LJN LAW JOURNAL NEWSLETTERS

The Corporate Counselor®

An ALM Publication

Volume 28, Number 10 • January 2014

# Another Look at Rule 10b5-1 Trading Plans

## *Where Does Their Reported Profit Advantage Really Come From?*

**By Aegis J. Frumento and Stephanie Korenman**

By establishing a prearranged plan to trade their companies' stock in compliance with SEC Rule 10b5-1, corporate executives avail themselves of the only formally codified affirmative defense against a charge of insider trading. However, statistical evidence demonstrating that executives in trading plans outperform their peers by 6% to 10% have twice brought trading plans under academic and journalistic scrutiny. Each time ultimately voices the recurring fear the rest of us have that executives who use such plans are getting away with insider trading.

**Aegis J. Frumento** and **Stephanie Korenman** co-head the Financial Markets Practice of Stern, Tannenbaum & Bell LLP in New York City. From 2006 through 2011, Mr. Frumento headed, and Ms. Korenman was senior counsel of, the Executive Financial Services department of Citigroup Smith Barney and later Morgan Stanley Smith Barney, responsible for all Rule 10b5-1 trading plans for Smith Barney (now Morgan Stanley) customers. They now represent broker-dealers, issuers, and executives implementing Rule 10b5-1 trading plans, and can be reached at afrumento@sterntannenbaum.com and skorenman@sterntannenbaum.com, respectively.

### Background

There is no consensus as to why these enhanced profits exist. Elementary logic shows that properly designed and implemented trading plans, in and of themselves, cannot confer any additional informational advantage to their trading executives. Stock trades in a Rule 10b5-1 trading plan can only reflect what knowledge an executive had when he or she adopted the plan. Therefore, any informational advantage that a plan might exploit must have existed when it was adopted, typically during a conventional "open trading window."

Professor Alan Jagolinzer first showed the profit advantage of trading in Rule 10b5-1 trading plans in 2006 and 2007. Jagolizner found that executives using trading plans outperformed those not using them by about a 6%. *See* Alan D. Jagolinzer, Do Insiders Trade Strategically Within the SEC Rule 10b5-1 Safe Harbor? Stanford University, September 2007, http://bit.ly/J08TER. This led *Business Week* to run a series of articles in late 2006 and early 2007 suggesting that executives were "gaming" Rule 10b5-1 trading plans to trade on inside information under the Rule's guise.

In response, the SEC's then-Director of Enforcement promised a "hard look" at Rule 10b5-1. *See* Remarks of Linda Chatman Thomsen at the 2007 Corporate Counsel Institute, March 8, 2007, http://1.usa.gov/1heqtlb. But nothing ever came of it.

Over the past year, the apparent profit advantages of using trading plans was again in the news, with a series of articles *The Wall Street Journal* ran from November 2012 through May 2013. The *WSJ* did its own analysis and concluded that executives in plans outperformed their peers by about 10%. Susan Pulliam and Rob Barry, Executives' Good Luck in Trading Own Stock, *The Wall Street Journal*, Nov. 27, 2012. This prompted another round of hand-wringing about executives "abusing" Rule 10b5-1 trading plans to garner outsized profits. But this time around, the SEC announced no intention to do anything about it. Michael Siconolfi and Jean Eaglesham, SEC Is Pressed to Revamp Executive Trading Plans, *The Wall Street Journal*, May 9, 2013.

### Why the Enhanced Profits?

A number of hypotheses might explain this profitable phenomenon. Trading results might by skewed by executives' power to terminate plans at will (one cannot trade on inside information if one does not trade at all), giving them an "option" to effect beneficial trades, but avoid disadvantageous ones. *See* Alexander P. Robbins, The Rule 10b5-1 Loophole: An Empirical Study, Working Paper, May 3, 2008, http://bit.ly/1dGQeIu. Or, executives might manipulate the timing and content of company news to give their own trading plans an advantage. *See* Stanley Veliotis, Rule 10b5-1 Trading

Plans and Insiders' Incentive to Misrepresent, 47 Am. *Bus L.J.* 313 (2010).

While those are plausible explanations, we, after having seen many plans in operation, discount them. Plans are not terminated that often, and at the release of important company news, more often than not the issuer itself suspends all executive trading plans. Moreover, there would by now have been prosecutions in the wake of such manipulations, and there have been none.

The most likely explanation for the enhanced profits may be that trading plans simply impose investment discipline. Almost all trading plans execute limit orders automatically once certain prices are reached. Executives in trading plans are usually selling at the peaks of a stock's up-and-down market movements, cherry-picking the best prices. Such disciplined traders will naturally outperform others, and there is nothing nefarious about it. *See, e.g.*, Rik Sen, Are Insider Sales Under 10b5-1 Plans Strategically Timed?, New York University, June 2008, http://bit.ly/18vehfp. But none of that animates the headlines. Outsized profits suggest insider trading, and that is what we explore here.

## How Rule 10b5-1 Works

Most Rule 10b5-1 stock trades are executed at a time when the executive is in possession of material non-public information. The affirmative defense to insider trading arises because, if the Rule is complied with, the decision to effect that trade — determining in advance the trade's quantity, timing and price — was made when the executive did not have material non-public information. Assuming that the executive did not have material non-public information when he or she adopted the trading plan, and assuming compliance with all of Rule 10b5-1's other requirements, simple logic dictates that the later-executed trades cannot be influenced by inside information.

In a properly implemented Rule 10b5-1 trading plan, the plan's trades are executed by algorithm. Most trades are automatically released to the market without human intervention. Only larger orders will go to a manned trading desk, where a trader will decide when to execute trades so as to maintain an orderly market. The trading executive is not a party to the trader's decisions, and the trader is not privy to any inside information. The execution of pre-planned orders cannot be influenced by material non-public information, because there is no conduit to carry this information, and even if there were, such information could not alter those executions.

Therefore, if a properly implemented Rule 10b5-1 trading plan is infected by inside information, the executive must have had that information when he or she first established the plan. And yet, all trading plans are adopted when an issuer certifies that there is no material non-public information, and almost always within an "open trading window." Thus, any profit advantages of Rule 10b5-1 trading plans necessarily begs the question whether "open trading windows" sufficiently insulate executives from exploitable information.

## 'Inside Information' and Mental States

The continuum of mental awareness begins with a vague notion and ends with a hard fact. Over the decades, courts have required that "inside information," to be actionable in a securities fraud case, be factual, not mere speculation, inchoate thoughts or plans. Over a half century ago, it was established that federal securities law "requires nothing more that the disclosure of basic facts. … " *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). The practical requirements of litigating real cases drives this emphasis on facts — an element of a claim must be amenable to being proven true or false by evidence. As mental states become increasingly conjectural, they become harder and ultimately impossible to prove. Ideas, goals, plans, hunches, feelings, gut instincts and the like are not factual enough to support an insider trading charge. Not even such quasi-factual matters as motives and legal consequences are enough to support a securities fraud charge. *See, e.g., Stedman v. Storer*, 308 F. Supp. 881 (S.D.N.Y. 1969).

When an issuer opens a trading window, it assumes that whatever mental states then extant have not yet evolved into actionable inside information. But that assumption raises two practical concerns. First, even in an open window, how confident are we that an executive does not have actionable inside information? The conventional thinking followed by most issuers is that a trading window should close six to eight weeks in advance of an earnings release. But that convention assumes actionable inside information first appears when quarterly financial results begin rolling up from divisions for consolidation into the issuer's quarterly or annual reports.

However, most companies adopting Rule 10b5-1 plans are information companies like technology, Internet and pharmaceutical concerns. Executives in such enterprises surely know well in advance of any formal financial reporting what is generally happening in their companies. The information they have may not be concrete enough for periodic reports or even an earnings expectation statement, but it can still provide a trading edge. This is especially true toward the end of the open-window period. Many, perhaps most, trading plans are adopted very late in the open-window period, often in the last week. Relying on convention to close the trading window six to eight weeks ahead of an earnings release may give issuers some comfort, but in truth they cannot really know when informal knowledge has gelled into actionable inside information. They can never quite be sure that they have closed an open window soon enough.

The second question is related: Can even speculative knowledge confer a trading advantage? Ideas, hunches, feelings and gut instincts are not actionable inside information, but it seems unrealistic to say that they do not put an executive in a better position to trade his company's stock. Modern executives bring creativity, imagination and insight to bear on the prospects of their companies, and if they don't one should well wonder why they are paid so much. One need only imagine a Steve Jobs forming a mental picture of the iPod while in Apple's open window. Would not that alone give him a trading advantage, even though nothing exists that can yet be called material non-public information? Looked at in this light, the surprise is perhaps not that executives outperform their peers by 6% to 10%, but that they outperform them by only that much.

Some companies require their executives to seek personal permission to trade from their general counsel, avoiding general open windows. In the face of general counsel's probing questions about the executive's knowledge, some executives may not be permitted to trade or establish plans, and others may not even attempt to. In 2011, Professor Jagolinzer and colleagues published a report that deserves more widespread attention, because it compares how profitable executive trading is between open-window and individual preclearance trading policies. Alan D. Jagolinzer, David F. Larcker, and Daniel J. Taylor, Corporate Governance and the Information Content of Insider Trades, 49 *J. Accounting Research* (*JAR*) 1249 (Dec. 2011). Professor Jagolinzer concluded that executives trading in open windows outperformed those trading with individual preclearance by 7.2%, "suggest[ing] that restricted trading windows, by themselves, are not effective at reducing informed trading." *Id*. at 1252.

This result corroborates our own analysis. But because most Rule 10b5-1 trading plans are adopted in companies using a trading windows policy, the profit advantages of using trading windows apply with equal force to trading plans adopted in such windows. It is no coincidence that the profit advantage of a trading windows policy is in the same range as that typically found for Rule 10b5-1 trading plans. The profit advantages of trading plans have nothing to do with the plans themselves, and everything to do with the open windows when those plans were adopted. The knowledge executives had in the open windows may or may not be actionable inside information, but it is advantageous all the same.

## Best Practices

All this suggests two best practices. First, those issuers requiring longer waiting periods between the adoption of trading plans and the first trades under such plans are on the right track. This is not a new suggestion, but now at least we have a better understanding of why it is important. The mere existence of a mandatory waiting period — of any length — necessarily assumes that the executive may have material non-public information, and almost certainly has advantageous knowledge, even in an open window. Acting on that reasonable assumption, a waiting period forces time to pass before executing the first trade under a plan, ensuring that whatever knowledge the executive had when adopting the plan has matured into a disclosable fact or has dissipated as ephemeral. How much time should pass depends on the particulars of the company, but we would recommend at least 60 days.

Second, if open windows alone are not to be trusted, then all executives should be subjected to such a waiting period, and that means that executives should only trade in properly designed Rule 10b5-1 trading plans having long waiting periods.

## Conclusion

And so we come full circle to a surprising conclusion. Rule 10b5-1 trading plans cannot logically give executives a trading advantage over other traders; establishing plans in open trading windows appear to do that. Rather than being the culprits, trading plans with appropriate waiting periods provide the best available mechanism to mitigate the profit advantages of an open-window trading policy. Serious policing of executive stock trading requires more, not fewer, Rule 10b5-1 trading plans.

—❖—