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When a Good Plan Goes Bad: The Exploitation of Loopholes in the Rules Governing 10b5-1 Trading Plans

Introduction

Rule 10b5-1 Trading Plans can, and often do, serve as an affirmative defense to allegations of illegal insider trading. However, increased scrutiny has demonstrated that the Plans are ripe for abuse and in some instances have the perverse effect of providing a formidable shield for corporate wrongdoers who engage in illegal insider trading. The Securities and Exchange Commission ("SEC") and the United States Attorney's Office for the Southern District of New York have launched investigations into the alleged abuses of the Plans. In January 2013, the Council of Institutional Investors wrote to the SEC to express their "concerns with the potential misuse" of 10b5-1 Trading Plans, and to ask for "clear guidelines regarding the circumstances in which a 10b5-1 Plan may be adopted, modified, or canceled." [3] We think it is important for you to understand the structure of 10b5-1 Plans, their potential abuses, and how they can play a critical role for plaintiffs in securities fraud litigation.

Background

The SEC adopted Rule 10b5-1 in August 2000 to clarify the standard for federal insider trading liability. Prior to the adoption of Rule 10b5-1 it was unclear whether an insider must have "used" material non-public information in connection with the purchase or sale of a security, or whether the insider must have merely "knowingly possessed" such information in order for insider trading liability to attach. Rule 10b5-1 addressed this issue by codifying the "knowingly possessed" standard—meaning insiders are subject to insider trading liability if they execute insider trades while in knowing possession of material non-public information. Because the SEC acknowledged that this broad standard carried with it the potential for significantly increased exposure to insider trading liability, it also created an affirmative defense for corporate insiders – the 10b5-1 Trading Plan.

A 10b5-1 Trading plan is a predetermined plan for selling or trading Company stock. The Plan may be designed a couple of different ways. For example, the plan may require sales of a certain number of shares on a certain day, or may allow for trades any time the stock hits a preset price. Under no circumstances, however, can executives be aware of material non-public information at the time the plan is adopted, and the plan must be adopted in good faith. If these requirements are met, the fact that an

[3] Council of Institutional Investors, Request for Rulemaking Concerning Amending Rule 10b5-1 or Further Interpretive Guidance Regarding the Circumstances under which Rule 10b5-1 Trading Plans May be Adopted, Modified, or Cancelled (Jan. 2, 2013) *available at* http://www.sec.gov/rules/petitions/2013/petn4-658.pdf.

executive made trades based on a pre-established plan provides a strong defense in the face of insider trading allegations.

Potential for Abuse and Increased Scrutiny

While the concept underlying the 10b5-1 Trading Plan system is sound, the rules (or lack thereof) governing the system are riddled with shortcomings which can have the practical effect of eviscerating any exculpatory presumption in favor of executives trading under the plans. To begin with, there is an utter lack of transparency. Executives are not required to file the plans with any federal agency, nor are they required to disclose if they change, cancel, or amend the plans.

Additionally, executives are free to amend, cancel, or modify their existing plans at any time, thereby allowing them to exploit inside knowledge – the very thing that the Plans were intended to prevent. For example, studies show that executives often cancel their plans before positive Company news is announced – allowing them to immediately cash in on the increased stock price after the news becomes public regardless of whether they could have done so under the Plan. Indeed, a 2006 study "*Do Insiders Trade Strategically within the SEC Rule 10b5-1 Safe Harbor?*" written by Professor Alan D. Jagolinzer found that early terminations are associated with later positive performance. A follow up study by the same professor in 2009 found that 46% of early terminations of Plans requiring share sales occurred within 90 days before the Company released positive news, whereas only 11% of terminations of plans that called for share sales came before the release of negative news about the Company. Executives also opportunistically amend their plans. A recent Wall Street Journal Article highlighted how one executive's plan called for trading at $11 per share. When the stock fell well below $11, and stayed there, the executive amended his plan to permit selling at the current market price.

Executives are also free to begin trading under a plan immediately after it is adopted. The absence of a required waiting period is another loophole that permits executives to take advantage of insider knowledge while trading under the guise of a pre-determined plan. The shorter the period of time between plan adoption and first trades, the higher the specter of suspicion because it appears that the plan was adopted solely to capitalize on newly available insider information. Similarly, because there are no rules governing the duration of a trading plan, executives can enter into short-term plans that allow them to benefit from inside information but still give them the freedom to avoid being locked into a long term trading schedule. The shorter the plan period, the more prone it is to manipulation as well as allegations that it was not adopted in good faith.

Finally, the existence of a 10b5-1 Trading Plan does not prohibit an insider from executing other trades outside of the plan. Trades made outside of the plan are inherently suspicious because the plan is

intended to provide the insider with adequate diversification and liquidity – therefore any trades outside of the plan appear like they were made with the intent to benefit improperly from insider knowledge.

Journalists and academics have started to bring these shortcomings into the spotlight of mainstream media. For example, a recent Wall Street Journal piece, "*Executives' Good Luck in Trading Own Stock*," reported that executives trading under 10b5-1 Plans "do statistically much better than we'd expect." The article included numerous anecdotes of insiders exploiting loopholes in the rules governing 10b5-1 Trading plans to generate large and favorable returns. Professor Jagolinzer has conducted two studies on trading patterns under 10b5-1 Plans and concluded that trading under the plans generates abnormally large returns. The criticisms led to increased scrutiny by the United States Attorney's Office for the Southern District of New York and the SEC, both of which have launched investigations in to the potential abuses of the plans.

Role in Securities Litigation

Insider trading allegations are often central to proving a defendant's scienter (i.e., fraudulent intent) in securities fraud actions. Plaintiffs often argue that the defendant's insider sales allowed her to benefit from the alleged fraud by selling stock at artificially inflated prices while in possession of material non-public adverse information about the Company. Since the adoption of Rule 10b5-1, Plaintiffs have further argued that trades made pursuant to a 10b5-1 Plan can buttress the inference of scienter if the trades were suspicious – i.e., if the plan was short in duration, if there was no waiting period between the adoption of the plan and the first sale, or if the Plan was adopted, modified, or cancelled while in possession of material non-public adverse information. A review of recent case law demonstrates that courts have been inconsistent with their treatment of the latter argument, with some finding that trades under 10b5-1 Plans do not indicate scienter, while others acknowledge that "[a] Rule 10b5-1 trading plan may give rise to an inference of scienter because 'a clever insider might "maximize" their gain from knowledge of an impending price drop over an extended amount of time, and seek to disguise their conduct with a 10b5-1 plan.'" *Freudenberg v. E*Trade Fin. Corp.*, 712 F. Supp. 2d 171, 200 (S.D.N.Y. 2010).

With the current heightened scrutiny into the potential abuses of 10b5-1 Plans, we expect courts to become uniformly more receptive to arguments that securities fraud defendants acted with scienter even while trading pursuant to a 10b5-1 Plan. We also believe that ongoing investigations by the United States Attorney's Office and the SEC could result in changes to the rules governing 10b5-1 Trading Plans. We will continue to monitor this area and will keep you updated on any developments.