



Some Challenges for Congress's Proposed Reform of Insider Trading Plans

John P. Anderson

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The Securities and Exchange Commission (SEC) promulgated rule 10b5-1(c) as one component of a broad insider trading reform package in 2000. The rule offers an affirmative defense from insider trading liability for corporate insiders who trade in their own firm's shares pursuant to qualified trading plans (Trading Plans). Studies suggest, however, that contrary to their intended purpose, insiders are using these Trading Plans strategically to trade based on material nonpublic information. The SEC has been aware of the strategic use of Trading Plans for years but has not yet addressed the problem. Congress may, however, force the SEC's hand with the Promoting Transparent Standards for Corporate Insiders Act (the Act). If signed into law, the Act would require the SEC to study a number of proposed amendments to 10b5-1 aimed at limiting the strategic use of Trading Plans, report to Congress, and then implement the study's recommendations. There are, however, reasons for concern that the piecemeal changes proposed in the Act would do more harm than good.

ORIGIN AND PURPOSE OF 10B5-1 TRADING PLANS

The crime of insider trading has never been defined by statute in the United States. The principal statutory authority for America's insider trading enforcement regime is found in Securities Exchange Act of 1934 section 10(b), a general antifraud provision that prohibits the use or employment of "any manipulative or deceptive device or contrivance" in connection with the "purchase or sale of any security."¹ While section 10(b) was intended by Congress as a catchall provision, the Supreme Court has made it clear that "what it catches must be fraud,"² which means, inter alia, that insider trading liability requires proof of *scienter* (a guilty mind). The SEC began recognizing Trading Plans as part of a broad insider trading reform package that looked, at least in part, to resolve a split among federal courts over this demand of *scienter*.

Before 2000, the SEC had pushed a “knowing possession” test, whereby insiders would incur liability if they traded while in knowing possession of material nonpublic information, even if that information played no motivational role in the trade (e.g., the insider traded solely to raise funds to pay for his or her child’s college tuition). Some courts, however, rejected the SEC’s preferred test in favor of a more demanding “use” test, whereby the SEC and prosecutors must prove that material nonpublic information actually played a causal role in the insider’s decision to trade to satisfy the requirement of *scienter*.³ To resolve this dispute, the SEC promulgated rule 10b5-1(b), which defines trading “on the basis of” material nonpublic information broadly as trading with mere “awareness” of such information—essentially codifying its preferred knowing possession test.⁴ Imposing liability for trading while merely aware of material nonpublic information, however, presented two related problems for the rulemakers. First, with mere awareness as the only test, the rule imposes liability even on insiders who can prove to a jury that their trades had *nothing* to do with their awareness of material nonpublic information (and were therefore presumably free of *scienter*), potentially exceeding the rulemakers’ statutory authority under section 10(b). Second, since senior management can rarely—if ever—be certain that it is not in possession of material nonpublic information, the broad awareness test may chill legitimate trading by insiders (e.g., for portfolio diversification), and this would negatively impact the value of firm shares as a form of executive compensation. To address these concerns, the SEC adopted 10b5-1(c) Trading Plans as an affirmative defense to insider trading liability at the same time that it promulgated its rule 10b5-1(b) awareness test.⁵

To qualify, a Trading Plan must (1) be in writing; (2) detail the amount, price, and date of the securities to be purchased or sold or include a “written formula or algorithm” that determines the Plan transactions; (3) have been entered into while the insider was unaware of material nonpublic information; (4) not be subsequently influenced by any insider “over how, when, or whether to effect [particular Trading Plan] purchase or sales”; and, finally, (5) it must have been “entered into in good faith.” Moreover, a purchase or sale is not “pursuant” to a qualified Trading Plan if the trader “entered into or altered a corresponding or hedging transaction or position with respect to those securities” trading under the Plan.⁶

STRATEGIC USE OF TRADING PLANS

It seems that at the time of adoption, the SEC was aware that an affirmative defense to insider trading for those who execute their transactions through valid Trading Plans would present risks.⁷ First, Trading Plans would make it harder to detect insiders who hide their illegal trades by executing them through invalid Trading Plans that were adopted based on material nonpublic information, and second, Trading Plans would provide a loophole in the law for others to strategically terminate otherwise valid Plans based on material nonpublic information. Such concerns were proven valid by a series of studies conducted soon after the rule’s adoption.

For example, in 2005 the *Wall Street Journal* published the initial results of a study by Professor Alan Jagolinzer suggesting that insiders using Trading Plans were beating the market on average by 5.6 percentage points.⁸ From this and subsequent studies, Professor Jagolinzer concluded that insiders are using Trading Plans “strategically.”⁹ The *Wall Street Journal* then carried out its own study in 2012 that also suggested insiders were availing themselves of Trading Plans to trade on material nonpublic information.¹⁰ These studies were accompanied by calls for reform from institutional investors.¹¹ Yet despite persistent media and industry pressure, the SEC has yet to act. Why?

It may be that the SEC’s apparent reticence to reform the rule reflects a recognition that the strategic use of Trading Plans (disturbing as it may be) was the expected and worthwhile price to be paid for the benefit of increased flexibility in enforcement that has come with the broad 10b5-1(b) awareness test. And as explained above, both fealty to statutory authority and the economic realities of executive compensation suggest that the latter cannot be had without the former. In what follows, I suggest that these same realities also caution against most of the reforms proposed by Congress in the Act.

CONGRESS’S PROPOSED REFORMS

If signed into law, the Act would require the SEC to study whether rule 10b5-1(c) should be reformed to do the following:

- Restrict Trading Plan adoptions during issuer-prescribed trading windows
- Impose a mandatory delay between the adoption of a Trading Plan and the execution of the first trade under that Plan
- Limit issuer and insider discretion to adopt multiple, overlapping Trading Plans
- Place limits on the frequency with which insiders may modify or cancel Trading Plans
- Require that insiders file Trading Plan adoptions, amendments, terminations, and transactions with the SEC
- Demand the boards of issuers that permit the use of Trading Plans to (1) adopt Trading Plan policies, (2) monitor Plan transactions, and (3) ensure that Trading Plan policies include guidelines on equity hedging, holding, and ownership

All but the last of these proposals, however, present legal and practical challenges that Congress and the SEC should consider and weigh before amending the rule.¹²

CHALLENGES FOR PROPOSED REFORMS

Restricting adoption to trading windows. Limiting the adoption of Trading Plans to issuer-prescribed trading windows would make it more difficult for insiders to use these Plans to hide illegal trades.

But this limitation would also make it more difficult for insiders to avail themselves of the affirmative defense while executing legitimate trades in good faith. Imagine that two days after her firm imposed a three-week blackout period,¹³ a CFO learns of a serious personal financial exigency that requires the liquidation of some of her firm's shares within four weeks. Assume she is not aware of any material nonpublic information at the moment, but given her position, she fears she may become aware of some such information in three weeks. This is the sort of situation Trading Plans were initially adopted to address: protecting well-meaning insiders from an overbroad application of the 10b5-1(b) awareness test. The proposed amendment would, however, force this conscientious CFO to wait three weeks and take her chances on whether she will acquire material nonpublic information during that time. If she does acquire such information, then despite her good faith, the proposed amendment would force her to choose between obtaining an expensive loan and potential prison time for insider trading liability. Such a result would be in tension with section 10(b)'s requirement of *scienter* and may therefore exceed the SEC's statutory authority.

Imposing mandatory delays. Imposing a mandatory delay between Trading Plan adoption and the first trade under the plan would generate a similar problem. Some commentators have suggested requiring a delay of three to six months between Trading Plan adoption and the first trade under the plan.¹⁴ But note how such a mandatory delay would render Trading Plans useless to the conscientious CFO in the previous example. She knows she will need to sell her shares in four weeks; she is not currently aware of material nonpublic information, though she may be in four weeks; but she cannot currently trade because of the firm's blackout period. Under the current rule, this conscientious CFO could simply enter into a Trading Plan that will execute its first trade in four weeks (the very purpose for which Trading Plans were intended), but a three-to-six-month mandatory delay would render the Plans useless to her, forcing this well-intentioned executive to face an expensive solution to her cash problem or insider trading liability.

Limiting adoption of overlapping plans. The proposal to limit adoption of multiple Trading Plans is presumably aimed at preventing the practice of hedging one Trading Plan against another. But 10b5-1 already expressly prohibits such hedging,¹⁵ so adding this requirement does little more than make it more difficult to violate the existing rule. Any benefits from this prophylactic measure should be weighed against the costs (namely, the legitimate uses of multiple Plan adoptions). For example, most Trading Plans are more than one year in duration, and some commentators have suggested that shorter Plans should be regarded as "aggressive"—raising the suspicion of strategic use—and therefore in tension with the spirit of the rule.¹⁶ If it is presumed that most Trading Plans will be a year or more in length, then it should be expected that, as changes in personal, world, and market circumstances arise, an insider's legitimate investment needs may warrant the adoption of a second, long-term, overlapping Plan (or even a third) without terminating the original Plan. Restrictions on multiple Trading Plans should not preclude such legitimate uses.

Limitations on termination. Limiting the ability of insiders to terminate existing Trading Plans would presumably respond to studies indicating that insiders are strategically terminating Plans to beat the market based on material nonpublic information.¹⁷ But if new restrictions make it more difficult for insiders to terminate an existing long-term Trading Plan, and they are also unable to adopt an overlapping Plan (also owing to proposed restrictions), then their hands will be tied in the event of a legitimate change in investment strategy. Such restrictions would create a perverse incentive for insiders to adopt more aggressive short-term Plans in order to ensure sufficient flexibility to address unforeseen personal or market exigencies.

Mandatory disclosure. It is difficult to reconcile the presumed rationale for a disclosure requirement (that it will provide the investing public with useful information) with the role of Trading Plans as an affirmative defense to insider trading liability. After all, Trading Plans may be adopted by insiders only while they are unaware of material nonpublic information and are therefore only trading to either diversify their portfolio or address a personal need. Consequently, disclosure of Trading Plan adoptions will give investors useful information concerning the performance prospects of a company only if they are illegal Plans. Such a disclosure regime would likely create more confusion than clarity for the investing public. These concerns may explain why a Trading Plan disclosure requirement proposed by the SEC in 2002 was never adopted.¹⁸

Mandatory compliance. That issuers adopt internal policies concerning their employees' use of Trading Plans is the least troublesome of the Act's proposed reforms, but it may also be unnecessary. After all, at least under the misappropriation theory of insider trading liability, the only harm done by such trading is that it deprives the issuer of the exclusive use of its own proprietary information.¹⁹ For this reason, issuers already have a strong incentive to keep track of their employees' trading in firm shares. And issuers do appear to be keeping a very close eye on their employees' use (even strategic use) of Trading Plans. For example, Professor M. Todd Henderson and others have shown that boards actually "bargain" with executives over blackout periods and constraints on the use of Trading Plans when setting executive pay.²⁰ Some issuers grant their executives more latitude to trade in firms' shares than others, and those with more restrictive trading policies tend to offer their executives about 13 percent more in total compensation.²¹ This bargaining cuts in both directions. Professor Henderson's study suggests that firms that permit their executives to use Trading Plans strategically tend to pay their executives a lesser amount that roughly offsets profits from such trading.²² If it is true that issuers have been negotiating the use of Trading Plans as part of executive pay packages for some time, then perhaps firms are already effectively monitoring Plan use without the need for additional regulatory incentives.

Finally, it should come as no surprise that the liquidity of firm shares offered as compensation is of crucial importance to employees as they bargain with issuers over pay. If employees cannot readily liquidate firm shares, those shares are less valuable to them, and employees will therefore demand either more cash or more equity as compensation. New restrictions placed on Trading

Plan use by the proposed reforms outlined above would, therefore, come at a price. And this price must be paid by issuers and ultimately their shareholders—the very persons the laws against insider trading are designed to protect. Congress and the SEC should be mindful of this as they weigh the proposed reforms.

CONCLUSION

Trading Plans were introduced in 2000 for two principal reasons: (1) to limit the risk that the rule 10b5-1(b) awareness test would come in tension with its statutory authority in section 10(b) by imposing liability on insiders who trade for legitimate purposes and therefore without scienter, and (2) to protect the liquidity of equity offered to insiders as part of their compensation packages. The reforms proposed by the Act risk undermining both purposes. But if these reforms would be unwise, there remains the question of how to address the fact that insiders are using Trading Plans strategically. One option would be for Congress to finally define insider trading by statute. In doing so, Congress could adopt the equal access model for liability embraced by Europe and many other major market economies. The equal access model is not fraud based and therefore imposes no demand of *scienter*. This would solve the first concern raised for the reforms outlined above, but not the second. It would also have the unfortunate consequence of occasionally exposing those with innocent motives to insider trading liability.²³ Alternatively, the SEC could simply drop its 10b5-1(b) awareness test and require instead that liability be imposed only when the insider *uses* material nonpublic information in a trade. Under such a use-based regime, a more restrictive Trading Plan rule could still perform a useful function as a nonexclusive safe harbor for insider trading liability. If there is no desire to embrace either of the preceding options, then regulators could simply leave the delicate balance effected by the current regime in place without amendment.

ABOUT THE AUTHOR

John P. Anderson is a professor at the Mississippi College School of Law. He practiced in the areas of securities enforcement and white-collar criminal law at the Washington, DC, law firms of Eversheds Sutherland and WilmerHale before entering academia in 2010. Professor Anderson has published several articles concerning insider trading in top law reviews, and he recently published a book, *Insider Trading: Law, Ethics, and Reform*, with Cambridge University Press (2018). He received a PhD in philosophy and a JD from the University of Virginia and a BA in philosophy from the University of California, Berkeley.

NOTES

1. Securities Exchange Act of 1934, 15 U.S.C. § 78(j) (2018).
2. *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980).
3. Just before the SEC’s adoption of rule 10b5-1(b) in 2000, the Eleventh Circuit rejected the SEC’s preferred knowing possession test for insider trading liability as exceeding the agency’s statutory authority pursuant to section 10(b) of the Exchange Act. *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998). The Ninth Circuit soon followed the Eleventh Circuit in rejecting the SEC’s knowing possession test in *United States v. Smith*, 155 F.3d 1051, 1070 (9th Cir. 1998).
4. 17 C.F.R. § 240.10b5-1(b) (2000).
5. 17 C.F.R. § 240.10b5-1(c) (2000).
6. 17 C.F.R. §§ 240.10b5-1(c)(1)(i)–(ii).
7. Michael Siconolfi and Jean Eaglesham, “SEC Is Pressed to Revamp Executive Trading Plans,” *Wall Street Journal*, May 9, 2013 (quoting former SEC commissioner Joseph Grundfest stating that the weaknesses inherent to Trading Plans were “well known” by the commission and its staff at the time of adoption).
8. Tony Cooke and Serena Ng, “Insiders Prosper despite SEC Rule,” *Wall Street Journal*, August 5, 2005.
9. Alan D. Jagolinzer, “SEC Rule 10b5-1 and Insiders’ Strategic Trade,” *Management Science* 55, no. 2 (2009), 224–39.
10. Susan Pulliam and Rob Barry, “Executives’ Good Luck in Trading Own Stock,” *Wall Street Journal*, November 27, 2012.
11. Council of Institutional Investors, Letter from Jeff Mahoney to Mary Jo White, May 9, 2013, https://www.cii.org/files/issues_and_advocacy/correspondence/2013/05_09_13_cii_letter_to_sec_rule_10b5-1_trading_plans.pdf.
12. Many of the following concerns were first raised in John P. Anderson, “Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform,” *Utah Law Review* 2015, no. 2 (2015): 339–89, and have since been updated and revised in John P. Anderson, “Undoing a Deal with the Devil: Some Challenges for Congress’s Proposed Reform of Insider Trading Plans,” *Virginia Law & Business Review* 13 (forthcoming, 2019): 1–12.
13. Though not expressly required by law, as a matter of “good corporate practice,” issuers typically include “trading windows,” “blackout periods,” or both as components of their insider trading compliance programs. A trading window (which typically opens a day or two after a quarterly filing and closes 10 to 30 days later) is a period during which an issuer affirmatively permits its insiders to trade. Stephen M. Bainbridge, *Insider Trading Law and Policy* (Los Angeles: Foundation Press, 2014), 155. A blackout period, by contrast, is a firm-imposed period during which insiders are affirmatively prohibited from trading. See Bainbridge, *Insider Trading Law and Policy*, 156.
14. Council of Institutional Investors, Letter from Jeff Mahoney; Sougata Mukherjee, “The Dangerous Game Corporate Executives Are Playing,” *Triangle Business Journal*, December 11, 2012.
15. 17 C.F.R. § 240.10b5-1(c)(1)(i)(C) (2000).
16. Ed Welsch, “Trading Plans Offer a Good Clue to Sell,” *Wall Street Journal*, April 9, 2008 (noting that, according to one research firm, while determining whether a Trading Plan is “aggressive” is a “very subjective thing,” metrics such as volume, major insider divestiture, and length are indicators).
17. Jesse M. Fried, “Insider Abstention,” *Yale Law Journal* 113, no. 2 (2003): 455–92; Allan Horwich, “The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1,” *Business Lawyer* 62, no. 3 (2007): 913–54; Jagolinzer, “SEC Rule 10b5-1,” 227.
18. Form 8-K Disclosure of Certain Management Transactions, 67 Fed. Reg. 19914 (proposed April 23, 2002) (to be codified at 17 C.F.R. pts. 230, 239, and 249); Horwich, “The Origin,” 934–35 (noting that although the SEC proposed that certain Plans should be disclosed—and that proposal was “never formally withdrawn”—the proposal “appears to have been consigned to oblivion”).
19. *United States v. O’Hagan*, 521 U.S. 642, 654 (1997) (“A company’s confidential information . . . qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information, in violation of a fiduciary duty . . . constitutes a fraud akin to embezzlement.”).

20. M. Todd Henderson, "Insider Trading and CEO Pay," *Vanderbilt Law Review* 64, no. 2 (2011): 505, 506–7; Darren Roulstine, "The Relation between Insider-Trading Restrictions and Executive Compensation," *Journal of Accounting Research* 31, no. 3 (2003): 525, 526.
21. Henderson, "Insider Training and CEO Pay," 515; Roulstine, "The Relation between Insider-Trading Restrictions and Executive Compensation," 526.
22. Henderson, "Insider Trading and CEO Pay," 506.
23. This author has argued elsewhere that Congress should adopt a statute-based wrongful use insider trading regime. See John P. Anderson, *Insider Trading: Law, Ethics, and Reform* (Cambridge: Cambridge University Press, 2018).