Corporate Executives and Insider Trading:
Are Rule 10b5-1 Trading Plans *Really* Being Abused?

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Agenda and Overview

- The Current Buzz on 10b5-1 Trading Plans
- What are Rule 10b5-1 Trading Plans--Really
- How Can Insiders Trade without Engaging in Insider Trading?
- Cracked Windows--The Real Problem
- Viewing Rule 10b5-1 Trading Plans as a Solution Instead of a Problem

What's "News" About 10b5-1 Plans?

The Wall Street Journal's "Expose`"

- 9 Articles from Nov. 27, 2012 to May 9, 2013
- Started with an internal study of 10b5-1 trading
  - Showed a 10% edge to insiders trading in 10b5-1 plans
- Mixed with anecdotes of particularly "lucky" insiders
- Followed up with calls by investors for more disclosure
- SEC investigations of insider trading by some executives
- Call for "action"

Is this News?

- No. Virtually the same thing happened in 2007-2008
- Prof. Jagolinzer's studies found a 7% edge by executives trading in 10b5-1 plans
- Business Week ran a series of articles about executives "gaming" 10b5-1 plans
- Calls for action
- SEC looking at it "hard"

And?

- Nothing happened.
- SEC's "hard" look resulted in no changes to Rule 10b5-1
- The same is happening today. On 5/9/13, the WSJ reported:
  - "The SEC hasn't ruled out taking action to amend its guidance or regulations on the plans, but no such review is under war, according to a person familiar with the agency."
- Why not? Why is this supposed "edge" that insiders have when using 10b5-1 plans falling on deaf regulatory ears?

What are Rule 10b5-1 Trading Plans Really?

Material Non-Public Information

- Factual Information Only
  - Not hunches, intuitions, expectations, plans, ideas, etc.
  - "Provable" facts
- Must be "Material"
  - Important to the investment decision of a "reasonable investor"
- Both these Determinations Are Subjective
  - An executive looking to trade can easily get them wrong
    - His own biases will lead him to make judgment calls in his own favor
  - The conventional solution: Put the determination into "neutral" hands
    - Invariably the Issuer's General Counsel

When is a Trade "On the Basis of" Material Non-Public Information?

- Section 10(b) requires that one "use or employ" information
  - Mere "possession" is not enough, but it is easier to prove
  - Normal strategy: Prove possession, and infer "use" from that
- What if one possesses information, but does not "use" it?
  - This spawned years of litigation, and led to the "possession vs. use" debate
  - Some courts ruled that defendants had to be given the opportunity to show they did not "use" the information they possessed
- An Evidentiary Problem for the SEC
  - If a defendant could show other reasons for trading, it might become impossible to prove "use" of the inside information
- SEC Enacted Rule 10b5-1 to solve this very practical problem

Rule 10b5-1: Possession Presumes Use

- Under Rule 10b5-1, "Use" of material non-public information will be conclusively presumed from the "knowing awareness" of it
- This is NOT binding on Federal Courts
  - But it is persuasive evidence
  - No one has yet challenged it, quelling for now the possession/use debate
- This is binding in SEC Administrative Proceedings
- HOWEVER, Rule 10b5-1 does offer an affirmative defense to and insider trading charge, if the Rule is complied with
  - These track the arguments made in the litigations, but
  - Require clear evidentiary proof
- Rule 10b5-1 Plans are designed around the affirmative defense

The Rule 10b5-1 Trading Plan

- To get the Rule 10b5-1 Affirmative Defense, you must prove that although you may have had possession of inside information when you trade, you did not use it in trading. You must prove this in the prescribed way:
  - Through a **written document created when you do NOT have MNPI**
  - Embodying one of these:
    - A **binding contract** to buy or sell shares, or
    - A **binding instruction** to a 3rd party to buy or sell shares, or
    - A **plan** for a 3rd party to trade on your behalf **without "subsequent influence"** from you.
- In common practice, these elements meld into a *trading plan*
  - A "binding contract" between an executive and a broker
  - Giving the broker "binding instructions" to buy or sell shares
  - Upon which the executive exerts no "subsequent influence"
- *BUT: The Key Is that you DO NOT have MNPI When You Made the DECISION to trade.*

The Corporation's Dilemma: How to Prevent Insider Trading while Still Allowing Insiders to Trade

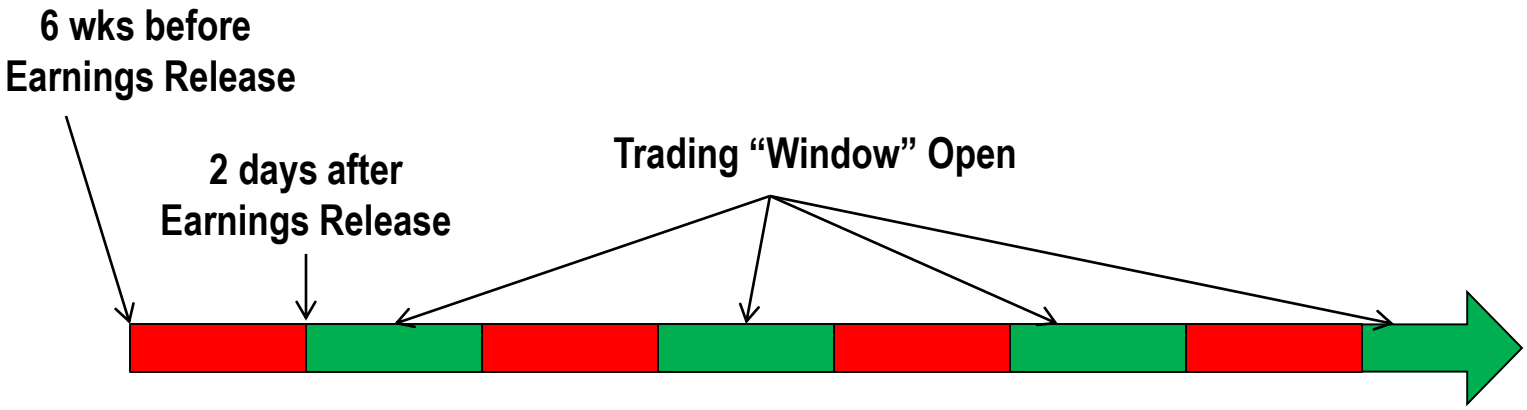
Corporate Responsibility for Insider Trading

- Probably no legal liability for an executive's insider trading
  - Issuer itself would have had to purchase or sell
- Yet all corporations seek to control insider trading
  - Issuers are "gatekeepers," they are in the best position to prevent it
  - "Gatekeeper Liability"
    - Discussed academically for decades
    - Very few laws are yet founded on it
      - One real world example: Dramshop Acts can make bartenders liable for the drunken acts of their patrons
    - But even if gatekeeper liability is not the law, common sense favors it here
      - It is how the corporation does "the right thing"
      - Failure could lead to popular sentiment turning against the issuer--reputational risk
      - Failure could lead to new laws or regulations
  - Practical concerns for the expense and disruption to the corporation of having an executive charged with insider trading

The Typical Insider Trading Policy

- Executives may only trade when the Corporation permits it
- Three questions must be asked
  - Who grants permission? Usually the general counsel
  - Who must get permission?
  - How is permission given?
- Generally there are two kinds of permission
  - Individualized permission
    - Requires specific pre-clearance before every trade
  - Blanket permission limited in time
    - The opening and closing of a trading “window”
  - There could be hybrids combining these two

A Year of Windows



- Use of Windows assumes there is no MNPI that has not been disclosed
- If that is true, then any trading decisions made in the open window
  - Cannot be on the basis of MNPI
  - Cannot be insider trading
- If that is true for any trading decision made in the open window
  - Then it should not matter when the trade is actually executed
  - So, 10b5-1 Trades in closed windows SHOULD be protected.
  - If they aren't, then it must be because insiders have MNPI in the open windows!

The More Serious Problem: Are Trading Windows Cracked?

Don't Executives Always Have Inside Information?

- Only lawyers believe that executives can ever be on a level playing field with the investing public
  - Non-lawyers know intuitively that executives always have better information--they expect it
- Yet, executives routinely sell the shares of their own companies
- How? The trading "window"
  - A period of time when all "material information" about the company is considered to have been made public
  - Generally through the release of an earnings report or the filing of a quarterly or annual report with the SEC
    - 10Qs and 10Ks. Also prospectuses, Form 8-Ks, etc.
    - Because these require disclosure of all MNPI, by definition there is no MNPI in an open window--at least that's the theory

But There Are at Least Two Problems With Windows

- **First**: How Can We Know They've Been Closed Soon Enough?
- **Second**: What About MNPI That is Not Suffiently "Factual" to give rise to Insider Trading Charges?
- These two problems are inherent in all trading window schemes, and they are inherent in the securities laws.
  - That's why there is no SEC rush to "solve" them

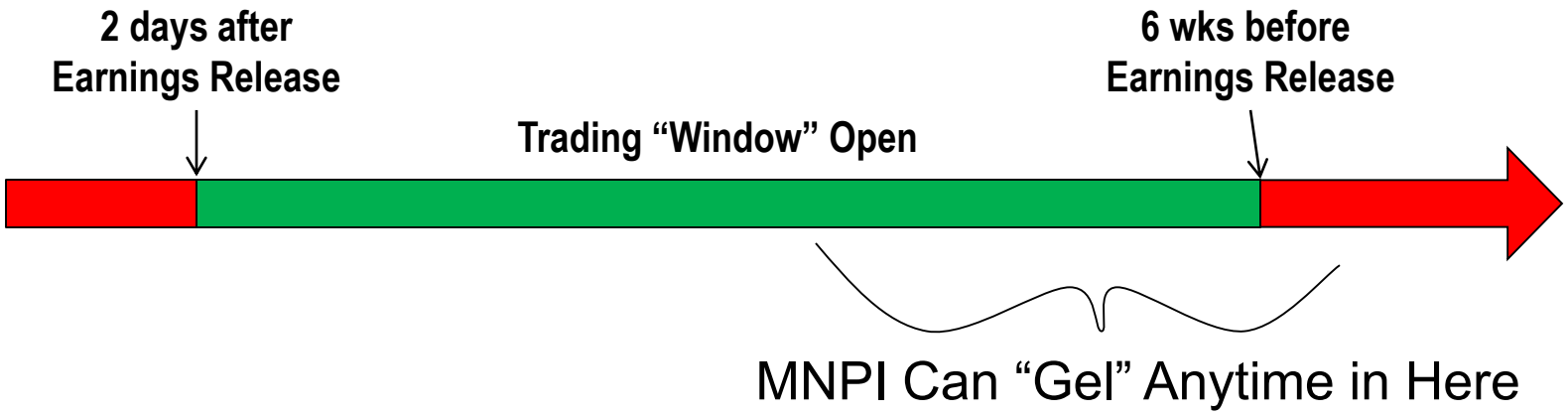
How to Open a "Window"

- Start with an actual disclosure
  - Typically an earnings report
- Wait for the disclosure to be fully disseminated
  - Typically two trading days
- Then, open the window for affected executives
- Executives can trade directly, and enter into Rule 10b5-1 Trading Plans, while the window is open

The First Problem: How Does A Corporation Know When to Close A Window?

- It doesn't "know." It is only General Counsel's best guess.
- The aim is to close the window before executives learn new non-public information ahead of the next earnings report
- General Counsel typically acts on these key assumptions
  - Material information is financial in nature
  - Will become known only when new earnings reports start being rolled up from operating divisions
  - And will not "gel" into actionable "information" until after the roll-up starts
- Typically, then, a window will close 5-7 weeks before the next earnings release

The Evolution of "Information"



- Note that many Rule 10b5-1 Trading Plans are adopted late in the open window period, often the last day

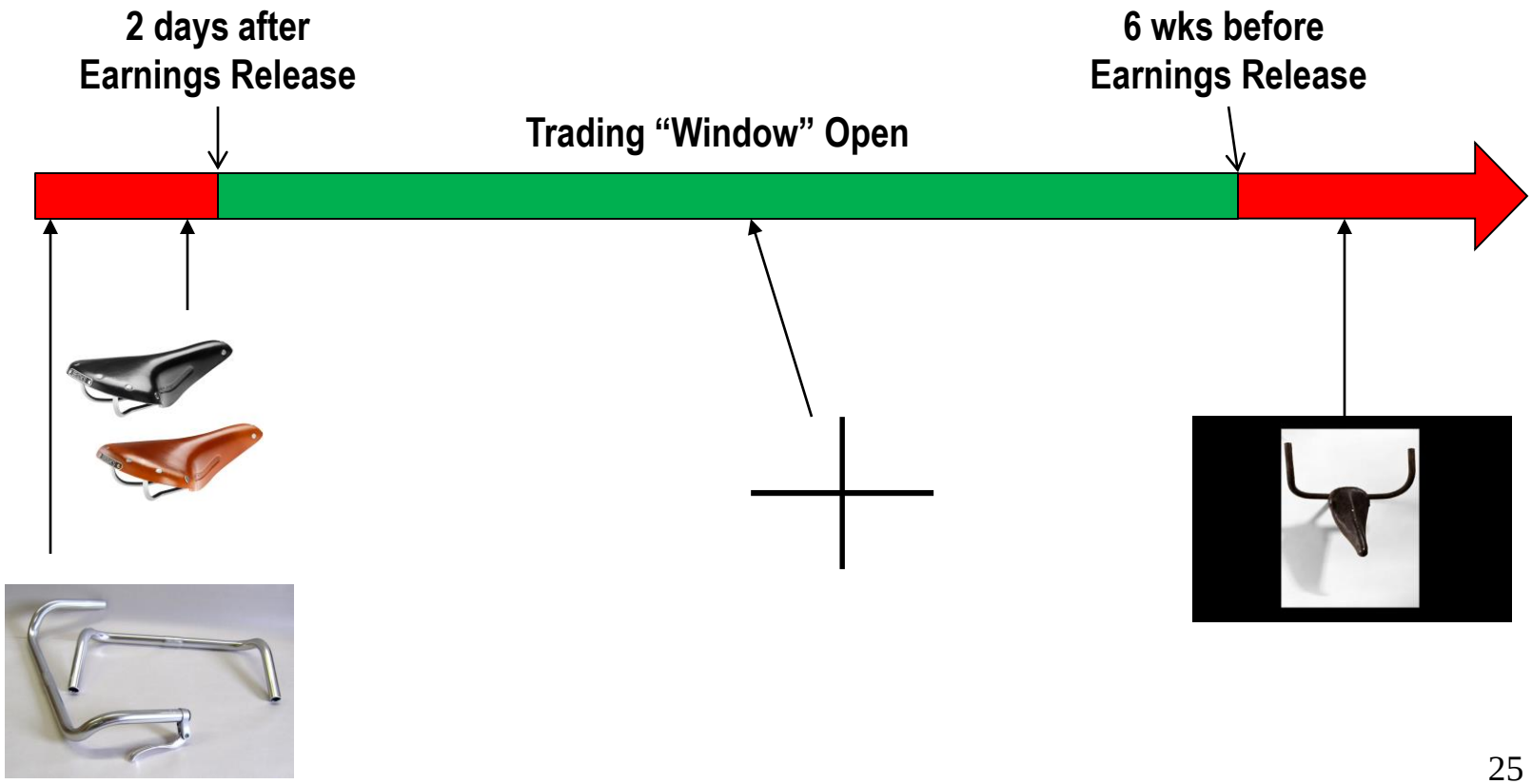
General Counsel's Dilemma in Closing Windows

- The assumptions he relies on are all soft
  - Material information might well be non-financial
  - It may be generating a "buzz" well before numbers are rolled up
  - It is too much to expect that senior management does not know very well what is going on in the divisions until they see actual numbers
  - Information does not have to "gel" very much to give executives trading advantages
- GC can only act on what he knows
  - No way to know how much the executives have been exposed to
  - Can't even be sure what he would deem "material" in the absence of a real need to disclose
- The legal sufficiency of information is a litigation question that can only be answered after the fact, never before.
- So, when to close a window is always a risky judgment call

The Second Problem: A Bullish Example

The Components Being:

So Does Picasso Have MNPI In the Open Window?



The Upshot: Windows Alone May Not be Enough

- You can never be confident that a window closed soon enough
  - It is always possible that material non-public information is leaking into an executive's trading decisions even in an open window, especially near the close of one
- You can never police the acquisition of insight by executives, because that is not factual enough to be MNPI
  - But Both Can Provide Insiders a Trading Edge
- The SEC has never officially adopted the practice of windows
- Windows, invented by securities lawyers, based on technical foundations, are vulnerable to common-sense attack

[1]Source: Alan D. Jagolinzer, SEC Rule 10b5-1 and Insiders' Strategic Trade (Sept. 17, 2007), available at http://www.gsb.stanford.edu/cldr/cgrp/documents/10b5-1Jagolinzer.pdf.

New Academic Evidence Supports This

- Jagolinzer study (2011) showed a 7% edge to insiders trading in windows as opposed to insiders needing to preclear with GC.[1]
- Compare to Jagolinzer's 2007 study showing the same edge to insiders using 10b5-1 Plans,[2] similar to the current WSJ study.
- Logically, if 10b5-1 Plans are adopted on the basis of the information that insiders have during open windows, then it is the information that they have in open windows that is the real problem, not the 10b5-1 plans themselves.

[1]Source: Alan D. Jagolizer, David F. Larker, and Daniel J. Taylor, Corporate Governance and the Information Content of Insider Trades, 49 J. of Accounting Res. 1249 (Dec. 2011).

[2]Source: Alan D. Jagolinzer, SEC Rule 10b5-1 and Insiders' Strategic Trade (Sept. 17, 2007),
available at http://www.gsb.stanford.edu/cldr/cgrp/documents/10b5-1Jagolinzer.pdf.

Viewing Rule 10b5-1 Trading Plans as a Solution Rather Than a Problem

How to Use Rule 10b5-1 Trading Plans To Better Police Insider Trading

- *First:* Write a "cooling off" period into the Plan
  - This creates a time between when the Plan is adopted and when the first trade may take place
    - Becoming common--30 to 90 days
  - The cooling off period just assumes that when the Plan is adopted, the executive has some actionable knowledge
    - The waiting period allows the information to dissipate or be disclosed, so that it will not affect the later trading
- *Second:* Eliminate free terminations
  - Treat terminations the same as amendments, including "cooling" periods
- *Third:* Require all executives to adopt a company-approved Plan
  - Prohibit non-10b5-1 Plan trading, even in open windows
  - Use open windows ONLY as times to adopt 10b5-1 Plans

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