). Finally, the Second Circuit has held that the SEC had the authority to pursue a party for insider trading liability under Rule 14e-3 in the tender offer context, despite the lack of a fiduciary duty as classically conceived in *Chiarella*. William J. Cook, *From Insider Trading to Unfair Trading: Chestman II and Rule 14e-3*, 22 STETSON L. REV. 171, 174 (1992).

49. David M. Brodsky & Daniel J. Kramer, *A Critique of the Misappropriation Theory of Insider Trading*, 20 CARDOZO L. REV. 41, 41-42 (1998).

50. *In re* Cady, Roberts & Co., Exchange Act Release No. 34-6668, 40 S.E.C. 907, 911 (Nov. 8, 1961).

51. *Id*. at 909.

52. *Id*. at 911.

53. *See id*. ("[F]ailure to make disclosure [when in possession of material, nonpublic information] constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.").

position; and (2) the "inherent unfairness" problems implicated in allowing someone to "take[] advantage of such information knowing it is unavailable to those with whom he is dealing."[54] Gintel, though he was not an officer or director, was nevertheless an "insider" because he had a relationship giving him access to the information. Subsequent courts have grappled with how far to extend liability for insider trading[55] and have even gone so far as to extend liability to tippers and tippees.[56]

C. Courts Imply a Private Right of Action Under Rule 10b-5

While the SEC, in promulgating Rule 10b-5, declined to specify the remedies available upon breach,[57] courts have implied a private right of action under the Rule.[58] The first court to do so was the Eastern District of Pennsylvania in *Kardon v. National Gypsum Co*.[59] In deliberating whether defendants had fraudulently induced the plaintiffs to sell their stock in two corporations, as a first-order matter the court found that the plaintiffs could properly maintain a suit under Rule 10b-5. The court noted that "[i]t is . . . true that there is no provision in Sec. 10 [of the '34 Act] or elsewhere expressly allowing civil suits by persons injured as a result of violation of Sec. 10 or of the Rule," but reasoned that violating a statute either by acting or by failing to act could amount to an actionable tort "'if . . . (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual . . . and (b) the interest invaded is one which the enactment is intended to protect.'"[60]

Since *Kardon*, courts have refined the elements required to sustain a private right of action.[61] A prima facie showing of a Rule 10b-5 violation

54. *Id*. at 912.

55. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 235 (1980) (holding that mere possession of nonpublic market information does not cause a duty to disclose).

56. *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 654 (1983) (finding that a tippee has a duty to abstain from trading on material, nonpublic information if the tipper has breached his fiduciary duty by disclosing the information to the tippee and the tippee knows or should know of that breach). This type of liability has been referred to as "outsider trading." *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 198 (1991) (explaining that "[t]rading of this type is frequently described as 'outsider trading,' so denominated because the traders are outsiders with respect to the issuer of the securities they trade").

57. *See* Exchange Act Release No. 34-3230, 1942 WL 34443 (May 21, 1942) (explaining that securities fraud is a prohibited but failing to lay out any remedies).

58. *See, e.g.*, Deckert v. Independence Shares Corp., 311 U.S. 282, 288 (1940) (stating that "[t]he power to *enforce* implies the power to make effective the right of recovery afforded by the ['33 Act]").

59. 69 F. Supp. 512, 514 (E.D. Pa. 1946).

60. *Id*. at 513 (quoting RESTATEMENT (SECOND) OF TORTS § 286).

61. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730-31 (1975)

in the case of an individual requires six elements: "(1) a material misrepresentation or omission, (2) scienter (a wrongful state of mind), (3) a connection between the misrepresentation or omission and the purchase or sale of a security, (4) reliance upon the misrepresentation or omission, (5) economic loss, and (6) loss causation."[62]

The second component of a private cause of action, scienter, was first recognized by the Supreme Court in *Ernst & Ernst v. Hochfelder*[63] in 1976. Plaintiffs, who were customers of First Securities Company of Chicago, a securities brokerage firm, were induced to invest in a fraudulent investment scheme carried out by the company's president and majority shareholder.[64] After the president confessed the scheme in a suicide note, the plaintiffs sued First Securities' long-time auditing firm, Ernst & Ernst, on the theory that the auditors had "aided and abetted" the president's violations of Rule 10b-5 by failing to properly audit the company.[65] The plaintiffs' theory then amounted to a claim of negligent nonfeasance.[66] In reversing the Seventh Circuit and resolving a circuit split on the issue,[67] the Supreme Court held that a private cause of action for damages may not be maintained without any claim of "'scienter' — *intent* to deceive, manipulate, or defraud."[68]

The SEC, in contrast with a private plaintiff, generally needs only to prove four elements to establish liability for a Rule 10b-5 violation: "(1) a

(affirming a Second Circuit decision limiting private rights of action to plaintiffs who are actual purchasers or sellers of securities).

62. Stanley Veliotis, *Rule 10b5-1 Trading Plans and Insiders' Incentive to Misrepresent*, 47 AM. BUS. L.J. 313, 316 (2010).

63. 425 U.S. 185 (1976).

64. *Id*. at 189.

65. *Id*. at 189-90.

66. *Id*. at 190.

67. Prior to *Ernst & Ernst*, the courts of appeals had split on whether negligence was sufficient for liability to attach in a securities violation case. Several courts of appeals held that some form of negligence was sufficient. *See, e.g*., White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974) (discussing courts that held negligence was sufficient); Myzel v. Fields, 386 F.2d 718, 746-48 (8th Cir. 1967) (expanding the concept of fraud to include innocent nondislcosures); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963) (holding that intent to mislead is not required). Other courts, however, had held that something more than negligence must be proved to find a defendant liable. *See, e.g*., Clegg v. Conk, 507 F.2d 1351, 1361-1362 (10th Cir. 1974) (requiring more than simple negligence); Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2nd Cir. 1973) (finding that reckless or willful or reckless disregard for the truth is required). The Supreme Court pointed out in *Ernst & Ernst* that, in a few cases, the appeals courts have held that negligence was sufficient for liability, but have paradoxically gone on to find the defendants not liable despite their actions being negligent. *Ernst & Ernst*, 425 U.S. at 193 n.12 (citing Smallwood v. Pearl Brewing Co., 489 F.2d 579, 606 (5th Cir. 1974); Kohn v. Am. Metal Climax, Inc., 458 F.2d 255, 286 (3d Cir. 1972)).

68. *Ernst & Ernst*, 425 U.S. at 193 (emphasis added).

material misrepresentation, (2) in connection with the purchase or sale of a security, (3) scienter, and (4) use of the jurisdictional means."[69] This means that the Commission does not need to show the fifth and sixth elements of a private right of action under Rule 10b-5, economic loss and loss causation.[70] Also in contrast with private plaintiffs, the Department of Justice (at the behest of the SEC)[71] may bring a criminal enforcement action against a party for Rule 10b-5 violations.[72] A criminal enforcement proceeding requires an additional showing of "willfulness" for liability to attach.[73]

D. *The Split of Authorities Surrounding the Scienter Requirement for Insider Trading*

While the Supreme Court's decision in *Ernst & Ernst* purported to resolve one circuit split, it inadvertently furthered another — one that ultimately resulted in the SEC's promulgation of Rule 10b5-1. The requirement that a party have acted with the requisite state of mind seemed clear enough; however, applying that element became much less clear in practice. To what notion should the party's scienter attach? Must he knowingly *possess* material, nonpublic information, or must he knowingly *base his decision to trade* (or to refrain from trading) on that information?[74] In the first instance, an allegation of insider trading becomes much more of a strict liability type of claim[75] while the later poses a much higher burden on the plaintiff.[76]

69. Geman v. SEC, 334 F.3d 1183, 1192 (10th Cir. 2003) (internal citation omitted); M. P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1608 (2007).

70. *See id.* at 1608 n.51 (explaining that, unlike a private cause of action, the SEC does not need to show reliance or loss causation).

71. *See* Linda Chatman Thomsen, *International Institute for Securities Market Development: An Overview of Enforcement*, SEC. AND EXCH. COMM'N 1 (2005), http://www.sec.gov/about/offices/oia/oia_enforce/overviewenfor.pdf (explaining that criminal enforcement actions are done through the DOJ and U.S. Attorney's offices and that the SEC assists in these efforts by providing access to its investigative files and assigning staff to assist in the prosecutions).

72. Griffin Finan et al., *Securities Fraud*, 48 AM. CRIM. L. REV. 1129, 1132 (2011).

73. *Id.*

74. *See* Karen Schoen, *Insider Trading: The "Possession Versus Use" Debate*, 148 U. PA. L. REV. 239, 249-52 (1999) (discussing the differences between these two standards).

75. *See* United States v. Smith, 155 F.3d 1051, 1068 n.25 (9th Cir. 1998) ("[A] knowing-possession standard would, we think, go a long way toward making insider trading a strict liability crime.").

76. *See* SEC v. Adler, 137 F.3d 1325, 1337 (11th Cir. 1998) ("The strongest argument that has been articulated in support of the knowing possession test is that a strict use test would pose serious difficulties of proof for the SEC.").

The SEC, for its part, has been in favor of the strict liability approach, advocating for knowing possession to be sufficient to prove scienter, since at least 1978.[77] In a hearing before a House Subcommittee relating to the Insider Trading Sanctions Act of 1984, for example, the SEC General Counsel at the time, Daniel Goelzer, indicated that the Commission's "consistent position has been that possession of material inside information is the test," while also noting that in adjudicative decisions, the Commission had not always prevailed on that ground.[78] In a later address, Goelzer affirmed the Commission's commitment to the knowing possession test to determine liability for insider trading over the "more stringent" use test but admitted that, in situations "where the trader has a 'plausible argument that complicates proof', the SEC will be 'cautious' about bringing the case."[79]

Courts have not always agreed with the SEC, although some earlier cases lend support for the Commission's view. In *SEC v. Texas Gulf Sulphur Co.*,[80] the Second Circuit expounded upon the idea, first advocated in *Cady, Roberts*, that an insider in possession of material, nonpublic information must either disclose the information prior to trading or abstain altogether (known as "disclose or abstain").[81] As the en banc court stated:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[82]

This language seems to suggest the presence of only two options and, as a corollary, the absence of a middle ground for possession of material, nonpublic information *and* trading without basing the decision to act on the insider information. However, the court points out that the rationale for Rule 10b-5 is to prevent:

77. *Id.* at 1336 n.28. *But see* Schoen, *supra* note 74, at 254 ("Despite the assertion by SEC Enforcement Director William R. McLucas that the Commission has always advocated 'knowing possession' as the appropriate rule for insider trading liability, the SEC has been inconsistent in its interpretation of the rule.").

78. *Insider Trading Sanctions and SEC Enforcement Legislation: Hearing on H.R. 559 Before the Subcomm. on Telecomms., Consumer Prot., and Fin. of the H. Comm. on Energy and Commerce*, 98th Cong. 48-49 (1983) (statement of Daniel Goelzer, SEC General Counsel).

79. *Adler*, 137 F.3d at 1336 n.28 (quoting 15 Sec. Reg. & L. Rep. (BNA) 1820, 1821 (1983)).

80. 401 F.2d 833 (1968).

81. *Texas Gulf Sulphur*, 401 F.2d at 848.

82. *Id.*

> [A]nyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" . . . [from] *tak[ing]* "*advantage of such information* knowing it is unavailable to those with whom he is dealing[.]"[83]

By this view, the actual harm stems from the taking advantage of insider information, rather than mere possession coincident with a trade.

In the midst of the development of the possession-versus-use debate, Congress took action in a manner that could be interpreted as attempting to resolve the dispute. In response to a perceived rise in the incidence of insider trading as a result of mergers and tender offers, as well as the growth in options markets,[84] Congress amended the '34 Act through enactment of the Insider Trading Sanctions Act of 1984 ("ITSA"). The ITSA afforded the SEC authority to pursue treble damages in a civil case for securities fraud. In other words, the parties who were alleged to have engaged in violations of the federal securities laws "by purchasing or selling a security . . . while in possession of material, nonpublic information" could be subject to a penalty of up to thrice the gains garnered or losses avoided.[85] Despite the fact that Congress used the language "in possession" in the ITSA, the legislative history of the Act belies the claim that Congress intended to alter the common law definition of insider trading, which generally required the decision to engage in or abstain from *trading* to be based on the material, nonpublic information.[86]

The Second Circuit again entered the possession-versus-use fray years after *Texas Gulf Sulphur*, in its 1993 opinion, *United States v. Teicher*.[87] In *Teicher*, the Second Circuit agreed with the SEC that no connection need be shown between the inside information and use thereof; possession is enough.[88] The Second Circuit remarked, albeit in dicta, that:

> [A]s the government points out, both § 10(b) and Rule 10b-5

83. *Id.* (quoting *In re* Cady, Roberts & Co., Exchange Act Release No. 34-6668, 40 S.E.C. 907, 912 (Nov. 8, 1961) (emphasis added)).

84. *Insider Trading Sanctions and SEC Enforcement Legislation: Hearing on H.R. 559 Before the Subcomm. on Telecomms., Consumer Prot., and Fin. of the H. Comm. on Energy and Commerce*, 98th Cong. 48-49 (1983).

85. 15 U.S.C. §§ 78u-1(a)(1)-(2) (2012).

86. *See* H.R. REP. NO. 98-355, at 1 (1983) (stating that the purpose of the amendment is to enable the SEC to recover in court "a civil money penalty to up to three times the amount of profit gained or loss avoided by a person who violates, or aids and abets a violation of, the federal securities laws *by purchasing or selling a security* while in possession of material nonpublic information") (emphasis added).

87. 987 F.2d 112 (2d Cir. 1993).

88. *Id.*

> require only that a deceptive practice be conducted "in connection with the purchase or sale of a security." We have previously stated that the "in connection with" clause must be "construed . . . flexibly to include deceptive practices 'touching' the sale of securities, a relationship which has been described as 'very tenuous indeed.'"[89]

Given this broad construction, the court expressed incredulity as to how anyone could adhere to the use test. It cited, as additional support, the notion of "disclose or abstain," stating that:

> [A] "knowing possession" standard comports with the oft-quoted maxim that one with a fiduciary or similar duty to hold material nonpublic information in confidence must either "disclose or abstain" with regard to trading. When the fiduciary is an insider who is not in a position to make a public announcement, the fiduciary must abstain.[90]

In *SEC v. Adler*, the Eleventh Circuit took an opposing view to both the SEC and the Second Circuit, saying that a showing of *use* of the inside information in making a trading decision was necessary to convict.[91] In a well-articulated opinion that details the history of the debate, the Eleventh Circuit acknowledged that the use test did impose a higher burden of proof on the plaintiff because it required connecting scienter and causation. However, the court believed it could overcome this problem by imposing a presumption of use:

> It is true that it often would be difficult for the SEC to have to prove that an insider used the inside information, i.e., that the inside information has a causal connection to a particular trade. However, we believe that the SEC's problems in this regard are sufficiently alleviated by the inference of use that arises from the fact that an insider traded while in possession of inside information.[92]

The court further noted that its approach was the one that best fit with legislative intent and judicial precedent, both of which contradicted a strict liability regime for knowing possession of insider information coincident with a trade.[93] Additionally, it said, both the statutory scheme and Supreme Court precedent supported a use requirement, as evidenced by a consistent focus on fraud and deception.[94] Finally, the court noted that if its test

89. *Id.* at 120.
90. *Id.* (internal citation omitted).
91. 137 F.3d 1325, 1337 (11th Cir. 1998).
92. *Id.* (internal footnote omitted).
93. *Id.*
94. *Id.* at 1338.

proved unworkable, the SEC could simply adopt a new rule "as the SEC has done in the context of tender offers, or a rule adopting a presumption approach in which proof that an insider traded while in possession of material nonpublic information would shift the burden of persuasion on the use issue to the insider."[95]

Within months of the Eleventh Circuit's decision, the Ninth Circuit also took up the question of what standard would be applicable to scienter in the context of insider trading and it too held, in *United States v. Smith,* that both possession and use were necessary elements.[96] In *Smith*, the SEC brought a claim against Richard Smith, a vice president for a California-based software design firm, alleging that Smith's bulk selloff of his company stock within a one-week period and simultaneous short selling amounted to violations of Rule 10b-5.[97] The District Court had given the jury an instruction regarding the requisite scienter that suggested mere possession was sufficient to find Smith liable, stating, "[T]he government need not prove that the defendant sold or sold short [company] stock solely because of the material nonpublic information."[98] The Ninth Circuit, in reversing the lower court's decision, recognized that its standard would increase the difficulty of the prosecution proving its case.[99] Nonetheless, it thought the burden was "by no means insuperable," and that "[a]ny number of types of circumstantial evidence might be relevant to the causation issue."[100]

II. CLARIFICATION OF THE SCIENTER REQUIREMENT AND BIRTH OF THE 10B5-1 PLAN

The Eleventh Circuit's suggestion in *Adler* that the SEC could promulgate a new rule if it found the use test unworkable proved somewhat prescient: The SEC took up the court's proposal and was considering what was to become of Rule 10b5-1 before the end of the following year.[101] The SEC rule was initially proposed Rule 10b5-1 on December 20, 1999[102] and, after a comment period, the final rule published on August 24, 2000, with

95. *Id*. at 1337 n.33.
96. 155 F.3d 1051, 1069 (9th Cir. 1998).
97. *Id*. at 1053-54.
98. *Id*. at 1066.
99. *Id*. at 1069.
100. *Id*.
101. *See* Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,600 (Dec. 28, 1999) (acknowledging the *Adler* court's suggestion and proposing Rule 10b5-1 to address the possession/use issue).
102. *Id*. at 72,611.

an effective date of October 23, 2000.[103]

In the Adopting Release, the SEC specifically stated that its goal in promulgating Rule 10b5-1 was to provide guidance on "what, if any, causal connection must be shown between the trader's possession of inside information and his or her trading."[104] Not surprisingly, the Commission adopted its prior view of the requisite connection, which was that "knowing possession" of material, nonpublic information in conjunction with trading was sufficient for liability.[105] As the Commission stated:

> [W]e believe that awareness, rather than use, most effectively serves the fundamental goal of insider trading law — protecting investor confidence in market integrity. The awareness standard reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information. Additionally, a clear awareness standard will provide greater clarity and certainty than a presumption or "strong inference" approach.[106]

Recognizing that corporate executives are often in possession of confidential information and often trade in their own company's stock (given, for example, that a significant portion of executive compensation is in the form of stock options[107]), however, the SEC also adopted a new affirmative defense, the 10b5-1 plan.[108] The 10b5-1 plan, according to the Commission, was created to protect insiders who were in possession of insider information but who nonetheless did not base their trading decision on the material. The defense aimed to afford insiders the ability "to plan securities transactions in advance at a time when they are not aware of material nonpublic information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material nonpublic information."[109]

A. Requirements of a 10b5-1 Trading Plan

To effectively meet an allegation of insider trading, a 10b5-1 plan

103. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000). Rule 10b5-1 was issued on August 15, 2000. *Id*. at 51,740.

104. *Id*. at 51,727.

105. *Id*.

106. *Id*.

107. *See* Richard A. Booth, *Why Stock Options Are the Best Form of Executive Compensation (and How to Make Them Even Better)*, 6 N.Y.U. J. L. & BUS. 281, 282-83 (2010) (noting that one study found stock options for two hundred CEOs yielding more than half their total pay).

108. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,716.

109. *Id*. at 51,728.

must: (1) be established in good faith at a time when the participant does not possess material, nonpublic information; (2) pre-ordain trading price and volume (or provide a formula to determine price and number of securities to be traded); (3) prohibit a participant from later exerting influence over the method or timing of transactions or whether the trade takes place at all; and, (4) disallow a participant to change or deviate from the plan terms except to cancel a plan, which the participant may do even if he or she is in possession of insider information at that point.[110] The plans then can be challenged on a number of fronts, including whether the insider entered into the plan after coming into possession of material, nonpublic information[111] or whether the insider entered into the plan in good faith and not as part of a scheme to evade insider trading liability.[112] Additionally, a plan participant cannot get around a plan by taking a hedging position on any transaction provided for in the plan.[113]

Both companies and insiders for the most part quickly embraced the new 10b5-1 plans. The sheer number of press releases announcing the adoption of plans by corporate executives suggests that many companies tout adoption of a 10b5-1 plan to boost consumer confidence.[114] Other companies appear to disclose executives' participation in the plans to ward off litigation.[115] If they do not deter plaintiffs from filing suit altogether,

110. 17 C.F.R. § 240.10b5-1(c)(1)(i)-(ii) (2012); Elizabeth Noe & Rey Pascual, *Stay Current: Federal Prosecutors And Regulators Target 10B5-1 Plans - How To Mitigate Exposure And Maximize Compliance*, PAUL HASTINGS 2 (Jan. 2013), http://www.paulhastings.com/Resources/Upload/Publications/2327.pdf.

111. *See* Jean Eaglesham & Rob Barry, *Trading Plans Under Fire: Despite 2007 Warning, Experts Say Loopholes Remain for Corporate Insiders*, WALL ST. J., Dec. 14, 2012, at C1 (noting that executives are "vulnerable" if they set up a Rule 10b5-1 plan while already in possession of inside information).

112. *See* Noe & Pascual, *supra* note 110, at 2 (prioritizing the good faith requirement as supreme).

113. 17 C.F.R. § 240.10b5-1(c)(1)(i)(C) (2012).

114. *See, e.g.*, Press Release, PRNewswire, Scripps Officers Adopt 10b5-1 Trading Plans (Dec. 28, 2012), *available at* http://www.prnewswire.com/news-releases/scripps-officers-adopt-10b5-1-trading-plans-185048111.html (publicizing the idea that the Rule 10b5-1 plans allow the officers to diversify their personal holdings and fund the payment of tax liabilities); Noe & Pascual, *supra* note 110, at 3 (advising clients to "[c]onsider public disclosure of Rule 10b5-1 plans[,] [because] [a]lthough public disclosure is not required, and there may be certain disadvantages to disclosing planned stock sales by executives, it ensures a public record of the plan's existence, and may also assist if civil securities class action litigation is filed.").

115. *See, e.g.*, Press Release, Business Wire, Vringo Issues Statement About Recent Director And Officer Transactions Pursuant To Rule 10B5-1 Trading Plans (Jan. 29, 2013), *available at* http://www.thestreet.com/story/11825087/1/vringo-issues-statement-about-recent-director-and-officer-transactions-pursuant-to-rule-10b5-1-trading-plans.html (noting that recent transactions by officers and directors pertaining to restricted stock units were pursuant to legal Rule 10b5-1 plans and will be reported to the SEC).

they at least put them on notice that pursuing litigation against the insiders will not be an easy task.

III. LOOPHOLES HAVE BEEN DISCOVERED AND EXPLOITED IN 10B5-1 PLANS

Despite the SEC's assertion that Rule 10b5-1 and the affirmative defense would "clarify and enhance existing prohibitions against insider trading,"[116] over time, they instead give insiders ample opportunity to not only engage in insider trading, but also hide behind a legally sanctioned shield. Weaknesses in the affirmative defense in particular include that insiders do not have to disclose the existence of the plans; nor do they have to reveal the specific provisions of their plans, and they are able to cancel their plan at any time without disclosing the plan's cancellation.[117] Moreover, insiders can legally implement a plan immediately before the point when they come into possession of material, nonpublic information. There is no requirement that a plan be in place for a pre-specified amount of time before trades begin.[118] Finally, even when an insider participates in a 10b5-1 plan, he is free to trade outside of it.[119]

The ability of insiders to withhold from investors the existence of 10b5-1 plans or their provisions, as well as the ability to change or discontinue them without disclosure, provides ample opportunity for abuse.[120] This means that corporate executives can put plans in place and then decide at the critical moment (when a definitive merger agreement is executed and public announcement is imminent, for example) whether or not to leave the plan in place, which will result in a trade.[121] Moreover, the ability to cancel the plan at any time can be a way to avoid losses. For example, Former Qwest Communications International CEO Joseph Nacchio was convicted of nineteen counts of insider trading in 2007 after

116. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000).

117. *See* Veliotis, *supra* note 62, at 326-30.

118. *See* Brandon C. Parris, *Rule 10b5-1 Plans: Staying Out of Trouble*, 17 BUS. L. TODAY 21, 23 (2008) (noting that there are no limitations regarding the timeline/length of Rule 10b5-1 plans, thus implying that there is no requirement for a plan to be in place for a pre-specified period before a trade).

119. *See Id.* at 24 (noting the lack of formal restrictions on executives trading outside of the Rule 10b5-1 plans).

120. *See* Eaglesham & Barry, *supra* note 111 (noting that executives need not disclose their Rule 10b5-1 plans, one of the loopholes that possibly contributes to executives having the ability to conduct inside trades).

121. *See* Justin Lahart, *For Insiders, It's All in the Timing*, WALL ST. J., Nov. 29, 2012, at C10 (discussing that executives can implement Rule 10b5-1 plans while anticipating certain transactions and decide, at a later time, whether to trade or not).

selling off more than $50 million in company stock in 2001 when he knew the company's future prospects were deteriorating.[122] The SEC successfully contended that Nacchio had accelerated trades made under a 10b5-1 plan after learning that Qwest would miss revenue targets.[123] Alternatively, if insiders come into possession of material, nonpublic information that is better than anticipated and they are supposed to buy, they may decrease the "buy" price or amount of shares to be purchased.

Even if insiders participate in a 10b5-1 plan, they are free to trade outside of the plan.[124] This increases the difficulty of determining whether a given transaction took place within the boundaries of a plan, where it is prima facie beyond a charge of insider trading, or whether it was performed outside the plan, where it would be much more vulnerable. One could imagine a situation in which an insider could exploit both the ability to conceal the plan terms and the ability to trade outside the plan. The insider could implement a plan and concurrently trade outside of it, then later change the terms of the plan to encompass the outside trades as well. This would essentially provide insiders with backward-looking immunity.

One of the most salient examples of the egregiousness of these loopholes involves the CEO of Big Lots, Steve Fishman. In March 2012, Fishman sold some $10 million of company stock, outside of his pre-determined trading schedule set forth in his 10b5-1 plan.[125] One month later, Big Lots shares plummeted by twenty-four percent.[126] Subsequently, the *Wall Street Journal* reported that Fishman was the subject of a criminal probe.[127] After both a class action against Big Lots and a suit against Fishman were filed, Fishman announced his retirement.[128] Big Lots' general counsel maintained that Fishman's announcement had "nothing to

122. Carrie Johnson, *Nacchio Guilty of Insider Trading*, WASH. POST (April 20, 2007), http://www.washingtonpost.com/wp-dyn/content/article/2007/04/19/AR2007041902738.html.

123. Peter J. Henning, *The Fine Line Between Legal, and Illegal, Insider Trading*, N.Y. TIMES DEALBOOK (Dec. 10, 2012, 3:17 PM), http://dealbook.nytimes.com/2012/12/10/the-fine-line-between-legal-and-illegal-insider-trading/.

124. *See* Parris, *supra* note 118, at 24.

125. Susan Pulliam & Michael Rothfeld, *FBI Probes Big Lots Chief*, WALL ST. J. (Dec. 8, 2012, 2:03 PM), http://online.wsj.com/news/articles/SB10001424127887324640104578163674282467766.

126. *Id*.

127. *Id*.; *see also infra* notes 169-178 and accompanying text (outlining Big Lots' stock activity during Fishman's term as CEO).

128. Press Release, PRNewswire, Big Lots Announces CEO Planned Retirement And Transition Plan For The Coming Year (Dec. 4, 2012), *available at* http://www.prnewswire.com/news-releases/big-lots-announces-ceo-planned-retirement-and-transition-plan-for-the-coming-year-181998961.html.

do with the (*Wall Street Journal*) article or the investigation."[129]

Yet another loophole in 10b5-1 plans is the absence of rules about how long the trading plan must be in place before trading can begin under the plan. As the *Wall Street Journal* reported in November 2012, Chairman and CEO of flooring manufacturer Mohawk Industries, Jeffrey Lorberbaum, established a 10b5-1 plan just six days prior to engaging in significant trades in company stock.[130] After setting up his plan on March 9, 2006,[131] Lorberbaum began selling stock through a family partnership on March 15, eventually selling off approximately $10.4 million over the course of two weeks. One day after the last stock sale, Mohawk reported a downward revision in quarterly earnings expectations;[132] the following trading day, the company's stock fell by nearly 5.5 percent, representing the largest one-day decline in over two years.[133] According to the *Journal*, Loberbaum's sales prior to the stock price decline allowed him to sidestep approximately $700,000 in losses.[134] Mohawk's stock price, the *Journal* reported, did not recover for the better part of a year.[135]

In addition to more overt abuses of 10b5-1 plans resulting from ambiguities in SEC Rule 10b5-1, the safe harbor provided by the plans may motivate insiders to actively misrepresent company information.[136]

A. *Academic Literature Suggests Plans Fail to Curb Insider Trading*

The forgoing discussion of loopholes in 10b5-1 plans suggests that these plans have substantially failed to curb insider trading. However, empirical data both confirms and, to some extent, quantifies the problems associated with 10b5-1 plans. Todd Henderson, a law professor at the University of Chicago who has studied abuses of these plans, indicated the plans may even *increase* insider trading, saying in an interview with the

129. Tim Feran, *Big Lots: Retirement Isn't Tied to SEC Probe*, COLUMBUS DISPATCH (Dec. 6, 2012, 5:44 AM), http://www.dispatch.com/content/stories/business/2012/12/06/big-lots-retirement-isnt-tied-to-sec-probe.html.

130. Pulliam & Barry, *Executives' Good Luck*, *supra* note 6.

131. The partnership's purported reason for entering into the plan was that plan was "a component of its overall diversification strategy and tax planning." *Lorberbaum Group Preparing to Sell Mohawk Shares*, FLOOR DAILY (Mar. 10, 2006), http://www.floordaily.net/flooring-news/lorberbaum_group_preparing_to_sell_mohawk_shares.aspx.

132. Press Release, SEC, Mohawk Industries, Inc. Announces Earnings Guidance Adjustment (Mar. 30, 2006), http://www.sec.gov/Archives/edgar/data/851968/000085196806000035/eg3302005.htm.

133. Pulliam & Barry, *Executives' Good Luck*, *supra* note 6.

134. *Id.*

135. *Id.*

136. Veliotis, *supra* note 62, at 314.

Wall Street Journal that "'[t]his [creation of the 10b5-1 plan affirmative defense] was a huge gift to insiders' . . . 'The SEC claimed this would reduce the probability of insider trading but it has had the opposite effect.'"[137]

A 2009 study by Professor Alan Jagolinzer corroborates Henderson's comment. Jagolinzer analyzed 3,426 insiders at 1,241 firms[138] and found that, in general, 10b5-1 plan participants generate significant abnormal returns when compared with insiders from the same firms who did not participate in a plan.[139] The data indicates that plan participants were able to do so by terminating plans in advance of positive news events and by entering into sales commitments ahead of negative news announcements.[140] The majority of 10b5-1 plan transactions were sales.[141]

A 2012 study by Henderson, Jagolinzer, and Muller expanded Jagolinzer's 2009 study by exploring insiders' rationale for disclosing 10b5-1 plan participation.[142] The authors found that voluntary plan disclosure was a litigation tactic designed to "create legal cover for opportunistic insider trading."[143] Specifically, the data revealed that abnormal returns to a company are significantly more negative when following insider sales within a voluntarily disclosed 10b5-1 plan,[144] suggesting the insider auspiciously avoided a loss on his sale by selling in advance of bad news. The abnormal returns companies experienced were generally associated with a significant decline in earnings in relation to market expectations.[145] In about twenty-five percent of cases where plan details were specifically disclosed, the insider sold shortly before a non-earnings related decline in the company's stock price due to events such as announcement of a merger, a stock exchange-imposed trading halt, or a

137. Susan Pulliam & Rob Barry, *Disclosures on Trades is Sought*, WALL ST. J., Nov. 29, 2012, at C1.

138. Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, 55 MGMT. SCI. 224, 227 (2009), *available at* http://pubsonline.informs.org/doi/pdf/10.1287/mnsc.1080.0928.

139. *Id*. at 224.

140. *Id*. at 235.

141. *Id*. at 228. Specifically, Jagolinzer found that 10b5-1 sales accounted for seventeen times the average total dollar volume of purchases, and that a plan participant was twenty-nine times more likely to engage in a sale than a purchase during the observation period. *Id*.

142. M. Todd Henderson, Alan D. Jagolinzer, & Karl A. Muller III, *Hiding in Plain Sight: Can Disclosure Enhance Insiders' Trade Returns?* (Rock Ctr. for Corp. Gov. at Stanford Univ. Working Paper No. 7, Aug. 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1137928.

143. *Id*.

144. *Id*. at 2, 15-16.

145. *Id*. at 17.

drug trial failure.[146]

A study by Cohen, Malloy, and Pomorski, while not focused specifically on 10b5-1 plans, also supports the argument that the affirmative defense does little to curb insider trading.[147] In analyzing "opportunistic," or irregular, insider traders, the authors observed that "trades of opportunistic insiders show[ed] significant predictive power for future news announcements about the firm, while routine trades by insiders [did] not."[148] The results were consistent with the authors' hypothesis that transactions based on the insiders' superior knowledge were less likely to be irregularly timed, while transactions made for liquidity or diversification reasons were more likely to be irregularly timed.[149] The study was also harmonious with Jagolinzer's 2009 study, the authors noted, because the data showed similar results both pre and post-adoption of the 10b5-1 plan defense.[150]

B. Litigation Also Fails to Effectively Prevent Insider Trading

Historically, litigation has not been an effective method of curbing 10b5-1 plan abuses. This may come as a surprise to some: after all, recall that a 10b5-1 defense rests on the integrity of the plan itself; it will succeed as a defense "only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this [rule]."[151] In theory, this requirement should weed out those executives who establish a plan while already in possession of inside information — those who exhibit suspicious behavior like implementing or cancelling a plan within days of making significant, advantageous trades. In practice, though, the good faith prerequisite does little, if anything, to poke holes in the 10b5-1 defense.

One reason for the ineffectuality of adjudication is the fact that courts may only consider publicly available evidence at the motion to dismiss stage.[152] Specifically, under Federal Rule of Civil Procedure 12(b)(6), at

146. *Id.* at 17-18.

147. Lauren Cohen, Christopher Malloy & Lukasz Pomorski, *Decoding Inside Information*, 67 J. FIN. 1009, 1013, 1015-16 (2012), *available at* http://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2012.01740.x/pdf.

148. *Id.* at 1013.

149. *Id.* at 1041.

150. *Id.* at 1015-16. The authors also found that opportunistic trading was significantly positively correlated with later SEC enforcement against the insider, and that opportunistic traders significantly decreased trading activity after SEC enforcement actions were highlighted in the news. *Id.* at 1041.

151. 17 C.F.R. § 240.10b5-1(c)(1)(ii) (2012).

152. Henderson et al., *supra* note 142, at 4.

this point in the pleadings a court may only utilize "the pleadings themselves, materials embraced by the pleadings, exhibits attached to the pleadings, and matters of public record."[153] As an evidentiary matter, a court may also consider matters that are "generally known" or that "can be accurately or readily determined" from trustworthy sources,[154] which includes SEC filings.[155] The only indications the court would have that an executive's establishment of a 10b5-1 plan was not in good faith, therefore, would be "matters of public record"[156] or matters "generally known"[157] that tended to show the plan was established while the executive was in possession of insider information. Because insider information is, by its terms, nonpublic, one can see the conundrum plaintiffs face in successfully challenging a 10b5-1 plan defense at the motion to dismiss stage.

Add to these constraints the heightened pleading standard for a Rule 10b-5 violation imposed under the Private Securities Litigation Reform Act of 1995 (PSLRA),[158] and little is left to stop 10b5-1 plan abuses via judicial enforcement. *Central Laborers' Pension Fund v. Integrated Electrical Services Inc.*,[159] a 2007 case heard by the Fifth Circuit Court of Appeals, offers a typical example of how such securities class actions proceed under the PSLRA. In *Central Laborers' Pension Fund*, the plaintiffs alleged that defendants, executives of a publicly traded corporation, had materially

153. Mills v. City of Grand Forks, 614 F.3d 495, 498 (8th Cir. 2010).

154. FED. R. EVID. 201(b)(1)-(2); *see also* Kramer v. Time Warner Inc., 937 F.2d 767, 773 (2d Cir. 1991) ("In considering a motion to dismiss for failure to state a claim under Fed.R.Civ.P. 12(b)(6), a district court must limit itself to facts stated in the complaint or in documents attached to the complaint as exhibits or incorporated in the complaint by reference."). The pleadings encompass the complaint as well as answers. FED. R. CIV. P. 7(a)(1)-(2). Answers, in turn, lay out the affirmative defenses, listed in FED. R. CIV. P. 8(c). A party would, under Rule 8(c), state the existence of a 10b5-1 plan in response to an allegation of insider trading.

155. *Kramer*, 937 F.2d at 773 (rejecting an argument that SEC filings should not be considered at the motion to dismiss stage because they were not sufficiently incorporated in the complaint).

156. *City of Grand Forks*, 614 F.3d at 498.

157. FED. R. EVID. 201(b)(1).

158. Pub. L. 104–67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.). The PSLRA imposed heightened pleading requirements for scienter in cases alleging violations of § 10b and Rule 10b-5, in large part because of concern over frivolous securities class action lawsuits. Daniela Nanau, *Analyzing Post-Market Boom Jurisprudence in the Second and Ninth Circuits: Has the Pendulum Really Swung Too Far in Favor of Plaintiffs?*, 3 CARDOZO PUB. L. POL'Y & ETHICS J. 943, 961-64 (2006). The heightened standard calls for pleadings with particularity strong inferences of scienter, and it was clarified by the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* to mean that "[a] complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." 551 U.S. 308, 324 (2007).

159. 497 F.3d 546 (5th Cir. 2007) [hereinafter *Cent. Laborers' Pension Fund*].

misrepresented the health of the company, resulting in harm to the plaintiffs.[160] To rebut plaintiff's allegation that defendants had the requisite scienter[161] in making misrepresentations because, among other things, company executives had engaged in suspicious trading activity, defendant executives raised a 10b5-1 plan defense.[162]

The Fifth Circuit noted in passing that the 10b5-1 plan in question did not appear to meet the good faith requirement.[163] Nonetheless, the pleadings, taken together, failed to "permit a strong inference of scienter."[164] Given the enhanced pleading requirement for scienter and the fact that allegations of insider trading are often advanced as but one piece of circumstantial evidence in favor of a finding of scienter, it is unsurprising that 10b5-1 plans themselves lose significance in a broader section 10(b) case.[165]

On the other hand, procedural constraints have not entirely deprived litigation of its teeth in curbing 10b5-1 plan manipulations: Some exploitations of 10b5-1 plans have been so egregious that courts cannot overlook them. The majority of these cases are associated with a high-profile scandal. In 2010, for example, former CEO of Countrywide Financial, Angelo Mozilo, was ordered to pay a record $67.5 million to

160. *Id.* at 549.

161. The "requisite scienter" in § 10(b) and Rule 10b-5 violations, which were alleged here, is "either intent *or severe recklessness*." *Id.* at 551 (internal quotations and citation omitted) (emphasis in original). Severe recklessness, in turn, is:

> [L]imited to those highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it.

Id. (quoting Nathenson v. Zonagen Inc., 267 F.3d 400, 408 (2001)).

162. *Id.* at 554.

163. *See id.* (remarking that company CFO William Reynolds had entered into his 10b5-1 plan during the class period and that the defendant had failed to respond to this allegation; therefore, "the insider trading allegations contribute[d] to an inference of scienter on the part of Reynolds.").

164. *Id.* at 555.

165. For examples of similar cases glossing over the validity of a Rule 10b5-1 plan in the context of a broader § 10(b) case, see Metzler Inv. GMBH v. Corinthian Colls., Inc., 540 F.3d 1049, 1066-67 (9th Cir. 2008) (noting, in a larger discussion of whether defendants in a securities fraud class action possessed the requisite level of scienter, that two defendants had executed the majority of their trades pursuant to a 10b5-1 plan but giving that fact no weight either way); Elam v. Neidorff, 544 F.3d 921, 928-29 (8th Cir. 2008) (finding no inference of the requisite level of scienter where defendants' stock sales were made pursuant to Rule 10b5-1 trading plans but omitting to discuss whether the plans themselves were undertaken in good faith); and *In re* NutriSystem, Inc. Sec. Litig., 653 F. Supp. 2d 563, 576 (E.D. Pa. 2009) (concluding that plaintiffs failed to plead facts specific to support a finding that defendants entered into Rule 10b5-1 plans while aware of insider information).

settle an SEC case charging Mozilo and two former Countrywide executives with deliberately misleading investors about the deteriorating condition of the company, described as "a looming disaster in which Countrywide was buckling under the weight of increasing risky mortgage underwriting, mounting defaults and delinquencies, and a deteriorating business model."[166] Forty-five million of the settlement was attributed to "disgorgement of ill-gotten gains" associated with Mozilo's alleged insider trading.[167] In one of several related securities class actions, the Central District of California District Court noted that Mozilo's excessive amendments to his plans "appear[ed] to defeat the very purpose of 10b5–1 plans."[168]

IV. INTEREST IN REFORMING 10B5-1 PLANS GAINS WIDESPREAD SALIENCE

A. *The Media Shines the Spotlight on 10b5-1 Plans*

Although it has commonly been acknowledged within the corporate world that executives are abusing 10b5-1 plans, the problems with such plans gained importance among a more widespread audience in November 2012, when the *Wall Street Journal* published an exposé on the topic.[169] The article, titled *Executives' Good Luck in Trading Own Stock*, studied thousands of SEC filings from 2004 that disclosed instances in which corporate executives traded their own company's stock within the five-day period proceeding company disclosure of material information.[170]

What the *Journal* found was arguably unimpressive: Of the more than twenty-thousand executives who traded in their own company's stock during the relevant time period, only about seven percent experienced gains of more than ten percent (or avoided losses of the same amount) within the week following disclosure of material news, while only half that number experienced losses of ten percent or more.[171] Given that insiders are intimately familiar with both their industry and their company, it is not

166. Blake Ellis, *Countrywide's Mozilo to Pay $67.5 Million Settlement*, CNNMONEY (Oct. 15, 2010, 5:16 PM), http://money.cnn.com/2010/10/15/news/companies/mozilo_SEC/index.htm?hpt=T2.

167. Press Release, SEC, Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive (Oct. 15, 2012), *available at* http://www.sec.gov/news/press/2010/2010-197.htm.

168. *In re* Countrywide Fin. Corp. Sec. Litig., 554 F. Supp. 2d 1044, 1069 (C.D. Cal. 2009).

169. Pulliam & Barry, *Executives' Good Luck*, *supra* note 6.

170. *Id*.

171. *Id*.

shocking that they would record abnormal gains and avoid abnormal losses, even if they were not in possession of material, nonpublic information at the time of a trade.[172] The cynical mind might go so far as to assume that executives frequently engage in insider trading, thus rendering it similarly unsurprising that executives who "dip[] in and out" of the market, as opposed to those who "follow a consistent yearly pattern in their trading," tend to experience statistically better returns.[173]

What the *Journal* article did expose, however, were the problems in determining whether executives who experienced those abnormal gains were protected by a valid 10b5-1 plan. As the *Journal* quoted one hedge fund manager as saying, "Sometimes a 10b5-1 plan is legitimate and other times it's not, but there is no way of knowing because there is no disclosure of anything to investors."[174] The article highlighted six corporate executives who sold stock, valued anywhere from $170,000 to $14 million, in advance of company disclosure of negative, market-moving news, and who consequently avoided significant losses.[175] In five of the six cases, company spokespeople averred that the fortuitously timed trades were within the boundaries of 10b5-1 plans.[176] The sixth instance, involving the sale of Big Lots stock by the company's CEO, Steve Fishman, outside of a 10b5-1 plan, is discussed in this Comment.[177] Fishman's sale of a significant amount of Big Lots stock allowed him to avoid a $2.4 million loss; despite that, a company representative stated that the trade in question was appropriately made "'at a time when the company's trading window was open.'"[178]

The ensuing public response to the *Wall Street Journal* article highlighting abuses of 10b5-1 plans is an example of what scholars describe as a classic channel of demand for business law reform.[179] They note that "[f]rom time to time, specific business issues acquire widespread

172. *See, e.g.*, Jagolinzer, *supra* note 138, at 237 (cautioning that "it is important to note that that evidence [indicating that insiders utilizing 10b5-1 plans experienced abnormal gains and avoided abnormal losses] is not necessarily indicative of illegal behavior").

173. Pulliam & Barry, *Executives' Good Luck*, *supra* note 6.

174. *Id.* (quoting David Berman of investment banking firm Berman Capital Management).

175. *Id.*

176. *Id.*

177. *See supra* notes 125-129 and accompanying text for a discussion of Fishman and Big Lots.

178. Pulliam & Barry, *Executives' Good Luck*, *supra* note 6.

179. John Armour, Jack B. Jacob & Curtis J. Milhaupt, *A Comparative Analysis of Hostile Takeover Regimes in the US, UK and Japan* 3-4 (Columbia Law and Econ., Working Paper No. 377, Aug. 12, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1657953.

political salience, leading to a *populist* demand for reform."[180] This often occurs, they say, in answer to a scandal, such as Enron and WorldCom.[181]

Such scandals, in turn, have commonly been uncovered or brought to the fore by investigative journalism done by the *Wall Street Journal*. The work of James B. Stewart of the *Journal*, regarding insider trading in the 1980s, helped shine the spotlight on the prevalence of insider trading on Wall Street during that era.[182] Because of the increased awareness of the systemic abuse, Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988, which extended the civil penalties for insider trading to employees who fail to prevent other employees from engaging in insider trading, and, like the ITSA, provided for treble damages.[183] Likewise, it was *Journal* reporter Jonathan Weil who brought Enron's questionable accounting practices to the fore in his 2000 article, *Energy Traders Cite Gains, But Some Math Is Missing*.[184] A few years later, in 2006, the *Journal* also reported on a troubling pattern in several companies' stock option granting practices,[185] an effort for which it

180. *Id*. at 4.

181. *Id*.

182. Stewart and fellow *Journal* writer Daniel Hertzberg were awarded the Pulitzer Prize for Explanatory Journalism in 1988. *Explanatory Journalism*, THE PULITZER PRIZES, http://www.pulitzer.org/bycat/Explanatory-Journalism (last visited Mar. 16, 2013). Stewart and Hertzberg reported on Dennis Levine, an investment banker charged with setting up connections with numerous Wall Street professionals, all of whom engaged in insider trading. *Levine Receives Prison Term, $362,000 Fine*, WALL ST. J., Feb. 23, 1987, at 2. Stewart's discoveries of the endemic insider trading and corruption on Wall Street at the time are chronicled in his 1992 best-selling book, *Den of Thieves*.

183. Pub. L. 100-704, 102 Stat. 4677 (1988); *see also supra*, notes 84-86 and accompanying text.

184. WALL ST. J., Sept. 20, 2000, at T1.

185. *See* Charles Forelle & James Bandler, *The Perfect Payday; Some CEOs Reap Millions by Landing Stock Options When They Are Most Valuable; Luck — Or Something Else?*, WALL ST. J., Mar. 18, 2006, at A1 (discussing Affiliated Computer Services Inc.'s granting of stock options to CEO Jeffery Rich from 1995 to 2002, all being dated before a rise in price and often after the price had experienced a steep decline); James Bandler & Jennifer Levitz, *U.S. Intensifies Stock Options Probe; Subpoenas by Prosecutors in Manhattan Office Signal Major Step-Up in Security*, WALL ST. J., May 19, 2006, at A3 (discussing investigation by federal prosecutors into five different companies in an effort to discern whether effective dates on stock options were deliberately changed, or "backdated"); Jennifer Levitz, *Investigation into Stock-Options Dating Widens*, WALL ST. J., May 20, 2006, at A2 (discussing three more companies that were investigated for improper stock options dating); Charles Forelle & James Bandler, *Matter of Timing: Five More Companies Show Questionable Options Pattern — Chip Industry's KLA-Tencor Among Firms With Grants Before Stock-Price Jumps — A 20 Million-to-One Shot*, WALL ST. J., May 22, 2006, at A1 (noting that a new statistical study indicated five more companies with questionable and improbable stock options granting patterns); Charles Forelle, *How Journal Found Options Pattern*, WALL ST. J., May 22, 2006, at A11 (discussing the methodology used to identify questionable stock options granting patterns).

garnered the Pulitzer Prize,[186] and which contributed to the prosecution of companies engaged in illegal backdating and increased disclosure rules regarding in-the-money option grants to executives.[187]

The *Journal* appears to be leading the charge once again, having exposed widespread manipulation of 10b5-1 plans. As a consequence, interest in reforming the use of such plans has generated movement from the SEC, action among various investor groups, and revised advice from the legal community.

B. Various Stakeholders Suggest Fixes for 10b5-1 Plans

Recognizing that there are numerous loopholes in 10b5-1 plans, different stakeholders are already pushing for change to ameliorate these problems. The SEC itself recognized the potential for misuse intrinsic to the 10b5-1 affirmative defense and consequently attempted to close some of the loopholes as early as 2002.[188] Reacting to what it described as "advances in technology and the increased dependence on the ready availability of current corporate information [that] have reshaped the way our markets operate," the SEC proposed an amendment to Form 8-K, a filing made by companies to disclose material information an ongoing basis.[189] The amendment would have made mandatory disclosure of "[e]ach director's and executive officer's adoption, modification or termination of a contract, instruction or written plan for the purchase or sale of company equity securities intended to satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c) . . . ."[190]

The SEC's proposed adjustment to the 10b5-1 affirmative defense,

186. Katharine Q. Seeyle & James Barron, *Wall Street Journal Wins 2 Pulitzer Prizes; History of Civil Rights Reporting Also Wins*, N.Y. TIMES, Apr. 17, 2007, at B8.

187. *See* Jonathan J. Tompkins, *Opportunity Knocks, but the SEC Answers: Examining the Manipulation of Stock Options Through the Spring-Loading of Grants and Rule 10b-5*, 26 WASH. U. J.L. & POL'Y 413, 417-18, 418 n.28 (2008) (noting that over one hundred companies were scrutinized by federal prosecutors, and that the SEC promulgated Final Rule: Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) to require thorough disclosure of in-the-money grants).

188. Form 8-K Disclosure of Certain Management Transactions, 67. Fed. Reg. 19,914, 19,914 (Apr. 23, 2002).

189. *Id*. at 19,915. For information on what must be disclosed on a Form 8-K, see *Form 8-K*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/answers/form8k.htm (last visited Apr. 1, 2013).

190. Form 8-K Disclosure of Certain Management Transactions, 67. Fed. Reg. at 19,915. Amending Form 8-K to require more timely disclosure of certain insider trades, the SEC believed, "would enable investors to make investment and voting decisions on a more timely and better informed basis, provide more timely information regarding management's view of company performance or prospects, protect investors, and promote fair dealing in company equity securities . . . ." *Id*.

however, was but one part of a broader proposal to make more timely disclosures regarding director and officer transactions in corporate equity securities.[191] The majority of comments received in response to the proposed rule neglected to mention the affirmative defense at all.[192] Those that did largely expressed opposition to the 10b5-1(c) aspects of the proposal, citing concerns regarding "creating opportunities for unfair arbitrage on an insider's transactions,"[193] and a fear of misleading or confusing investors, especially because insiders would still be free to trade outside of a plan.[194] One of the lone voices in favor of the enhanced disclosure with regard to 10b5-1 plans was William Miller, then-CEO of Legg Mason Funds Management, who noted, "Under the current standard, shareholders are in the dark about amounts, timing, etc. Since these plans can be changed frequently without current disclosure, important information may be obscured. Having the plans, and especially changes to the plans, publicly disclosed is in the public interest."[195] The final rule adopted by the SEC ultimately made no mention of 10b5-1 plans.[196]

191. *See id*. at 19,914 ("We are proposing amendments that would require some public companies to file current reports describing: directors' and executive officers' transactions in company equity securities . . . .").

192. *See* Comments on Proposed Rule: Form 8-K Disclosure of Certain Management Transactions, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/rules/proposed/s70902.shtml (last visited Apr. 3, 2013) (listing the comments, of which only a minority mention Rule 10b5-1).

193. Letter from Stanley Keller, Chair of the Comm. on Fed. Regulation of Sec., Scott Spector, Chair of the Subcomm. on Emp. Benefits, Exec. Comp. and Section 16 & Anne G. Plimpton, Vice Chair of the Subcomm. on Emp. Benefits, Exec. Comp. and Section 16, to Jonathan G. Katz, Sec'y of the Sec. and Exch. Comm'n 23 (July 12, 2002), http://www.sec.gov/rules/proposed/s70902/skeller.htm; *see also* Letter from Luke Farber, Derivatives Prods. Comm., to Jonathan G. Katz, Sec'y of the Sec. and Exch. Comm'n 6 (June 24, 2002), http://www.sec.gov/rules/proposed/s70902/lfarber1.htm ("[D]isclosure of this information is unnecessary and could be harmful to the competitive position of the agent or counterparty. Public release of such information also raises the risk of front-running in advance of transactions.").

194. *See* Letter from Robert Singley, Vice President and Assistant Sec'y of Wells Fargo & Co., to Jonathan G. Katz, Sec'y of the Sec. and Exch. Comm'n (June 26, 2002), http://www.sec.gov/rules/proposed/s70902/rsingley.htm (expressing concerns about potential confusions to investors).

195. Letter from William H. Miller, III, Chief Exec. Officer of Legg Mason Funds Mgmt., to Jonathan G. Katz, Sec'y of the Sec. and Exch. Comm'n (June 25, 2002), http://www.sec.gov/rules/proposed/s70902/wmiller.txt. In 2006, Miller, whose opinion was ultimately discarded along with the proposed changes, was called "the greatest money manager of our time," having beaten the market for fifteen consecutive years at that time. Andy Serwer, *The Greatest Money Manager of Our Time*, FORTUNE, Nov. 27, 2006, *available at* http://money.cnn.com/2006/11/14/magazines/fortune/Bill_miller.fortune/index.htm?postversion=2006111507.

196. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date;

In 2007, the SEC again appeared to be taking a harder look at 10b5-1 plans, but once again, no changes ensued. At the fifteenth annual National Association of Stock Plan Professionals in October 2007, then-Director of Enforcement for the SEC Linda Thomsen noted that the Commission was aware of the literature suggesting that the plans were being abused.[197] Thomsen stated:

> The date [sic] suggests that executives with plans sell more frequently and more strategically ahead of announcements of bad news. This raises the possibility that plans are being abused essentially to facilitate trading on inside information. . . . If executives are in fact trading on inside information and using a plan for cover, the plan will provide no defense.[198]

Despite Thomsen's remarks, little regulatory movement toward increased disclosure or enforcement occurred for the next several years. It was not until the November 2012 *Wall Street Journal* exposé on 10b5-1 plan misuse that interest in increased regulation was reignited. Within weeks of the article's publication, a consortium of pension funds called Council of Institutional Investors (CII) submitted a letter to the SEC Chairwoman requesting the agency heighten its regulation of the plans.[199] The letter suggests, among other things, that:

- The plans only be adoptable within a pre-specified window,
- the insider be prohibited from having multiple 10b5-1 plans with possibly overlapping provisions,
- the first trade under a 10b5-1 plan be preferably three months after adoption of the plan, and
- the insider be prohibited from frequently modifying or cancelling the plan.[200]

Additionally, the letter stated that the CII advocates pre-announced disclosure of 10b5-1 plans and immediate disclosure of plan amendments and plan transactions, and it recommended that the employer's board of

Correction, Exchange Act Release No. 33-8400A, 83 SEC Docket 1427 (Aug. 4, 2004).

197. *See* Linda Chatman Thomsen, Dir., Sec. and Exch. Comm'n Div. of Enforcement, Opening Remarks Before the 15th Annual National Association of Stock Plan Professionals (NASPP) Conference (Oct. 10, 2007), http://www.sec.gov/news/speech/2007/spch101007lct.htm#9 [hereinafter Thomsen Speech] (citing research conducted by Jagolinzer). For more information on Jagolinzer and other scholars' studies of how executives manipulate Rule 10b5-1 plans, *see supra* notes 137-150 and accompanying text.

198. *Id.*

199. Letter from Jeff Mahoney, Gen. Counsel of the Council of Institutional Investors, to the Hon. Elisse B. Walter, Chairman of the Sec. and Exch. Comm'n (Dec. 28, 2012), http://www.sec.gov/rules/petitions/2013/petn4-658.pdf.

200. *Id.* at 3.

directors adopt policies covering 10b5-1 plan practices, monitor plan transactions, and ensure that such company policies discuss plan use in the context of equity hedging and ownership.[201]

SEC Chairwoman Elisse B. Walter declined to comment on the CII letter at the time,[202] but the Commission did express its intention to improve enforcement, if not regulation. Its own response to the *Wall Street Journal* article consisted of opening a probe into trading activity by VeriFone Systems CEO Douglas Bergeron and Big Lots CEO Steve Fishman, both of whom were cited in the original *Journal* article.[203] Soon thereafter, it was reported that the SEC had widened its probe to include executives from a broad array of companies.[204]

C. The Legal Community Advises Clients to Increase Transparency

In the wake of the *Wall Street Journal* article and increased enforcement activity from the SEC, legal advisors have counseled clients to err on the side of providing more transparency in plan dealings.[205] In client update blogs and newsletters, many have encouraged corporations to adopt a form of "best practices" for plan creation and maintenance that generally includes:

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201. *Id*. at 1.

202. Michael Siconolfi, *Pension Funds Seek Insider Curbs; In Letter to SEC Chairman, Group Expresses Concern that Executives Benefit from Improper Trader*, WALL ST. J. (Dec. 30, 2012, 8:01 PM), http://online.wsj.com/news/articles/SB10001424127887323635504578211781992442110.

203. Susan Pulliam, Jean Eaglesham & Rob Barry, *Insider-Trading Probe Widens; U.S. Launches Criminal Investigation Into Stock Sales by Company Executives*, WALL ST. J. (Dec. 10, 2012, 8:33 PM), http://online.wsj.com/news/articles/SB10001424127887323339704578171703191880378.

204. *See* Susan Pulliam, *SEC Expands Probe on Executives Trades*, WALL ST. J., Feb. 5, 2013, at C3 (stating that the SEC was expanding its investigation to companies other than previously mentioned/investigated).

205. *See, e.g.*, Yelena M. Barychev, Francis E. Dehel, Melissa Palat Murawsky & Michael E. Plunkett, *Current Developments in Securities Laws: 10b5-1 Plans Making Headlines*, BLANK ROME LLP 2 (Jan. 2013), http://www.blankrome.com/siteFiles/UpToDate-Dec12-Jan13-No9.pdf (suggesting that companies publically disclose adoptions, terminations, or amendments of 10b5-1 plans); Steve Bochner & Nicki Locker, *WSGR Insight & Analysis: Rule 10b5-1 Trading Plans: Considerations in Light of Increased Scrutiny*, WILSON SONSINI GOODRICH & ROSATI 2 (March 2013), *available at* http://www.jdsupra.com/legalnews/rule-10b5-1-trading-plans-consideration-76433/ (encouraging companies to publically disclose 10b5-1 plans on Form 4 and Form 144 filings); *Publications: The Spotlight Shines on Rule 10b5-1 Plans: What Public Companies Should Consider Now*, GIBSON DUNN 3 (Jan. 22, 2013), http://gibsondunn.com/publications/pages/Spotlight-Shines-Rule10b5-1Plans-What-PublicCompanies-ShouldConsider.aspx (suggesting companies publically disclose 10b5-1 plans in advance or at the time they are established).

- Delay: Requiring at least a modest delay between plan adoption and commencement of trading under the plan.
- Disclosure: Providing for voluntary public disclosure of the plan either prior to concurrently with its creation.
- Dollar Limits: Imposing transaction limits (either absolute dollar or volume limits or proportional to the executives' holdings) within a pre-specified time period.

Other legal advisors have gone beyond providing advice and are taking additional measures such as hosting webinars on best practices and risk management with regard to the plans.[206]

D. Other Suggestions for Reformation of 10b5-1 Plans

As awareness of 10b5-1 plan abuse grows, an increasing number of voices will undoubtedly add to the discussion on reformation of the plans. Future SEC action with regard to the plans will likely look similar to proposals put forth by the CII and law firm advice to clients; it may also incorporate elements of the following suggestions.

ABOLISH THE PLANS ALTOGETHER: Cohen et al. suggested that the existence of 10b5-1 plans as an affirmative defense did nothing to discourage opportunistic trading,[207] while Henderson found that executives may be manipulating the plans with the primary goal of decreasing litigation, though plan participants continue to generate abnormal returns.[208] The implication of the academic literature, therefore, is that perhaps the SEC should abolish the 10b5-1 plan defense altogether. The Commission would avoid the administrative costs associated with investigating whether a plan was properly implemented and insiders would be deprived of a litigation shield protecting opportunistic trades. To mitigate the harshness of such a move, the Commission might reconsider its approach in the possession-versus-use debate and whether the Eleventh Circuit's approach in *Adler*[209] might be better suited to evaluating insider trading.

REQUIRE ADDITIONAL DISCLOSURE: Rather than abolishing the 10b5-1

206. *See WSGR Alert: The Latest on Insider Trading: Directors and Executives Face Heightened Scrutiny Associated with Stock Trades Even under Rule 10b5-1 Trading Plans*, WILSON SONSINI GOODRICH & ROSATI (Feb. 4, 2013), http://www.wsgr.com/wsgr/Display.aspx?SectionName=publications/PDFSearch/wsgralert-rule-10b5-1.htm#1 (scheduling a webinar focused on managing risks associated with Rule 10b5-1 plans).

207. Cohen et al., *supra* notes 147-150, and accompanying text.

208. Henderson et al., *supra* notes 142-146, and accompanying text.

209. 137 F.3d 1325, 1338-39 (11th Cir. 1998).

affirmative defense, the Commission instead may revisit its 2002 proposal to require additional disclosure of plan creation, termination, and modification on the Form 8-K. This move would be in line with both Miller's comments in favor of enhanced disclosure[210] and the more recent suggestions from the CII, whose members have already endorsed heightened disclosure through commitment to corporate governance best practices.[211] The benefit of additional disclosure would need to be considered in light of the accompanying harm of front running and potential confusion, however.

REQUIRE DELAY BETWEEN PLAN IMPLEMENTATION AND TRADING: A required "vesting" period after plan implementation would mitigate opportunistic sales in advance of negative earnings announcements or the release of other unfavorable news. Jagolinzer found in his 2009 study that plan initiation was associated with forthcoming adverse news events; in other words, insiders avoid losses by putting plans in place when they know bad news is imminent.[212] The data showed that the average time between plan creation and significantly negative news events was 72.2 days.[213] By widening that delay to, for example, 90 days and making the period mandatory, the Commission could close one of the most significant loopholes in the plan. The CII, in its letter to the SEC, specifically requested a lag of three months or more.[214]

PREVENT FREQUENT PLAN MODIFICATION AND CANCELLATION: An enforcement mechanism to preclude insiders from frequently modifying a plan would address concerns that executives can change plans after coming into possession of insider information. Specifically, such a rule would prevent insiders from adjusting a plan's "buy" volume up to take advantage of positive news, or the "sell" volume downward to avoid losses. An effective rule would also speak to concerns that executives cancel plans in order to take advantage of positive forthcoming news, as Jagolinzer found was occurring.[215]

The CII suggests that the SEC put a stop to these specific loopholes, but declines to propose a prevention or enforcement method.[216] Elsewhere in its request for rulemaking letter to the SEC, however, the group does

210. Letter from William H. Miller, III, *supra* note 195.
211. *See* Letter from Jeff Mahoney, *supra* note 200, at 1 (showing concern of CII members with respect to potential misuse of trading plans).
212. Jagolinzer, *supra* note 138, at 17.
213. *Id*.
214. Letter from Jeff Mahoney, *supra* note 199, at 3.
215. Jagolinzer, *supra* note 139, at 224.
216. Letter from Jeff Mahoney, *supra* note 199, at 3.

recommend that the SEC only allow plan adoption during the company-specified trading window, which typically coincides with the announcement of quarterly earnings.[217] This proposal could be expanded to require plan modifications and cancellations to be undertaken within the same window, thereby preventing opportunistic plan changes.

CONCLUSION

"Direct evidence of insider trading is rare," representatives of the SEC Division of Enforcement said in a 1998 speech.[218] "There are no smoking guns or physical evidence that can be scientifically linked to a perpetrator. Unless the insider trader confesses his knowledge in some admissible form, evidence is almost entirely circumstantial."[219] Unfortunately, that circumstantial evidence is all the more obscured by the use of 10b5-1 plans.

Various groups have voiced concerns about the affirmative defense from the beginning, but renewed focus on possible reformation of the plans arose after the *Wall Street Journal* published an exposé in November 2012, highlighting several instances of particularly suspicious trading activity taking place under 10b5-1 plans.[220] The *Journal*'s article appears to corroborate both academic literature on the subject and case law. The SEC, for its part, appears to be approaching reform from an enforcement perspective, while other groups are pushing for regulatory change. While it is as yet unclear whether 10b5-1 plans will survive an impending regulatory shift, it is more apparent that some adjusting is necessary to control insider trading that appears to be proliferating under the current defense.

217. *Id.* In its letter, the CII requested the SEC to adopt guidelines or to amend Rule 10b5-1 to require plan participants to follow protocols, including that, "Companies and company insiders should only be permitted to adopt Rule 10b5-1 trading plans when they are permitted to buy or sell securities during company-adopted trading windows . . . ." *Id.*

218. Thomas C. Newkirk, Assoc. Dir. of the Sec. and Exch. Comm'n Div. of Enforcement & Melissa A. Robertson, Senior Counsel of the Sec. and Exch. Comm'n Div. of Enforcement, Remarks Before the 16th International Symposium on Economic Crime 11 (Sept. 19, 1998), http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm.

219. *Id.*

220. *See* Pulliam & Barry, *Executives' Good Luck*, *supra* note 6.