

The Uses and Abuses of Rule 10b5-1

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ABSTRACT

Firm insiders have used Rule 10b5-1, which allows them to pre-commit to trades when they don't possess insider information so they can trade at times when they do, to sell tens of billions of dollars of stock since the SEC promulgated the Rule in 2000. The SEC intended the Rule to permit insiders the opportunity for uninformed diversification trades, but we present evidence that the Rule (as written and as implemented) has several flaws that give insiders increased strategic trading opportunities compared with the pre-Rule world. We present empirical evidence suggesting that insiders using plans outperform insiders not using plans.

The Rule does not require mandatory disclosure of trading plans, so we exploit this as an opportunity to examine the interaction between disclosure choice and trading outcomes. We present evidence showing that disclosure is increasing in firm litigation risk and insider profit-making potential, and that, counter-intuitively, insiders making the most detailed disclosures outperform the market the most. In other words, transparency is not acting as a disinfectant but a false signal of cleanliness. This ability to hide in plain sight is a downside of disclosure that is unappreciated by the existing literature. We also show how the Rule embeds a costless put option for insiders to profit from future bad news, even if very unlikely, and we discuss how this option may or may not be efficient for firms and shareholders.

Finally, we address the public policy implications of the findings that some insiders are using the Rule strategically to increase their profit-making opportunities. We consider various reforms – mandatory disclosure, limiting termination options, etc. – and conclude that the SEC should not act since various market players (D&O insurance carriers, boards, institutional investors, and so on) have the right incentives to reduce strategic abuse of the Rule while maintaining its benign use. We also an alternative regulation that would achieve the SEC's stated goal more simply, and discuss the implications of the empirical findings for the general debate about insider trading regulation.

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Introduction

In 2000, the Securities Exchange Commission promulgated a new rule (Rule 10b5-1) creating a safe harbor for firm insiders who pre-commit to stock trades. The idea was to broaden when insiders could trade by moving the inquiry into the possession of inside information from the time of the trade to the time when the trade was planned. The intent was to provide insiders, who were generally constrained by legal risk as to the times when they could trade, additional opportunities for *uninformed*, diversification trade. We discuss, however, evidence that some insiders have strategically utilized the Rule to make informed trades or to make informed decisions to abstain from trading. We present both empirical and normative analysis of the Rule.

If the intent of the Rule was to relax insiders' trading constraints, it seems to have had tremendous success: thousands of executives have traded billions of dollars pursuant to these plans, and they have done so at times and in amounts that might have drawn scrutiny before the Rule. The primary benefit of these plans is reduced legal risk, especially the ability to rebut scienter claims in shareholder class actions, and firm insiders have used this protection to make many more trades than they would have without the Rule.

But the SEC intended to divert trades to these plans to reduce the probability insiders would use inside information in making trades, and evidence indicates that along this dimension the Rule has been much less successful. We present empirical evidence showing that insiders using these plans outperform insiders not using these plans, and in ways consistent with exploiting certain features of the Rule. Current research finds sales trades executed within Rule 10b5-1 plans earn returns that are, on average, greater than returns earned by the market index and also returns earned by insiders who execute sales outside of Rule 10b5-1 plans. These findings point in the opposite direction of the SEC's stated purpose of *reducing* informed trades by insiders.

This does not mean, however, the Rule is necessarily flawed. It may be, for example, that social welfare benefits of the Rule, in cases where insiders are fully compliant, outweigh social costs in cases where insiders may be exploitive. These are difficult, if not impossible, calculations to make. Perhaps one useful means to evaluate the Rule is to consider ways to improve Pareto optimality – is it possible to minimize the number of bad transactions while not reducing the number good transactions or to somehow find the optimal number of bad transactions. To do this, we need to understand how insiders might exploit the Rule. We consider two aspects.

First, the SEC did not require firms or insiders using the Rule to disclose the existence or details of their trading plans. The result is large variation in disclosure practices across firms, which allows us the ability to empirically assess whether correlation exists between disclosure and insider profits. Evidence shows that sales trades executed within Rule

10b5-1 plans that have been publicly disclosed earn returns that are, on average, *greater* than returns earned by sales trades executed within Rule 10b5-1 plans that have not been publicly disclosed.¹ In fact, returns are increasing in disclosure, meaning the insiders who make the most transparent disclosures about their future trading plans earn the largest abnormal returns.

Disclosure here, then, does not seem to be a disinfectant but, rather a potential false signal of cleanliness.² We call this counter-intuitive practice “scienter disclosure,” because disclosure reduces legal risk by rebutting the scienter element of fraud suits.³ As we discuss below, the greater the specificity of disclosure, the more likely defendant insiders can win at the motion-to-dismiss phase of litigation, and therefore the less likely a suit will be filed in the first place. The ability to use disclosure in this way suggests potential legal reforms that might make the Rule more efficient and ones (like mandatory disclosure) that won’t.

Second, the SEC interpreted the Rule to allow insiders to selectively terminate pre-committed to trades based on subsequently obtained inside information. This interpretation is consistent with arguments put forth by Professor Jesse Fried, who argues that termination (what he calls “insider abstention”) is unobjectionable, and perhaps even efficient, because of a symmetric cross-subsidy between the ability to abstain (and avoid losses) and the ban on using inside information to plan trades (and not make gains).⁴ Whatever the merits of Fried’s argument in the context of “regular” insider trading (i.e., trades executed outside of Rule 10b5-1), authorized informed abstention strategically favors insiders in the context of the Rule. Legal abstention under Rule 10b5-1 gives insiders a costless option on the future – what we call “insider insurance” – that allows them to plan trades even for low probability bad events, since these trades can be cancelled (at little or no cost) if the bad events do not come to pass. At the extreme, this interpretation amounts to legalization of a information-based option, since insiders can guarantee returns based on their inside information. The existence of insider insurance will likely produce some cases in which insiders can profit at the expense of outsiders in ways unintended by the SEC.

¹ See M. Todd Henderson, et al., “Scienter Disclosure,” Univ. Chic. Law & Economics, Olin Working Paper No. 411, available at <http://ssrn.com/abstract=1137928>.

² Disinfectant is the common description of disclosure: “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” LOUIS BRANDEIS, *OTHER PEOPLE’S MONEY, AND HOW BANKERS USE IT* (1933).

³ This type of strategic disclosure works perfectly only if litigants and courts do not know about its existence. The strategy might work even if they do, since the ability to distinguish between strategic and non-strategic uses will be imperfect, but it will be marginally less effective.

⁴ See Jesse Fried, *Insider Abstention*, 113 YALE L.J. 455 (2003). His argument is the gains insiders may earn through cancelling planned trades to take advantage of good news compensate insiders for the fact that they cannot initiate trades to take advantage of bad news. Thus, returns from two hypothetical trades (the allowed abstention and the disallowed trade with information) cancel each other out, resulting in a neutral net outcome for insiders.

Nevertheless, this costless insurance may be socially efficient in some cases, because it may induce risk-averse insiders to take risks that maximize shareholder value. It is, of course, also possible for the insurance to create a tendency to take excessive risks, even greater than those shareholders contract for. This is likely to vary widely by firm. At the very least, once boards are aware of this feature of the Rule, they can use this fact to tailor compensation packages to address it.

Whether efficient or not at a firm level, these insider-insurance trades are not likely redeemed by the socially useful functions of insider trading, since the information signal from insuring against low-probability events is slight and may be difficult for the market to unpack from other trading activity. Banning these selective terminations, or, perhaps better yet, inducing a cost for this option is another potential reform explored below.

Empirical evidence also shows that both of these characteristics of the Rule—“scienter disclosure” and “insider insurance”—are increasingly useful as firm litigation risk rises and are increasingly deployed by firms with what is traditionally considered good governance, that is, increasing board influence from external and institutional owners. This suggests these forces of good governance are not interested in disclosure for the sake of disclosure, since they do not press for it in cases where the firm is unlikely to need disclosure to reduce legal risk, but rather use disclosure to self-interestedly reduce overall firm costs.

To discuss these and other findings, this paper is organized as follows: Section I briefly outlines the insider trading law that Rule 10b5-1 was designed to influence. It also discusses the basic features of the Rule. Section II describes the costs and benefits of adoption and disclosure of these plans. Section III presents the potential weaknesses of the current Rule, if the Rule’s intent is to mitigate insiders’ informed trade opportunities. Section IV provides a summary of the empirical evidence on insiders’ returns and firms’ choices to disclose participation within and details regarding Rule 10b5-1 trading plans, and the economic implications of these choices. This discussion should also provide insight into firm-specific governance factors associated with observed Rule 10b5-1 disclosure and trading patterns. Section V discusses some policy implications of the current regulatory environment surrounding Rule 10b5-1. It also considers what general lessons can be learned about the rules versus standards debate in regulating insider trading.

I. INSIDER TRADING LAW AND RULE 10B5-1

Paying corporate executives with firm stock helps align the interests of shareholder-owners and managers, however, over-accumulation of firm equity can induce excess risk on executives, whose human capital is also invested in the firm. Since risk-averse insiders tend to prefer diversified portfolios, one can expect most insiders to sell shares with some regularity

to minimize the amount of firm stock they hold.⁵ (We return below to the question of whether the SEC's intent to provide trading opportunities is efficient, but for the bulk of the paper, we take the SEC at its word that it wants to do this and assume, for the sake of argument, that this is a good thing.) These insider trades may impose costs on firms if there is even the perception that insiders trade based on non-public information, since insider trading claims often provide the key scienter element of securities fraud class actions suits. Here we see a natural tension embedded in modern compensation practices: insiders want to trade, either to earn abnormal profits or to create a diverse portfolio, but trading, either benign or opportunistic, can create legal risk.

Law tries to help by providing public ordering and encouraging private ordering designed to optimize the risk for firms, insiders, and society as a whole. It is in a discussion of this background ordering that we find the genesis of Rule 10b5-1.

A. Federal Law

Insider trading is typically not illegal. Only some trades by some insiders under some circumstances may violate federal law or satisfy the scienter requirement in a securities fraud class action. The contours are not at all clear.

There is no federal statute that specifically forbids trading by insiders based on information not known to those whom they trade against, so the legality of insider trades is based on a vague statute, rules and interpretations of the SEC, and a body of case law interpreting these. Section 10(b) of the Securities Exchange Act of 1934 is the wellspring of this body of law: "It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device" Since the statute is ambiguous on the question of whether trades based on asymmetric information on an anonymous exchange are "manipulative or deceptive," the statute delegates to the SEC the authority to write rules to implement the statute for "the public interest or for the protection of investors".

The relevant SEC rule is not a model of clarity either. Rule 10b-5 makes it unlawful to use interstate commerce to, among other things, "employ any . . . scheme . . . to defraud . . . in connection with the purchase or sale of any security." The result of executive agency ambiguity layered on top of congressional ambiguity is judicial power to decide what is and what is not illegal. The law of insider trading is effectively federal common law or, as Chief Justice Rehnquist wrote, "a judicial oak which has grown from little more than a legislative acorn."⁶

As the chief prosecutor of these cases, the SEC's point of view has

⁵ See Eli Ofek & David Yermack, *Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership*, 55 J. FIN. 1367 (2000) (finding senior executives unwind most new option exercises by selling previously owned shares).

⁶ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

considerable influence. The SEC has fairly consistently taken the view (also taken by a minority of states⁷) that insiders have a duty to disclose all material information available to them before trading—the so-called “disclose or abstain” rule.⁸ The rule was first announced in *Cady, Roberts & Co.*, an enforcement proceeding in 1961.⁹ The SEC found liability in the case of an outside director who tipped his partner in a brokerage business about an upcoming dividend cut. Relying on two separate theories—first, that the director expropriated corporate information for personal use; and second, that there is “inherent unfairness” in trading on information knowing it is not known by the other side—the SEC declared an insider in possession of material, nonpublic information (hereinafter “inside” information) must disclose such information before trading or abstain from trading.¹⁰

The Second Circuit endorsed this view several years later, holding in *SEC v. Texas Gulf Sulphur*, that insiders of a mining company trading in advance of public disclosure of a favorable geology report violated Rule 10b-5.¹¹ The court specifically blessed the disclose-or-abstain rule the SEC announced in *Cady, Roberts*, noting this rule “is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.”¹²

The practical impact of all this is a de facto rule of mandatory abstention for insiders in possession of material information unknown to outsiders.¹³ Mandatory abstention from trading is undoubtedly

⁷ See *Oliver v. Oliver* (Ga. 1903)

⁸ The SEC’s position in litigation over the years has been that liability could arise from trades made by any person that has an informational advantage, no matter how that informational advantage arose. There is deep irony here. The expert agency tasked with writing and executing rules interpreting the securities statutes, takes a position—trading only based on equal access to information—that is fundamentally inconsistent with markets arising in the first place. A more generous reading of the SEC’s position is that it understands the need for informational asymmetry, but given limited monitoring and enforcement resources has to lower the burden to make out any particular case in order to achieve the optimal deterrence of socially destructive trading by insiders. Whatever the rationale, the judiciary, especially the Supreme Court, has consistently rejected the SEC’s attempts to broadly define insider trading when involving third parties like journalists, printers, and others unrelated or tangentially related to the inside information. The basic SEC approach regarding insiders is, however, long standing and largely undisturbed by courts.

⁹ *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961),

¹⁰ *Id.*

¹¹ 401 F.2d 833 (2d Cir. 1968),

¹² *Id.* (“It was the intent of Congress that all members of the investing public should be subject to identical market risks . . . The investors were not trading on equal footing with outside investors”)

¹³ The other option, disclosure, is unavailable since the information is likely unknown to outsiders for a (corporate) reason. Taking the information for personal use would be both a violation of an insider’s fiduciary duties (to not profit against the corporation or its shareholders) and, according to the SEC, unfair to market traders outside of the firm, and thus degrading of the public’s confidence in public securities markets.

overinclusive. A rule of this nature would unnecessarily deter insiders from making trades even at times when insiders do not have inside information or are not using it to inform a trading decision. As a result, firms will face additional costs from having to compensate managers for bearing more firm-specific risk.

Some courts recognized this problem, and accepted an “I-would-have-traded-anyway” defense. In *SEC v. Adler*, the Eleventh Circuit held that the government had to prove not only that an insider “possessed” inside information at the time of trading, but also the insider “used” the information to make the trading decision.¹⁴ The prototypical case was an insider claiming she planned to make a trade on the date in question some time before when she did not possess inside information, and the possession of inside information at the time was purely an unfortunate and unintended coincidence. These cases routinely include a reason for the planned sale, such as the expiration of a mandatory holding period following an IPO or other transaction, or in order to pay extraordinary expenses. The SEC, supported by other circuit courts, continued to claim the statute banned trading while merely in “possession” of inside information, and its burden was only to show this.¹⁵

Before turning to the SEC’s attempted resolution of this split of authority, it is worth pausing to consider the private ordering that operates in the background of these legal rules.

B. Private Ordering

The SEC’s disclose-or-abstain rule strongly deters trades by insiders, so firms are forced to find a way of providing trading opportunities for insiders, while minimizing the potential firm costs of such trades. The biggest potential cost from trades is the risk of fraud. Insider stock sales are frequently used as evidence of “scienter,” a necessary element of any securities fraud case, especially when they are unusual in time or amount. All else being equal, insider sales showing managers benefited monetarily from trades made during the time when alleged misrepresentations affected the firm’s stock price will increase the firm’s litigation risk.¹⁶ Although in the pre-Rule world insiders could have pre-committed to trades, such private contracts were of limited value because they were not legitimate defenses to insider trading in many circuits (where the possession standard was the law), and were highly uncertain where they were accepted.

¹⁴ 137 F.3d 1325 (11th Cir. 1998). The Ninth Circuit adopted the same “use” standard in *United States v. Smith*, 155 F.3d 1051 (9th Cir. 1998).

¹⁵ See, for example, *United States v. Teicher*, 987 F.2 112 (2d Cir. 1993).

¹⁶ As discussed below, the expected costs for firms are quite large—several million dollars per year per firm—and, more importantly, the variance in settlement outcomes is likely to be high, with ranges from several million to several billion, depending on the conduct, the jury, and the underlying business and political climate.

Prior to the promulgation of Rule 10b5-1, the primary mechanism for limiting firm risk from insider sales was the use of contracts limiting the time and manner of insider sales. Firms impose “blackout windows” that restrict the times when insiders can trade to those when insiders are least likely to have access to inside information.¹⁷ This widespread practice means that there are very limited trading windows outside of which transactions are prohibited.¹⁸ Research suggests that, prior to Rule 10b5-1, insiders of firms with blackout windows dramatically reduce the trading within these windows.¹⁹

The restrictions are imperfect for several reasons. First, the restrictions are only a crude proxy for when insiders might actually possess inside information—for example, within 30 to 45 days of earnings announcements—and thus are likely to be both overinclusive and underinclusive. Trading outside of designated trading windows is verboten, even if the insider does not possess an informational advantage, and likewise, trading inside is likely to have some litigation prophylactic benefits, even if the insider does so based on material information.

Second, the restrictions greatly reduce the times at which insiders can trade, thus concentrating sales and raising the stakes for each sale. This may give insiders incentives to manipulate other aspects pertaining to the trade, such as the timing of the release of firm information, in ways that skirt the contractual restrictions. Studies show insiders are able to strategically time disclosures to avoid the restrictions of trading windows.²⁰ The lesson from this is that risk-reduction strategies in the discretion of management may not effectively provide a strong prophylactic effect.²¹ This is borne out somewhat by the fact there are no

¹⁷ Another version of this would be to require executives to put all firm equity into a blind trust. The costs of such a strategy are sufficiently large as to make this an unacceptable condition for executives. A more modest version of this is the use of pre-commitment trading plans discussed below.

¹⁸ A study by Carr Bettis and others found that, as of 1996, about 80% of firms imposed blackout periods. See J. Carr Bettis, et al., *Corporate Policies Restricting Trading by Insiders*, 57 J. FIN. ECON. 191 (2000). These windows come in two forms: static trading windows that permit trades at certain pre-specified periods, most commonly for the period 3 through 12 days following a quarterly earnings announcement; and dynamic trading windows that are adjusted depending on idiosyncratic, firm-specific situations. For example, a firm may want to block trades in an otherwise open window because of extra-ordinary news it is about to release. In practice, firms routinely use both of these strategies, which amount to nothing more than the firm’s best guess about the times when insiders may or may not possess inside information. See Netflix Insider Trading Policy, available at <http://ir.netflix.com/documentdisplay.cfm?DocumentID=74> (last visited August 28, 2006).

¹⁹ See Bettis et al., *supra* note ____.

²⁰ See David Aboody & R. Kasnik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCOUNTING & ECON. 73 (2000) (finding managers about to receive options disclose negative news and withhold good news in order to increase the options’ value).

²¹ See, for example, Q Cheng & K. Lo, “Insider Trading and Voluntary Disclosures,” Working Paper, University of British Columbia (2004) (timing of insider

cases in which a suit alleging insider trading has been dismissed on the grounds the trades complied with firm-imposed trading windows.

Finally, boards do not have great information about the private trading habits of insiders, since boards' ability to oversee the private trading of insiders is both impractical and not legally required.²² Insiders are compensated in options to align their incentives with shareholders, but insiders need to convert these options to cash, and would like to do so more often than shareholders would prefer. Trading windows are thus likely to force obfuscation of insider diversification, as much as compliance with insider trading policies.

In light of these problems and the uncertainty created by the split of authority on the "use" versus "possession" issue, the SEC promulgated Rule 10b5-1 to broaden the opportunity set for insiders' trades (thus providing incentives for firms to relax constraints from firm-imposed blackout windows), but trying to limit insiders' ability to use private information to their advantage. We turn now to a brief examination of the Rule.

C. Rule 10b5-1

The SEC established these plans as a defense to allegations of illegal insider trading in October 2000, after it adopted a broad interpretation of the "on the basis of" language in Rule 10b-5. The SEC formally codified the "knowing possession" standard, making federal prosecutions of insider trading significantly easier. Recognizing this tightening of the legal standard put even more pressure on executives trying to execute uninformed diversification trades, the SEC provided insiders with a new affirmative defense for trades planned at a time when the insider was uninformed, regardless of whether the insider was informed when the trades executed. In other words, the SEC codified a version the I-would-have-traded-anyway defense in cases in which the insider complied with the provisions of the Rule.²³ It chose rules over standards, and the results discussed in this paper show that the outcome appears mixed.

The Rule provides that insiders trade "on the basis of" when they are "aware of material nonpublic information when [they] made the purchase or sale."²⁴ This definition is subject to an affirmative defense if the insider can show that "before becoming aware of the information" the insider:

share purchases influences timing of good news and bad news); Jonathan Rogers, "Disclosure Quality and Management Trading Incentives," Working Paper, University of Pennsylvania (2004) (quality of disclosures influenced by timing of share purchases).

²² See, for example, *Beam v. Martha Stewart Living Omnimedia, Inc.*, 833 A.2d 961 (Del. Ch. 2003) (finding no duty for board to monitor or police sales of stock in private portfolio of CEO).

²³ In effect, the SEC gave a rule-based exception for the I-would-have-traded-anyway arguments that it found credible (those with hard evidence of pre-commitment) by offering a less costly way of achieving the same end.

²⁴ See 17 CFR § 240.10b5-1(b).

- “(1) entered into a binding contract to purchase or sell the security; (2) instructed another person to purchase or sell the security for the [insider’s] account, or (3) adopted a written plan for trading securities.”²⁵;
- put in the plan “(1) . . . the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; (2) . . . a written formula or algorithm . . . for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or (3) [did] not permit the [insider] to exercise any subsequent influence over [transactions]”²⁶; and
- did not “alter[] or deviate[] from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or enter[] into or altered a corresponding or hedging transaction or position with respect to those securities.”²⁷

This final prerequisite could be read as limiting the ability of an insider to selectively cancel plans based on inside information, however, the SEC does not take this position. Believing there can be no securities fraud without an actual purchase or sale transaction, the SEC stated that canceling a plan based on private information is not inconsistent with the Rule.²⁸ This position is based in part on the perceived reach of the statute, and is seemingly supported by Professor Fried’s argument about the efficiency benefits that might arise from allowing insiders to cancel planned trades.²⁹ We take up an analysis of Fried’s argument in the context of the Rule below.

The SEC did state, however, that canceling a plan in this way could raise questions about whether the plan was entered into in good faith. Hence another requirement: the Rule includes a catchall provision intended to avoid manipulation that complies with the letter but not spirit of the Rule. Plans that are not entered into in “good faith” or are entered into “as part of a plan or scheme to evade” the Rule do not get the benefit of the affirmative defense.³⁰ As discussed below, this safety valve is not likely effective in both theory and practice. It is not clear that this good faith requirement can be readily enforced by the SEC (perhaps because it is procedurally very difficult), and empirically, insiders appear to retain a strategic advantage.

²⁵ Rule 10b5-1(c)(i)(A)(1)-(3).

²⁶ Rule 10b5-1(c)(i)(B)(1)-(3).

²⁷ Rule 10b5-1(c)(i)(c)(1)-(3).

²⁸ See SEC Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Fourth Supplement, Rule 10b5-1, Question 15 (issued May 2001).

²⁹ See Fried, INSIDER ABSTENTION, *supra* note ____.

³⁰ Rule 10b5-1(c)(ii).

Returning to the strategies firms can use to allow trading, yet limit costs, firms could require (or simply allow) executives to make certain or all trades pursuant to pre-commitment trading plans.³¹ These plans could serve as substitutes for trading windows or other contractual restrictions. An insider with no legally significant information possession as of January 1st could enter into a trading plan on that day, agreeing to buy or sell shares pursuant to a set schedule, a pre-set trading algorithm, or merely designate authority to a broker. Thus, in June when the insider obtains possession of inside information, purchases or sales are still possible. According to the Rule, the June sales are not “on the basis of” inside information because of the pre-commitment. These plans are often explicit substitutes for compliance with trading windows, meaning that sales can be made under these plans at any time.³² (They are often adopted during open windows, however, as this helps meet the Rule’s requirement that the plan be entered into in “good faith” at a time when the insider does not have any inside information.)

The Rule as promulgated did not require disclosure of any kind, but in April 2002, the SEC proposed mandatory disclosure, through 8-K filings, of insiders’ use of Rule 10b5-1 trading plans.³³ Specifically, the proposal required disclosure of the name and title of the director or executive officer, the date on which the director or executive officer entered into the 10b5-1 plan, and a description of the contract, including duration, the aggregate number of securities to be purchased or sold, and the name of the counterparty or agent. The proposal also required disclosure if the director or executive officer later terminated or modified a plan.

There were relatively few comments on the proposal, but most were opposed to mandatory disclosure. The primary ground for opposition was that disclosure might send erroneous signals to the market about the insiders’ intent in entering into the plan. The following comment is typical:

Prospective arrangements for the sale or purchase of a company's securities, which may be conditional or otherwise subject to material limitations, are not, however, [indicative of insiders’ views of company performance.] There are a variety of reasons why a person may enter into a Rule 10b5-1 plan. Many executive officers have concentrated positions in company stock as a result of the company's

³¹ Rule 10b5-1(c)(1)(C).

³² Netflix’s insider trading policy is again typical: “[Trading window] restrictions on trading shall not apply to transactions made under a trading plan adopted pursuant to . . . Rule 10b5-1(c).” See Netflix Insider Trading Policy, available at <http://ir.netflix.com/documentdisplay.cfm?DocumentID=74> (last visited August 28, 2006).

³³ SEC Release No. 33-8090, Proposed Rule: Form 8-K Disclosure of Certain Management Transactions.

compensation policies, and they may be seeking to balance a need for investment diversification or liquidity against the not insignificant risk of "insider trading" liability under Rule 10b-5. The existence of a Rule 10b5-1 plan no more indicates an insider's view of a company's prospects than, for example, a universal shelf registration statement indicates a company's intention to allocate the entire shelf to equity securities. In other words, requiring disclosure of the mere presence of these plans would attribute meaning where none may exist.³⁴

The disclosure proposal was tabled indefinitely, so there is currently no requirement for firms or insiders to provide detail regarding whether or how they participate within their trading plans. Many firms, however, choose to disclose information regarding insiders' trade plans. These disclosure choices are inherently interesting because they potentially offer insight into firms' and insiders' utilization of the Rule.

We turn now to a discussion of the costs and benefits of adopting and disclosing these trading plans.

II. ADOPTION AND DISCLOSURE CHOICE

A. Adoption

Rule 10b5-1 trading plans have been adopted widely—at least 600 firms and over 1000 individual insiders have disclosed that they have used these plans since 2001. Since disclosure is not required and we are told by brokers who manage plans that thousands of them are not disclosed, this number likely materially underestimates the actual number in use.³⁵ Trading volume is high too, in fact statistically higher for most executives relative to trading prior to the Rule. Executives at Fortune 500 firms sold about \$8.5 billion in stock through these plans in 2006, a 60 percent increase from 2004.³⁶

The benefits of adoption are potentially large and inure primarily to the firm.³⁷ By reducing the probability a trade by an insider is informed (or, at the very least, the perception that it is), trades within the Rule should help the firms reduce their costs of capital and reduce the firm's litigation risk (by decreasing the expected costs associated with insider trading and securities fraud suits). Firms perceive these costs to be higher

³⁴ See Comment of Clearly Gottlieb Steen & Hamilton, June 24, 2002, available at <http://www.sec.gov/rules/proposed/s70902/clearygottlieb1.htm>.

³⁵ Interview on July 30, 2006.

³⁶ See Dionne Searcey & Kara Scannell, SEC Now Takes a Hard Look at Insiders' 'Regular' Sales, WALL STREET JOURNAL, April 4, 2007, at C1. Cite to statistics from HJM 2008.

³⁷ There are undoubtedly some benefits for insiders, but, as discussed in section II.B.1, these are small and dwarfed by the benefits to firms.

than the benefits of free trading by insiders, which explains their attempt to restrict insider trading by contract to times when least likely to expose the firm to these risks. Rule 10b5-1 trading plans presumably permit insiders and firms to capture the benefits of more liberal trading by insiders while mitigating the downside risks.

In light of these benefits, one might expect all insiders to enter into these plans, especially since at first blush a secret intent to trade can have no (or very little) costs. There is not good data on the question of adoption, however, so we cannot know for sure what percentage of firms or insiders are using these plans. Existing empirical studies, however, suggest that not all executives use these plans, and for executives that do use them, they do not do so for all their shares or at all times. Our interviews with corporate advisors support this conclusion, as they tell us that not all insiders adopt these plans and those who do so are often compelled by their firms.³⁸ This lack of universal adoption also explains why we see law firms and other academic articles and marketing materials.³⁹

There may be several reasons for the lack of universal adoption. First, insiders who believe that prices will rise in the future or who are planning to buy shares have little reason to enter into these plans. In fact, empirical studies show that nearly all insider trades in Rule 10b5-1 plans are sales.⁴⁰ Second, using a trading plan reduces trading flexibility, even if uninformed, and therefore imposes costs on insiders. For example, an insider might want to be able to sell after a run-up in stock price, even if the insider has no information that the particular price is at a peak. Pre-commitment by definition reduces future options for trading, and insiders might perceive (wrongly, as we show below) some costs in the form of lost profit-making opportunities. Third, the Rule has been in effect for less than a decade, and the uncertainty about how the Rule could be used and how it would be interpreted may limit the ubiquity of its use. There have been very few cases on point and little advice or interpretation by the SEC. Finally, some firms might prefer an alternative, and perhaps more rigorous, mechanism for policing insider trades, and therefore specifically ban the use of the plans by insiders. We are aware of several high-profile firms that take this approach. One firm we spoke with uses the general counsel to approve all trades by insiders, and therefore has prohibited the use of these plans.⁴¹

In addition to adoption, firms and insiders must also decide whether to disclose the existence of plans that are adopted. There are several obvious benefits and costs of disclosure. We turn to these next.

³⁸ Based on interviews with three lawyers representing firms on executive compensation matters, and two investment bankers who handle 10b5-1 contracts (conducting in December 2007).

³⁹ See, for example, Lyle Roberts & Nicholas Porritt, *Individual Trading Plans Can Help Defend Securities Fraud Claims*, COMPLIANCE WEEK, Jul. 7, 2004 (advertising the benefits of these plans).

⁴⁰ Many firm repurchase programs utilize Rule 10b5-1.

⁴¹ Interview with senior lawyer at Coca-Cola Co., conducted in June 2008.

B. Disclosure

At first cut, it would seem that disclosure is a sine qua non of reaping any of the benefits described above. How can a trading plan provide cost of capital or litigation prophylactic benefits if no one knows about it outside the firm? One might then expect that the set of firms that adopt but do not disclose the existence of these plans is empty. But that is not the case. Many hundreds of firms have adopted but not disclosed the existence of trading plans.

To answer this puzzle, one must recognize that disclosure has not just benefits but also costs, and in some cases the latter will swamp the former. For example, disclosure may increase marginal litigation prophylactic benefits, but may also decrease insider profit-making opportunities, either by reducing insider flexibility to time trades or by allowing outsiders to trade in advance of pre-planned trades. As one corporate advisor has written, many public companies may be reluctant to disclose Rule 10b5-1 plans, because “calling attention to decisions to sell by their insiders can only hurt the company because many investors believe these decisions reflect a loss of confidence by the insiders in the company.”⁴² We now turn to a consideration of the costs and benefits of disclosure.

1. Benefits of disclosure

Firms are likely to believe utilizing and disclosing 10b5-1 trading plans reduces their litigation risk exposure, be it from a securities fraud class action, shareholder derivative suit, or SEC enforcement proceeding.⁴³ For firms, the total potential losses from these suits are significant: average settlements over the past 10 years are approximately \$30 million per suit, with over 10 suits settling for between \$300 million and \$6 billion in 2005 alone.⁴⁴ Firms also incur substantial costs in defending suits, with legal fees alone exceeding \$2 million.⁴⁵ The risk of being sued is also relatively high, with an average of over 200 suits per year over the past 10 years, or about a 10 percent chance of a firm being sued over a five-

⁴² Interview with attorney Peter J. Romeo, conducted June 6, 2006. *See also*, Peter J. Romeo & Alan L. Dye, *Insider Trading Under Rules 10b5-1 and 10b5-2*, ALI-ABA 893, July 18, 2002.

⁴³ *Cf.* Bettis et al., *supra* note ____ (mentioning potential litigation risk reduction effect of blackout windows).

⁴⁴ *See* PwC Advisory, 2005 Securities Litigation Study, at 16-18, available at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2005_Final.pdf. *See also* Elaine Buckberg, *NERA Economic Consulting: Recent Trends in Shareholder Class Action Litigation* (2005), available at http://www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf.

⁴⁵ *See* Laurie P. Cohen, “Adding Insult to Injury: Firms Pay Wrongdoers’ Legal Fees”, *The Wall Street Journal*, February 17, 2004 (“A company’s average cost of defending against shareholder suits last year was \$2.2 million according to Tillinghast-Towers Perrin.”).

year period.⁴⁶ Firms insure against these losses, but only about half of expected losses (damages or settlements) are covered by insurance.⁴⁷ As such, reduction in ex ante litigation risk can be expected to lead to lower insurance premiums (for both firm-level and D&O insurance).

This benefit will inure primarily to the firm, despite the fact that managers are personally named in nearly all cases⁴⁸ and despite the fact that litigation against the firm might be expected to have a reputational cost for managers. This is because managers “almost never contribute personally to settlements,” because firms indemnify them, pay their legal expenses and portions of fines,⁴⁹ and pay for individuals’ D&O insurance premiums.⁵⁰ According to studies of the source of settlement payments, managers contribute less than one percent of total payments.⁵¹ Managers also rarely lose their jobs or suffer reputational losses from this type of litigation,⁵² leading Roberta Romano to conclude that suits have little to no deterrent effect on individual managers.⁵³ In addition, corporate insiders are very rarely the subject of SEC enforcement proceedings. The SEC litigates less than 50 insider trading cases per year (47 in 2007), and the targets are usually brokers, dealers, or various tippees of these constructive insiders, such as friends and family.⁵⁴ Although there have

⁴⁶ See PwC Advisory, 2005 Securities Litigation Study, at 16-18, available at http://www.pwc.com/images/us/eng/about/svcs/advisory/pi/SecLitStudy_2005_Final.pdf; see also Elaine Buckberg, *NERA Economic Consulting: Recent Trends in Shareholder Class Action Litigation* (2005), available at http://www.nera.com/image/BRO_RecentTrends2006_SEC979_PPB-FINAL.pdf (finding that the average public corporation faces a 10% probability that it will face at least one securities class action suit over five years). About 20 to 30 percent of all cases are dismissed, so the probability of facing a suit that survives a motion to dismiss is about 1% per year. *Id.* at 2.

⁴⁷ Interview with D&O insurance carrier, conducted June 2008.

⁴⁸ See PwC Advisory, *supra* note ___ at 11 (CEOs were named in 96% of all cases in 2005; CFOs in 82%; and Chair of the board in 72%).

⁴⁹ Firms can avoid paying legal expenses in a limited class of cases, for example, where the manager has engaged in criminal conduct. But even in these cases, firms are typically required (by Delaware law and firm charter) to pay for the defense upfront pending a final disposition of the case. See *Rite Aid* [insert cite] (holding that firm must continue to pay defense fees of former CFO, despite guilty plea to criminal fraud, because there had not been a “final disposition” of the case).

⁵⁰ See Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1499 (1996).

⁵¹ See, e.g., Frederick C. Dunbar, et. al., *Recent Trends III: What Explains Settlements in Shareholder Class Actions?* (Nat’l Economic Research Assocs., Inc. 1995) (over the period 1991 to 1994, about 70% of settlements were paid by firm insurance, with the remaining 30% being paid by the firms themselves).

⁵² An exception is criminal proceedings, but these are extremely rare (<50 per year by the SEC), and are the class of cases least likely to be influenced by trading plan disclosure practices.

⁵³ See Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. Econ. & Org. 55, 84 (1991).

⁵⁴ See Joanna Chung, *Watchdog alert over return of insider trading*, FIN. TIMES, June 4, 2008 (“The SEC brought 47 insider trading cases last year, similar to the number in 2006.”).

been a few high-profile cases involving corporate insiders, these too have usually been about trading in other firms' stock.⁵⁵

Although nothing within the Rule limits its application to cases in which the trading plan was disclosed prior to the trade or the filing of the complaint, the peculiarities of civil procedure and the typical course of this class of cases make such disclosure an important element of any risk reduction strategy. As a matter of practice, the vast majority of class action lawsuits alleging securities fraud are won or lost at the "motion to dismiss" phase of the litigation. In every case, defendants file a motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6), arguing that even if plaintiffs' allegations are true, relief cannot be granted on the face of the complaint. If the motion is not granted, the litigation proceeds to discovery, which is likely to be costly to defendants, in real dollar terms, in distraction and opportunity costs, and in potential piggyback litigation based on materials uncovered during the process. Hence, nearly all cases in which such a motion is not granted settle, often for many millions of dollars. According to a lawyer specializing in these cases we spoke with, "the game is won or lost with the motion to dismiss."⁵⁶

But the litigation prophylactic works well (if at all) only when the existence of the plan is publicly disclosed. This is because when ruling on a motion to dismiss, courts generally do not consider materials other than the pleadings, taking the facts alleged in the complaint as true; defendants may not rebut factual allegations at this stage in the process.⁵⁷ Publicly available documents, however, may be considered in securities fraud cases "as long as they are integral to the statements within the complaint."⁵⁸ "Integral" means basically related to the issues, and publicly available and accurate,⁵⁹ so courts routinely take judicial notice of SEC filings, prospectuses, analysts' reports, and other publicly available documents relating to a firm's financial statements, even if not part of the complaint.⁶⁰ This point highlights the need for defendants to make the existence of 10b5-1 trading plans public, either through press release or filing with the SEC.⁶¹

⁵⁵ The most high-profile case in recent memory is the prosecution of Martha Stewart. She was jailed not for trading, but for lying about trading, and not even in her own firm's stock, but rather in one where her friend was the CEO.

⁵⁶ This is widely accepted, but is confirmed by lawyers who try these cases. In an interview with lawyer Jim Kramer, we heard this refrain again and again. Interview conducted in June 2008.

⁵⁷ See, e.g., *Weiner v. Klais & Co.*, 108 F.3d 86, 88-89 (6th Cir.1997).

⁵⁸ *In re Cardinal Health Inc. Sec. Litig.*, 426 F.Supp.2d at 712 (emphasis added).

⁵⁹ See Fed. Rule of Evid. 201(b) (judicial notice appropriate if facts are "not subject to reasonable dispute in that [they are] either (1) generally known within the territorial jurisdiction of the trial court or (2) capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned.").

⁶⁰ See, e.g., *In re Royal Appliance Sec. Litig.*, 1995 WL 490131, at *2 (6th Cir. Aug.15, 1995).

⁶¹ Not all defendants will be as fortunate as those in *Monterey Pasta*, where plaintiffs alleged in the complaint that defendants' sales were made pursuant to Rule 10b5-1.

The several cases that have considered the issue of disclosure take a range of positions, all of which make disclosure a sine qua non of any defense at the motion to dismiss stage. The most extreme position is staked out by the court in *Fener v. Belo Corp.*, which holds that plaintiffs have an obligation to address in their complaint whether a trading plan was in effect, and if so, “why . . . this does not undercut a strong inference of scienter.”⁶² In effect, the court requires plaintiffs to rebut a potential affirmative defense as part of the case in chief, something that cuts against the typical conceptualization of pre-trial civil procedure. The court finds a way around this seemingly innovative result, by claiming that the existence and timing of a 10b5-1 trading plan is inherently part of plaintiff’s obligation to meet the pleading with particularity standards of the PSLRA—a strong inference of scienter is impossible without regard to whether or not a plan is in place.⁶³

A middle ground of sorts was taken by the court in *Friedman v. Rayovac Corp.* Plaintiffs alleged that defendants’ stock sales gave rise to a strong inference of scienter, in part because the fortuitously timed sales were the only ones made by defendants over a two-year period. Defendants attached a copy of defendants’ 10b5-1 trading plan to their motion to dismiss to rebut the inference of scienter. The court noted that it would generally not consider the trading plan or any other document appended to the motion to dismiss, but it would in this case since the plan was “publicly available on the SEC’s website and was filed as an exhibit to numerous reports Rayovac filed with the SEC.”⁶⁴ This result obtains in nearly every other case to address the issue.⁶⁵

The clear lesson from this line of cases is disclosed trading plans are likely operative at the motion to dismiss stage, while non-disclosed plans are likely not. This seems to represent the consensus view not only among courts, but also among corporate advisors. Institutional Shareholder Services, the largest proxy advising firm for institutional shareholders, concludes, “such plans should be filed in some form with the SEC so that

⁶² 425 F.Supp.2d 788 (N.D. Tex. 2006).

⁶³ A key issue on which these motions routinely turn is scienter. Under the revised pleading standards of the PSLRA of 1995, to survive a motion to dismiss, a plaintiff must plead with “particularity facts giving rise to a strong inference that the defendant acted with knowledge or recklessness.” In re Cardinal Health Inc. Sec. Litig., 426 F.Supp.2d 688, 718 (S.D. Ohio 2006). This is usually done through claims defendants profited from alleged misrepresentations by buying or selling the stock at artificially high or low prices. A trading plan can provide a counterpoint to such a claim, since it is arguably more difficult for insiders to profit from a misrepresentation when a trading plan is in place.

⁶⁴ *Friedman v. Rayovac Corp.*, 291 F. Supp. 2d 845, 855 (W.D. Wis. 2003).

⁶⁵ See In re Netflix, Inc. Sec. Litig., 2005 WL 1562858 (N.D. Cal. June 28, 2005) (considering publicly disclosed trading plan at motion to dismiss stage to find no strong inference of scienter); *Weitschner v. Monterey Pasta Company*, 2003 WL 22889372, No. C 03-0632 (N.D. Cal. Nov. 4, 2003) (same).

[they] . . . can be considered at the motion to dismiss stage.”⁶⁶ Lawyers advising firms on securities fraud litigation matters also think disclosure is a prerequisite to risk reduction: “[t]he adoption of the Rule 10b5-1 trading plans . . . should be publicly disclosed” to reduce the risk of litigation.⁶⁷

One court reaches a slightly different result, holding the consideration of a trading plan at the motion to dismiss stage is premature.⁶⁸ But even this case supports disclosure as a risk reduction strategy. Plaintiffs alleged that insider stock sales created a strong inference of scienter; defendants countered with respect to one defendant—Jensen—that his trades were based on a trading plan that was publicly disclosed. Plaintiffs noted in response, however, that Jensen entered into his trading plan after the class period began, thus raising factual issues about exactly when the plan was enacted and whether the enactment was in “good faith”. As the court noted, the timing arguments were “crucial” factual disputes because, in the light most favorable to the plaintiffs, they “could very well point to Jensen's effort to dump his . . . stock.”⁶⁹

These are clearly inappropriate issues for the court to resolve in defendants’ favor at the motion to dismiss stage, so the result is not controversial or inconsistent with the other courts that have considered this issue. Moreover, the ruling does not change the deterrent effect of disclosure. Disclosure is only ineffective in the small number of cases where factual issues, such as timing, are relevant, and, in any event, disclosure cannot hurt but certainly may help in these cases. As such, disclosure reduces the plaintiff’s ex ante probability of winning, even if ex post it is not sufficient in some narrow class of cases.⁷⁰ In addition, publicly available trading plans may be of more authority than other plans later in litigation, say at the summary judgment phase. Finally, firms may

⁶⁶ See ISS Securities Litigation Watch, “More on Trading Plans/Restrictions and Motions to Dismiss: Monterey Pasta Co. and Rayovac Corp.,” available at http://slw.issproxy.com/securities_litigation_blo/2003/11/index.html (last visited August 29, 2006).

⁶⁷ Lyle Roberts & Nicholas Porritt, “Individual Trading Plans Can Help Defend Securities Fraud Claims,” COMPLIANCE WEEK (Jul. 7, 2004). Numerous law firms advertise 10b5-1 plan design on their web sites, and all mention litigation risk reduction as a primary benefit. See Barry Siegel and Kelly Lenahan, “Rule 10b5-1 Trading Plans: Planned Liquidity for Insiders,” THE TECH. TIMES (Dec. 2002), reprinted at http://www.klehr.com/Articles/bs_kl1202.html (last visited Aug. 30, 2006) (“While public disclosure of a trading plan is not required, such disclosure often helps to minimize the market impact and negative implications of insider sales.”).

⁶⁸ See *In re Cardinal Health Inc. Sec. Litig.*, 426 F.Supp.2d 688 (S.D. Ohio 2006); *cf. In re Cray Inc.*, 431 F.Supp.2d 1114, 1131 (W.D.Wash., 2006) (in shareholder derivative action) and *Limatour v. Cray Inc.*, 432 F.Supp.2d 1129, 1151 n.9 (W.D.Wash., 2006.) (noting in dictum that affirmative defenses are not relevant at motion to dismiss stage, but that “the use of the plans may raise an inference in Defendants’ favor that the sales may not be suspicious.”).

⁶⁹ *Id.* at n.58.

⁷⁰ See, e.g., *Crocker v. Carrier Access Corp.*, 2006 WL 2038011 (Jul. 18, 2006, D.Colo.) (factual dispute about whether defendants controlled entity that was delegated authority under plan).

bear public relations costs from the filing of a suit, in which case raising the expected costs (or reducing the expected value of) a suit is important.

This result also points to the benefits from disclosing details about planned trades, as the more specific the disclosures, the more likely the plan can be dispositive at the motion to dismiss stage. A recent First Circuit decision highlights the importance of making specific disclosures to increase litigation benefits.⁷¹ The court reversed the lower court, which had granted defendants' motion to dismiss on the ground that the use of a Rule 10b5-1 plan rebutted plaintiffs' allegations of scienter. The court held that the motion to dismiss was improper, because the court could not tell from publicly available documents if the specific trades in question were covered by the plan: "[T]here is no evidence of when the trading plans went into effect, that such trading plans removed entirely from defendants' discretion the question of when sales would occur, or that they were unable to amend these trading plans."

Non-disclosed plans may still provide some litigation prophylactic benefit, but this won't come until the summary judgment or trial phase since non-public plans cannot be considered by the court before that time. Thus, non-disclosed plans provide more risk reduction than not having a plan at all; limited disclosure plans provide more than non-disclosed plans; and specific disclosure plans provide more than limited plans.⁷² Whatever benefits arise from disclosure must be compared against the costs of disclosure, which are different depending the nature and specificity of disclosure.

2. Costs of disclosure

Firms are generally the primary beneficiaries of 10b5-1 participation and disclosure, since it may lead to lower litigation costs, better pricing of firm securities, lower cost of capital, and improved firm reputation. While managers indirectly benefit from each of these benefits,

⁷¹ *Miss. Pub. Employ. Retire. Sys. v. Boston Scientific Corp.*, 523 F.3d 75 (1st Cir. 2008) (reversing grant of motion to dismiss because trial court inappropriately considered undisclosed 10b5-1 trading plan).

⁷² Although most obviously beneficial as a deterrent to private lawsuits, disclosure may also be relevant regarding government litigation. After all, the Rule was established as a carve-out from a broadening of the SEC's view about the requisite mental state for proving securities fraud. It is of course possible the government would take notice of the existence of a plan, disclosed or not, before it proceeded with litigation alleging illegal insider trading. In a recent case, however, a court used the existence of a trading plan to rebut the SEC's allegations of the requisite scienter for securities fraud. *See S.E.C. v. Healthsouth Corp.*, 261 F.Supp.2d 1298, 1322-3 (N.D.Ala., 2003). This case shows that while there may be cases in which the SEC learns of non-public trading plans during a pre-indictment investigation and is deterred from taking further action, this is not the only potential outcome. Moreover, even in cases in which a non-public plan would stall an investigation, firms may suffer public relations or other harms from SEC investigations—Wells Notices are commonly reported in the financial press—and public disclosure of trading plans may help reduce the risk of being investigated in the first place.

the evidence of managerial reputation, turnover, and incentives suggests that the benefit is very slight to non-existent.⁷³ In contrast, the costs of disclosure are likely to fall primarily on insiders, whose strategic trading options are likely to be curtailed as a result of the disclosure of trading plans.

First, insiders are likely to believe disclosing 10b5-1 trading plan participation in anticipation of future trades will reduce the profitability of these pending trades.⁷⁴ The basic intuition is fairly straightforward: if outsiders are aware of insiders' trading plans, they may change their buying or selling behavior in a way that can eliminate some (or all) of the profits from the planned sales. For example, say the plan is for the insider to sell 1 million shares on a particular (but undisclosed) day each month. If other investors know this, they may lower the price they are willing to pay pending the arrival of a large block of shares they know is about to enter the market. This would have the effect of lowering the price the insider would be able to get for the stock, and thus the expected profits from the transaction. This concern is often cited by legal advisors and firm executives as a justification for non-adoption or non-disclosure.

Second, insiders may also believe making specific disclosures about future trading implicitly commits them to trade in accordance with their plan. While this might seem trivial considering plans are often referred to as "binding contracts" or "pre-commitments," there is some flexibility built into trading plans according to the SEC's interpretation of the Rule—for example, it is arguable that plans can be terminated at any time, even when an insider is in possession of inside information. As discussed below, the cost of termination increases with the specificity of disclosure, since ex post monitoring is easier where details about planned trades are known. This "lock-in" effect is also a typical justification given for non-adoption or non-disclosure.

As with the issue of signaling sale plans, disclosure need not lock in an executive to a particularly bad outcome. Disclosure can be made in general terms, such as that a plan has been entered into and announcing the number of shares expected to be bought or sold sometime in the future. This coupled with the fact that plans can be designed to respond dynamically to negative or positive events, through the use of trading algorithms, limit and stop orders, and delegation to a fiduciary, such as a broker, should reduce this cost somewhat. There is a tradeoff, however, between disclosure and risk reduction, as the greater the disclosure, the more likely that it will be an effective deterrent. It isn't clear as a

⁷³ See, for example, Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 84 (1991).

⁷⁴ Nothing in the Rule requires that it be the exclusive mechanism for buying or selling during the operative period of the plan, but two considerations will limit this strategy. First, any sales made outside of an existing plan would be viewed with suspicion during any government investigation and would defeat any litigation prophylactic effect from disclosure. Second, any trades outside of the plan would be aggregated with sales under the trading plan for purposes of Rule 144 dribble-out limits.

theoretical matter how this cuts, with the likely answer being different for different firms. Since the only transactions that plan design seemingly cannot address—those in which the insider wishes to terminate based on inside information—are those likely to be most costly for firms (and for insiders not to take advantage of), the disclosure question is highly suggestive of power within the firm.

A third cost frequently mentioned by executives from firms that did not disclose the existence of trading plans is the loss of “privacy”.⁷⁵ Part of this is simply a less crass way of packaging the signaling and lock-in effects discussed above—executives don’t want to reveal their trading practices for fear of constraining profit making opportunities. There might be another part that is not about money, but it is hard to know what it might be in the context of executives who are required to disclose all details about their compensation, including details like perks, and all of their transactions in firm stock. The marginal loss of “privacy” from disclosing the transaction details before the trade instead of after the trade are likely very small. Moreover, disclosures about the existence of a plan, as compared to the details of the plan, do not tell anything about the executive’s private wealth portfolio.

Privacy losses are closely related to another reason commonly voiced: firms and executives have an aversion to voluntary disclosure beyond what is required by the law. This explanation runs counter to rational economic models predicting that firms will disclose beyond minimum mandatory levels if it is in their best interest. In other words, firms will disclose additional information when the potential benefits from disclosing information beyond that required exceed the costs. While the benefits are obvious, the costs are more difficult to determine. One possibility is that additional disclosure opens the firm to additional litigation risks, since the more disclosures the firm makes the more potential there is for plaintiffs’ lawyers to find misrepresentations. This cost shouldn’t be relevant for trading plan disclosures, however, since they are unlikely to be the kind of representations that investors rely on when making investment decisions and are, in any event, a litigation prophylactic. But there is some evidence that firms view mandatory disclosure laws as ceilings not floors.

Another firm cost of disclosure is the additional monitoring responsibility for the board imposed by disclosed trading plans. If firms speak publicly about the trading plans of insiders, the firm risks being sued if actual trading patterns deviate at all from the disclosed plans. Firms must therefore monitor in detail insider trading for compliance with public plans, and make any remedial disclosures necessary to make prior statements not misleading. This is, we are told by numerous corporate advisors, an onerous and scary proposition for firms.

⁷⁵ Based on interviews with lawyers who advise on the design of executive compensation contracts and who defend securities class actions. Conducted in September and November, 2007.

C. Corporate Governance Issues

While generalization about the magnitude of costs and benefits is difficult, the consensus view among corporate lawyers seems to be that the reduction in litigation risk and improvement in capital market pricing is much greater than any costs from reduced trading opportunities for individuals. If this assessment is correct, the choice not to adopt or not to disclose may be based more on the relative power of managers vis-à-vis firm owners and monitors, than on a firm-level consideration of costs and benefits.

Lucian Bebchuk and Jesse Fried argue that managers are able to dominate the pay-setting process in a way that allows them to extract rents in excess of their marginal contribution to firm performance.⁷⁶ If managers are powerful in this way, disclosure may not be made even if in the net interest of the firm. Although the managerial power hypotheses seem like a clean test of agency costs, in fact this analysis is complicated by the fact that if firm benefits exceed the costs to individual managers, firms could compensate insiders for bearing these costs. Firms could pay executives with cash or options or perks or other mechanism to offset lost trading opportunities. There is some empirical evidence that firms do this with respect to other mechanisms for restricting trading—such as blackout windows.⁷⁷ The ability of firms to make transfer payments—to convert from Kaldor-Hicks efficiency to Pareto efficiency—should, all else equal, make disclosure more likely. Usage of the Rule allows one to test the influence of executives on firm-level disclosure decisions, as one would expect boards dominated by insiders to make different disclosure decisions than a firm with a strong contingent of outside directors or powerful blockholders of firm equity.

The Rule's usage also allows one to test the influence or investment choices of institutional investors, who it is argued have better incentives to monitor managers and who supposedly prefer disclosure as an end in itself. If institutional investors care primarily about “good” governance, with transparency and disclosure as a proxy, then one could test whether the presence of large institutional shareholders influences the disclosure decision. The empirical evidence on these two theories is presented below.

We now turn to a discussion of some of the potential problems with the Rule, before turning to the existing empirical evidence.

⁷⁶ LUCIAN BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004). For a rebuttal, see M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs are Low*, 101 NORTHWESTERN UNIV. L. REV. 1543 (2006) (finding no change in compensation practices in firms where ownership and control are reunited).

⁷⁷ D.T. Roulstone, *The Relation Between Insider-Trading Restrictions and Insider Trading*, 41 J. ACCT. RESEARCH 525 (2003) (finding firms imposing blackout windows “pay a premium in total compensation relative to firms not restricting insider trading.”).

III. PROBLEMS WITH THE RULE

The ability of insiders to possibly use insider trading plans to increase profit-making opportunities while simultaneously reducing legal oversight of these trades arises from several features of the Rule and its interaction with existing securities laws.

A. Attenuating the “Use” Inquiry

1. Through time

Rule 10b5-1 shifts the focus of whether the insider possesses inside information to the plan initiation date in lieu of the trade execution date. One possible way to obtain some protection from the Rule while mitigating loss of profit is to initiate a plan based on short-term information. For example, an insider with inside information the firm’s stock price is likely to drop in the next month could initiate a plan based on information but under the guise of an uninformed trading plan. It seems clear this extreme case would violate the requirement the plan was entered into in “good faith.” Since the “good faith” element of Rule has not yet been tested, however, one cannot know for certain whether it would be easier for the government to show “bad faith” or that the insider “knowingly possessed” inside information. It seems that the case making out “bad faith” must include, among other things, a showing that the insider actually possessed inside information.⁷⁸ In addition it seems that the government must also include that the insider not only had the information at the time, but that it was a substantial factor in her decision to initiate the plan. If true, this means that the Rule may make presumably clear cases of insider trading more difficult for the government to prove.

This problem may be insignificant in cases in which insiders initiate plans based on short-term information, but grows as the distance between plan initiation and trading increases. Thus the Rule offers marginally greater protection if insiders obtain information and can therefore plan their trades well in advance of a pending event. This change in application timing may make the government’s case harder because it must prove the knowledge or use of information months before the trade. In the usual insider trading case, the mere appearance of impropriety—earning large profits (or avoiding large losses) immediately before a large stock price rise (or fall)—is enough for the SEC or private plaintiff to be able to make out a prima facie case. When examining trade execution dates, proving the insider possessed the information is often fairly straightforward, and flows directly from the timing of the trade. When the government or private plaintiff must prove possession earlier, the burden of proof likely becomes much more difficult. Memories and evidence weaken, but more

⁷⁸ Although the insider has the burden of showing good faith, this requirement still makes the government’s case more difficult, since it must make its case in chief and rebut evidence from the insider about good faith.

importantly, the circumstantial linkage between information and trade is a much more difficult leap for the trier of fact. This is especially true since the whole purpose of the trading plans is to create a presumption of propriety. Plan initiation dates that well precede pending news events are less likely to receive legal scrutiny.

Consider an insider who believes with great confidence on January 1st that an important drug being developed is unlikely to receive FDA approval six months hence. A Rule 10b5-1 plan is a potentially advantageous way in which the insider can profit from this news with less legal risk. The insider can set up a plan on January 1st to trade over the next six months, thereby profiting from the inside information. The use of a 10b5-1 plan makes proving that the insider used or possessed inside information to make the trade more difficult, because the Rule moves the inquiry back six months. This option may be strengthened (and perhaps the distance between plan initiation and trade execution may be shortened) if firms also disclose details regarding the plan before trades execute since courts may consider disclosure in motions to dismiss.

To be sure, an insider with six months warning about negative news could trade as soon as he learned of the news, and this attenuation from the time of the public announcement would provide greater protection than sales made closer to the public revelation. There are several aspects of this alternative strategy, however, that make the use of 10b5-1 plans preferable, perhaps strongly so. Most obviously, using a trading plan allows the insider the risk-free option of profiting from any increase in the firm's stock price before the final news event. This is possible because the insider can time sales closer to the bad news announcement coupled with a sales trigger in the event the price falls below a set price.⁷⁹ This ensures that insiders can profit from run-ups and avoid any losses.

Another reason is trading outside of a plan may be impossible because the insider is covered blackout windows restricting sales to certain times. Firms may be willing to permit these formerly forbidden trades because plans may provide or be thought to provide additional legal risk reduction. The legal inquiry is the same in both cases, asking whether the insider possessed information on January 1st (either the trade or the plan initiation day), but it marginal risk reduction may arise from the psychological or procedural benefits of falling within an explicit safe harbor.⁸⁰

2. Through manner

⁷⁹ For example, if the stock price is \$10 on January 1, the insider can plan sales starting in March if the stock price is \$10 or greater. In this way, the minimum the insider will get for her shares is likely to be \$10, and she is able to reap any potential gains above that amount. Other plans are possible in the event the stock price was likely to fall immediately, although a direct sale at that point would likely be a superior strategy.

⁸⁰ Also, this strategy—we call insider insurance—is valuable even when the insider is not highly confident.

Insiders may also be able to use a broker to make the government's case more difficult. The Rule permits insiders to, among other things, delegate trading to a broker as a way of insulating trades from government scrutiny. Delegation is equivalent to creating a trading algorithm with price ceilings or floors, and so long as the insider is not influencing the decisions, achieves the same result. The appeal of this approach is obvious—it is the corporate law equivalent of a politician putting her assets in a blind trust to short-circuit any allegations of corruption. An independent decision by a third party suggests that the insider's information did not influence the trades. In this way, suspicious trades—ones that earn profits or avoid losses around large stock price moves—are protected by the independence of the broker.

The purity of this approach may be suspect, as insiders could use the Rule's presumption to make the government's case more difficult, even in egregious cases. Consider the government's burden in the following two cases: In case 1, the insider learns on June 1st that the firm is going to lose its biggest customer in the next quarter, then sells a large block of stock on June 2nd, one day before the information is released to the public. In case 2, the insider enters into a trading plan on January 1st, delegating the trading of a percentage of his shares to a broker. The insider learns the information about the customer on June 1st, and the broker trades on June 2nd helping the insider avoid large losses. Although it is perhaps likely that the government could prove that the insider tipped the broker, this is a much more difficult case to make than in case 1 where there is no attenuation between the information and the trade. This problem becomes more difficult as the time between the plan initiation and the trade becomes longer, independent of the government's challenge in linking the executive to the broker.

Recognizing this potential loophole, some institutional investors have proposed requiring insiders to use different brokers than they've used in the past for other transactions.⁸¹ It is difficult to see how this would be effective at reducing the risk of insiders using this attenuation to make the government or plaintiff's case more difficult.

B. Insider Insurance

Another way for insiders to strategically operate within the Rule is to opportunistically cancel planned trades based on private information. As noted above, trading plans may be cancelled even based on inside information, and this gives insiders a valuable real option on future firm performance. As interpreted by the SEC, the Rule gives insiders a put option—the right to sell shares at a given price—on the firm's future

⁸¹ See "Stockholder Proposal Regarding the Use of Rule 10(b)5-1 Trading Plans," DEF 14A SEC Filing, filed by Safeway Inc., Apr. 2, 2008 (Precatory Proposal of shareholder, The American Federation of State, County, and Municipal Employees), available at www.sec.edgar-online.com/2008/04/02/0001193125-08-072906/Section20.asp.

performance. So if the insider believes there is some chance the firm's stock will fall in the future, she can pick the price at which she will sell (the strike price of the put) and plan sales periodically between the initiation of the plan and the expected bad news. If the bad state of the world happens, the insider exercises the put, and sells the shares under the plan. If not, she cancels the plan (equivalent to letting the put expire) and retains the shares.

For example, an insider who believes on January 1st that there is a 20 percent chance the firm will suffer the loss of its biggest customer in the third quarter, could enter into a trading plan on January 1st to sell a large block of stock at the end of the second quarter, when the stock price did not yet include the loss of the customer.⁸² If the bad state of the world for the firm does come to pass, the insider lets the pre-committed trade execute, and he avoids losses; but if the good state of the world happens, the insider simply terminates the trading plan. In effect, the Rule can turn the decision to sell based on inside information into a decision not to terminate based on inside information, only the former of which is illegal by statute.

Importantly, the option embedded in the Rule is costless or nearly so. As mentioned above, even disclosed plans can provide limited information—such as, “sales will be made each month up to 1000 shares each month”—and the insider who cancels planned sales can make other sales outside of the plan that disguise the cancellation to the market. This costless option amounts to nearly guaranteed loss avoidance, which is just another way of saying guaranteed profits in excess of those outsiders can earn. If canceling the plan had a cost, then this would be the cost of the put option.⁸³ For example, if, under a plan like that mentioned above, an insider disclosed a plan to sell shares at a certain future time but then disclosed she was canceling the planned sales, the market might interpret this as an attempt at manipulation, and impose a cost through the firm's stock price. But because firms do not have to disclose the existence of plans or their cancellation, the costs are likely to be very low.

The termination option that makes insider insurance valuable is traded off against reduced litigation risk reduction benefits, since the discussion above showed these benefits are increasing in disclosure specificity. In other words, an insider who is confident in the need for litigation protection (because she knows she will be selling) would opt for the benefits of specific disclosure (discussed next), and an insider who is less confident would perhaps opt for the option of termination.

⁸² Importantly, the fact that the probability of losing the customer is only 20 percent at this time means that the government would be unable to make out a case for insider trading as of January 1st.

⁸³ The “cost” here could be internal or external reputation costs, market reaction in the stock price or with respect to insider sales, and so on. There is evidence some stockholders are already pushing for changes to increase these costs by bringing terminations to public attention or by advocating public disclosure of terminations or a ban on terminations. *See* Precatory Proposal of AFSCME to Safeway, Inc.

A final point about insider insurance is worth mentioning briefly: it is possible that the ability to terminate planned sales is efficient for particular firms at particular times. The efficiency, which would arise from better alignment of shareholder and manager interests, is discussed below.⁸⁴

C. Scierter Disclosure

As just mentioned, insiders who do not need the option arising from the ability to terminate may opt for specific disclosures to enhance litigation prophylaxis. The ability to use disclosure as a shield, even when the trade is informed, may provide more litigation prophylaxis than warranted or intended. The bottom line is the Rule is not calibrated correctly, such that disclosure provides more protection in reality than planned. This is only sort of a loophole because the Rule allows for exactly this feature of disclosure, although it assumes insiders will not have long-term inside information or, if they do, litigants will be able to easily show they do.

Consider the CEO of a small biotech firm. On January 1st, she sees confidential reports from doctors conducting clinical trials on her firm's key drug suggesting the drug is likely (say, 90 percent likely) to be rejected by the FDA when it makes a decision in September. Wanting to profit from this information, the CEO can trade now on the news or she can put in place a plan to trade on the news sometime in the future, as the decision date is closer. These two courses are seemingly of equal risk. The inquiry into the possession of inside information centers on the same day – January 1st, when the trade was made or the plan to trade was made.

The latter course is, however, likely to be more profitable for two reasons. First, as noted above, it allows the insider to profit from any increase in the stock price from January until September. Delaying trading without a plan for some time would also have this benefit, but in the pre-Rule world, any delay increased the probability of litigation. The Rule thus allows the insider the riskless option (compared with the pre-Rule sale on January 1) of earning any stock price appreciation between the time of the knowledge and the time of the sale. Importantly, an insider can do this without risk (compared with the trade immediately strategy), since the plan can bake in price floors at which sales are automatically triggered.

Second, it allows insiders to sell more shares with the same legal risk, since sales can be spaced out over time in a way that may reduce the attention of either private lawyers or the government. Large sales in advance of bad news look suspicious, while smaller sales on a regular basis look more like random, diversification trades. Plaintiffs' lawyers and prosecutors have limited resources and are likely to focus on the most vulnerable potential defendants; this type of concealment is bound to distinguish insiders using scierter disclosure in a way that deters suits. We

⁸⁴ See section V.B.2.

report below apparent insider use of precisely this strategy.

A solution to this problem is simply increased judicial review of pre-commitment plans in cases in which an insider is likely to have had advanced knowledge by many months. This may be in particular classes of cases, such as drug approvals or loss of large customers, or in the case of certain insiders, such as CEOs or CFOs, who likely have better, long-term information than board members.

Although the number of cases in which insiders will have long-term information is likely small – we report below on only about 60 of these over a six year period – the gains from these trades are likely to be very large. Applying a variant of the Hand formula, however, shows these trades may still be harmful. If the externalities from insider trading are the product of these two attributes (external cost = number of cases x magnitude of losses avoided), then the social cost may be high even though rare.

IV. EMPIRICAL EVIDENCE

To recap, the purpose of the Rule was to offer insiders additional opportunities for uninformed, diversification trading, and the decision to disclose the existence of plans was left to the discretion of firms on the ground that the disclosure decision may send a complicated mix of signals to the market that was difficult to predict. This summary tees up two central questions: First, do insiders trading in plans perform better, worse, or the same as insiders trading outside of plans? And second, is firm governance or insider performance correlated with the disclosure decision? The empirical evidence to date reveals somewhat surprising answers to these two questions.

A. Plan Performance Versus Non-plan Performance

In the first comprehensive study of insider performance in 10b5-1 trading plans, one of the authors found sales executed within Rule 10b5-1 plans earn returns that are, on average, greater than returns earned by the market index and also returns earned by insiders who execute sales outside of Rule 10b5-1 plans.⁸⁵ The study finds “insiders’ sales systematically follow positive and precede negative firm performance, generating abnormal forward-looking returns larger than those earned by non-participating colleagues.”⁸⁶ After rejecting several possible innocent explanations for this finding,⁸⁷ the study concludes “trading within the

⁸⁵ See Alan D. Jagolinzer, “SEC Rule 10b5-1 and Insiders’ Strategic Trade,” (forthcoming MGMT. SCI. QUART. (2009)), available at <http://ssrn.com/abstract=541502>.

⁸⁶ See *id.*

⁸⁷ The benign explanations considered and rejected by the data are: (1) mean reversion; (2) market reaction to sales by insiders; and (3) abnormally negative returns for the firm in question. Explanation (1) was rejected because a control group of firms with similar run-ups in prices did not show a similar magnitude mean reversion over the same period. Explanation (2) was tested and rejected using a 3-day abnormal return,

Rule does not solely reflect uninformed diversification.”⁸⁸ In other words, it appears, on average, Rule 10b5-1 sales do not reflect the kinds of trades the SEC intended the Rule to protect.

More specifically, the study examines over 100,000 10b5-1 trades by more than 3000 insiders at over 1000 firms. These trades beat the market average by over 3.6 percent over a six-month period, compared with less than 0.3 percent for insiders trading outside 10b5-1 trading plans. See Figure 1. According to the study, this result is statistically very unlikely, and can be explained only as a result of some aspects of the Rule or the way in which plans are being used.

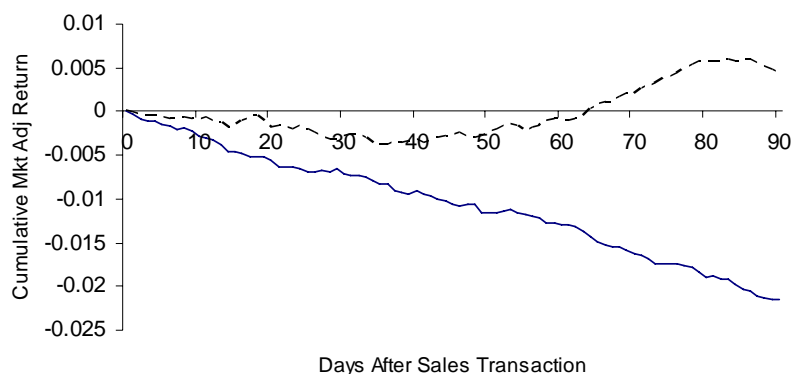


Figure 1. Returns to firm stock following sales in plans (solid line) and outside plans (dotted line)⁸⁹

Although the study does not generate a strong finding on the question of the specific cause of the abnormal returns insiders are able to generate, it does offer some potential explanations. First, the study tests whether insiders earn returns through classic insider trading—that is, initiating trading plans based on short-term information. The study looks at the timing of profitable trades compared with the time at which plans were entered into. The findings are inconsistent with the hypothesis that these trades insulate classic, short-term insider trading—in fact, trades further in time from the initiation of a trading plan outperform trades closer to the start date.⁹⁰

Second, the study looks at whether the Rule was being used to circumvent the traditional blackout windows, which restrict trading right before earnings announcements. Because these plans are routinely viewed as limiting insiders’ ability to profit from inside information, firms allow insiders to trade freely in them, even during typical blackout windows. The

which showed no extraordinary returns. Explanation (3) was rejected after looking at a comparison of returns across industry SIC code, and finding no bear market to speak of in these firms. *See id.*

⁸⁸ *See id.*

⁸⁹ *See id.*, Figure 1, Panel C.

⁹⁰ *See id.*

study finds there was slightly more trading in traditional blackout periods, however, there is no evidence of greater likelihood of sales preceding negative firm earning announcements. In other words, the Rule appears to work in this limited situation, since it frees up insiders from overinclusive blackout periods around earnings announcements, while not necessarily giving insiders opportunities to earn abnormal returns.

Third, the study looks at whether insiders profit by initiating plans to sell based on medium-term information (specifically, about 72 days on average). In this scheme, an insider with private information the firm's stock price was likely to fall in several months may initiate a plan to trade on this information while shielding it from scrutiny. At first blush, this seems like a sensible strategy for the insider. Trying to profit based on short-term information by initiating a plan is unlikely to work, since the scheme would be transparent, but using a plan to separate in time the information and the trades makes the case much weaker for the government or a securities class action plaintiff trying to make out scier. This is the attenuation in the strategy discussed above.

This is, of course, illegal, under both the Rule and the pre-Rule law. If the private information is known at the time the plan is set up, then the plan provides no protection, both because it is not made in "good faith" and because a prerequisite is an attestation by the trader that the plan was made when there was no material informational asymmetry. This means the same insider trading inquiry is made in both cases, only at different times. As mentioned above, the government's case may be more difficult in the plan cases, and this may explain the marginal increase in trading and the increase in profits for insiders.

A more likely scenario is one in which the insider believes there is some probability of bad news in the medium term, and is betting with a plan that it comes true. The use of free insider insurance makes this bet particularly attractive for insiders. Again, the analysis is exactly the same as the case in which there is no plan—if the conduct is illegal without a plan, it is illegal with a plan. So if the government threshold for knowledge is, say, believing something is likely to be true with greater than 50 percent probability, then this standard would apply at both the plan initiation and trade stage. Thus, putting aside the difference in making a case, the existence of a plan should not change the fundamental legal issues with or without a plan. The study data do not show one way or the other whether this strategy is being used.

Finally, the study considers whether insiders might be setting up plans several months in advance based on low probability beliefs of bad news (since these would not be actionable in a suit for insider trading if proved) with the understanding that they can terminate the planned sales in the event the belief does not come true. Since neither disclosure of the existence of or termination of plans is required, this is a strategy with fairly low cost. This possible explanation is supported by the fact that the study also found that voluntarily disclosed Rule 10b5-1 early plan terminations on average follow periods of negative returns and precede periods of

positive returns. Specifically, a plot of cumulative abnormal returns shows about -12 percent cumulative abnormal returns in the 30 days leading up to the date when a plan is terminated, followed by an increase of about 4 percentage points in the 30 days following early terminations. This change in the company's fortune (as reflected in the stock price) after termination is consistent with the theory above that insiders may be selectively terminating plans in a way that increases the probability of earning abnormal returns.

Anecdotal evidence from the data supports this conclusion. The firms in which insiders terminated plans early show signs of improving fortunes due to discrete news events in the period following the early terminations. In one case, a termination of a planned trade preceded the approval of a drug by the FDA; the firm's stock price rose over 25 percent on the news. Other early termination cases included news of a firm's first quarterly profit ever, a firm's best quarterly profit ever, a firm with a large increase in customer demand, a firm with its highest order rates, and so on. As discussed below, this behavior is probably not illegal under traditional insider-trading law, and may even be efficient from the standpoint of the firm's shareholders.⁹¹ It is only coupled with the strategies that we consider next does this behavior become normatively troubling, and even this is not obvious.

B. Relationship Between Disclosure and Trade Returns

The study on returns inside and outside 10b5-1 trading plans highlights a potential problem with the use of these plans, but does not isolate the exact mechanism by which insiders are able to exploit the current formulation of the Rule. Insight into this question can be gleaned from an analysis of the disclosure practices of firms allowing insiders to use 10b5-1 plans. As noted above, disclosure is entirely voluntary, not only as to the question of whether an insider is trading under a plan, but also with respect to the nature of disclosure. Firms can disclose before or after trades, or not at all; firms can disclose specific details about trading plans, including dates, prices, and amounts, or simply disclose their use by the firm or by specific insiders. Firms avail themselves of this considerable flexibility, and use a wide range of disclosure practices. The result is a dataset of thousands of firm years, which allows us to explore whether the disclosure practices are predictive of particular return patterns. If so, we can then hypothesize as to the strategies deployed by insiders. For example, if insiders are able to use disclosure as a shield to reduce their litigation risk, there may be a correlation between disclosure of some kind and the ability of insiders to earn abnormal profits.

Evidence suggests that insiders' 10b5-1 sales transactions (that is, insiders' avoidance of holding losses) are positively associated with the degree of disclosure regarding insiders' sales plans. The authors took all

⁹¹ See Fried, INSIDER ABSTENTION, *supra* note ____.

10b5-1 plans entered into between passage of the Rule and the end of 2007, and partitioned them into three disclosure categories with increasing amounts of disclosure: “no disclosure”; “limited disclosure”; and “specific disclosure.” Limited disclosures are where firms simply disclosed that a particular insider was trading under a 10b5-1 plan or provided insufficient details for an outsider to estimate the timing, volume, and/or price of expected future trades. Specific disclosures, by contrast, are those that allow such anticipation, either by providing narrow windows of trade timing, particular volumes or prices, or other information that would allow an outsider with other public information to front-run the insiders’ trades. The non-disclosure group was determined by observing trades in typical blackout windows—preceding earnings announcements—that likely would not exist in the absence of a trading plan pre-commitment.⁹²

As a general matter, the data show that the likelihood of Rule 10b5-1 disclosure is increasing in firm litigation risk. At first cut, these findings should not be surprising. Firms with high idiosyncratic volatility are more likely to be sued and also present more potential for insiders to use private information to earn profits at the expense of outsiders. Since marginal disclosure offers additional legal prophylaxis, we would expect increasing disclosure with litigation risk/profit-earning potential.

We turn now to a more detailed look at the extant data on the correlation between disclosure choice and insider profit-making potential.

1. Specific disclosure

The data show that sales within “specific disclosure” 10b5-1 plans, on average, precede the largest negative firm performance relative to the market.⁹³ The average cumulative abnormal returns in the six months after the first trade for companies making specific disclosures is -12 percent.⁹⁴ This result is statistically significant at the 1 percent confidence level. As shown on Figure 2, the large decline in stock price performance following insider trades for firms making specific disclosures occurs after a run up in the stock price. This is expected because increases in firm stock price lead to a greater percentage of insider wealth being held in firm stock, which under normal circumstances would result in sales under most plans.⁹⁵ The drop means insiders selling under plans with specific

⁹² This estimation is likely overinclusive, since it includes cases in which the firm, probably through the General Counsel, approved deviations from the contractual blackout periods. To account for this, firms that made these sorts of earnings-period exceptions were collected from the pre-Rule period, and any that appeared in the post-Rule period were excluded. This is likely to capture many, but not all, false positives in this estimation.

⁹³ This is proxied by the CRSP value-weighted portfolio index.

⁹⁴ The median firm returns were -7 percent for the six months following the first sales transaction.

⁹⁵ Here the model considered sales linked to price, the percentage of value of an individual’s portfolio held in stock, and so on.

disclosures are timing their sales prior to significant stock price drops.

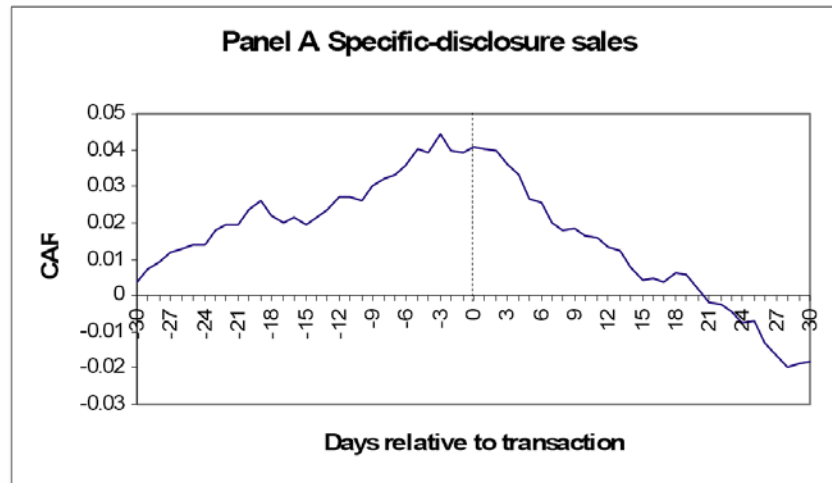


Figure 2: Stock price before and after specific disclosure sales⁹⁶

These plans appear to follow the scienter disclosure strategy discussed above. Insiders making specific disclosures value the termination option provided by limited disclosure less, likely because they are confident about the negative news coming in the medium term (the large drop in value occurred on average 140 days following plan initiation). This pessimism is confirmed by the statistical data, which shows very large stock drops over the 30 days following sales transactions.

Consistent with the strategic use of disclosure, insiders making specific disclosures also appear to be trying to hide their trades by spacing them deliberately in time between the plan initiation and the revelation of bad news. Insiders making specific disclosures trade much more often than other insiders, averaging about 25 trades within their plans compared with about 5 for insiders making no disclosures and 10 for insiders making limited disclosures. The average size of each transaction is also much smaller for insiders making disclosures: non-disclosing insiders' trades were six times larger than those of insiders making specific disclosures.⁹⁷ These trades are less likely to garner negative attention, both because of their smaller size and their pattern, which both suggest random, diversification trades.

2. Limited disclosure

Sales within "limited disclosure" 10b5-1 plans, on average, also

⁹⁶ See, M. Todd Henderson, et al., "Scienter Disclosure," University of Chicago Law & Econ. Working Paper (Figure 2) (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1137928.

⁹⁷ The average for specific disclosure insiders was about \$220,000, compared with over \$1.3 million for non-disclosure insiders.

precede negative firm performance relative to the market, but much less so than the specific group. As shown on Figure 3, these firms experienced an average of -2.2 percent market adjusted returns in the six-month period following sales.⁹⁸ These results are statistically significant at the 1 percent level.

We believe these plans follow the insider insurance strategy. Insiders making limited disclosures likely believe there is value in preserving the option to terminate their plans in the event the bad state of the world does not occur. Consistent with this uncertainty, returns over the 30 days following sales are negative, but less so than for the specific disclosure group.

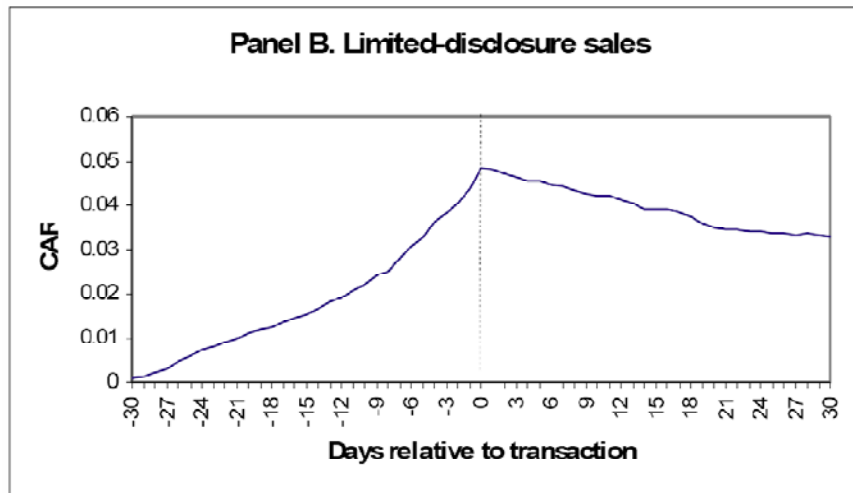


Figure 3: Stock price before and after limited disclosure sales⁹⁹

3. Non-disclosure

Finally, sales within non-disclosed (inferred) 10b5-1 plans, on average, do not precede negative firm performance relative to the market. This is shown on Figure 4. This pattern—an average no gain or loss following insider sales—is what one would expect from random, diversification trades, since it suggests the sale by an insider is not predictive of future returns.¹⁰⁰ This is the pattern the SEC presumably expected on average for all Rule 10b5-1 sales.

⁹⁸ The median was -5 percent return.

⁹⁹ See Henderson, *supra* note ____ (Figure 2).

¹⁰⁰ An obvious question this raises is why any insider would adopt but not disclose the existence of a plan. The answer, as discussed above, is simply that there are benefits and costs of disclosure, and in these cases the costs (for example, front running or false market signals) exceed the benefits. The benefits here are some litigation protection (at the summary judgment phase) or internal monitoring by boards or signaling by insiders of their private trading patterns.

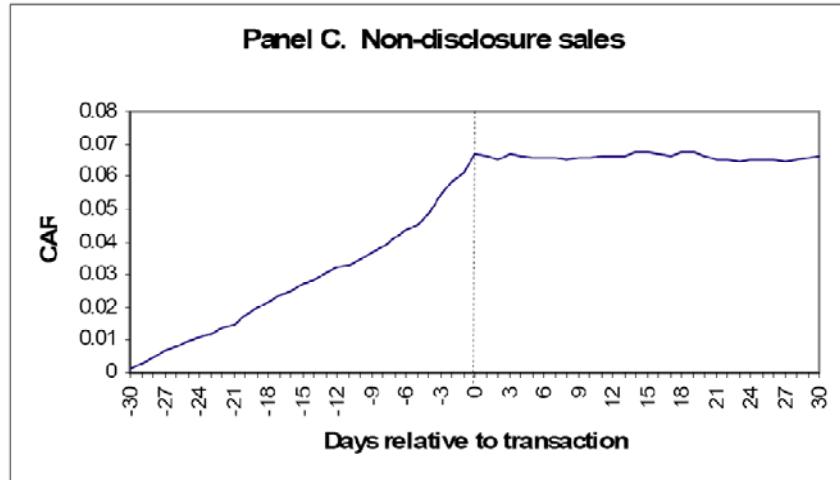


Figure 4: Stock price before and after non-disclosure sales¹⁰¹

The basic finding here—that disclosure and returns are correlated—is not surprising. Insofar as disclosure provides a shield of risk reduction, it does so both for legal and illegal trades, and therefore opens up trading opportunities, and thus profit-making opportunities, for insiders. The second-order finding—that the insiders who profit the most are those who make the most detailed disclosures—is somewhat puzzling on the surface. After all, why would insiders who provide the most detail about their future trades, and thereby remove the termination option, earn the highest returns by avoiding the largest losses. But when one considers the motivation for disclosure, the puzzle resolves: specific disclosure provides the strongest litigation protection and is therefore more useful when insiders are very confident about future trading value.

As for governance, classic theory predicts that ownership by large shareholders and the existence of external board members should generally constrain insider opportunism, which presumably in this case means increased disclosure. The data suggest, however, that disclosure is correlated *with* opportunism, meaning that disclosure here, which is more likely with strong boards or investors, is used as a shield to protect insiders acting selfishly instead of a sword to deter them from doing so. This suggests two related conclusions. First, institutional shareholders and outside board members do not seem to value disclosure for the sake of disclosure, since they arguably exert pressure for disclosure (either directly or indirectly) only in cases in which it matters – that is, where insiders are likely to be tempted to trade on inside information and where the firm is likely to face litigation. Second, firm monitors may recognize their limitations in policing insider trading, and accept scienter disclosure as a second-best solution.

¹⁰¹ *Id.*

The noted empirical conclusions raise a number of policy issues that are related to the Rule. In the next section, we examine the policy implications of these findings.

V. POLICY IMPLICATIONS

Although we have presented evidence of how the Rule can be used strategically in ways unintended by the SEC, this does not mean the Rule should be abandoned. After all, this tells us nothing about the impact of the rule on social welfare or the efficiency of capital markets and executive compensation. In this section, we look briefly at this question, which is obviously quite nettlesome. Putting these concerns to one side and taking the SEC at its policy word, we then examine the costs and benefits of ways of improving the rule. We conclude this section with a discussion of insider trading policy in general and then how the Rule sheds new light on the age-old debate about rules versus standards. Taking the SEC at its word that it wants to provide a rule allowing only uninformed, diversification trades, we also propose some alternative regulatory strategies that might do better along this dimension than Rule 10b5-1.

A. Efficiency and Social Welfare

The vast majority of trades (all sales) made under Rule 10b5-1 plans that we observed appear to be uninformed, diversification trades. These trades fall within both the letter and the spirit of the Rule. Of the tens of thousands sales transactions in the thousands of plans we tracked, at most, our findings suggest about less than one percent are potentially suspect. Moreover, an examination of some of these suspect sales suggests that many of them are likely benign. For example, of the less than 100 firms/insiders in the specific disclosure group, about half have sales patterns that appear to followed by no discernable negative change in the stock price of the firm. This means that these specific disclosures were likely not strategic, but rather some other factor motivated the disclosure.¹⁰² The number of strategic trades is actually then smaller than the data partition suggests, but the effect is then much larger than the regression results show. In other words, a few bad apples are spoiling the barrel. If this is true, then any policy change must resist throwing out the entire barrel.

That the number of trades that seem within the spirit of the Rule dwarfs the number that arguably fit within the letter but not the spirit doesn't tell us whether the Rule is good or bad from a social welfare perspective. In order to determine this, one needs to add up the benefits from the uninformed, diversification trades encouraged by the Rule and

¹⁰² An example would be an extremely risk averse director who wanted to eliminate all downside risk from serving and who, perhaps, believed in disclosure for disclosure sake. Many of the individuals making specific disclosures were non-executive directors.

compare them with the costs imposed by those trades that are informed and would not have happened but for the Rule.¹⁰³

Assuming we could measure these trades, which is unlikely, the social welfare calculation would still be challenging. The benefits for firms from increased trading possibilities and decreased informed trading may be significant, but are likely dispersed and very difficult to measure empirically, even roughly. On the other hand, the costs are likely to be easy to identify, at least in the abstract, but difficult to quantify fully. There will be, for example, individual traders on the other side of informed trades who could be said to have lost, that is, bought at too high a price, and this is a number that could theoretically be calculated. Other costs, however, such as the reduced confidence investors have in stock markets as a result of insider trading of this kind, are much more difficult to quantify, but may be, and have historically been, perceived by regulators to be large. This problem—hard costs, soft benefits—may lead to excessive pessimism about the Rule, both at the firm and social welfare level.

We cannot know or even guess at the relative sizes of these costs and benefits, but the absolute number of trades should give us at least a ballpark estimation. After all, costs and benefits are likely similar in magnitude for individual firms, and thus a larger number of uninformed trades likely cancels out costs from informed ones. The data we present suggests that the ratio of (likely) uninformed trades to (likely) informed trades is greater than 1000:1. If market participants (and others looking at trades, such as lawyers, courts, etc.) cannot differentiate between good and bad trades, however, the existence of some abuses might reduce (perhaps to zero) the firm-specific and market-wide gains from uninformed trades under the Rule. This is especially true if, as noted above, the magnitude of the losses in the informed cases is large. Even if this is true, it might be that 95 percent right is about as good as we can expect – something known as Blum’s law – and any reform may only decrease the value net of costs.

In light of this uncertainty about the social welfare of the Rule, any reform efforts should be viewed with serious reservations. The wise course for the SEC may be to do nothing and see if the market can correct itself. This is all the more likely with the publication of this data to the key players, including legal advisors, D&O insurers, brokers, institutional investors, plaintiffs’ lawyers, judges, and prosecutors. Already shareholders have filed precatory proposals demanding changes to the use of these trading plans,¹⁰⁴ insurers have changed their policies to give discounts for firms using trading plans wisely, defense lawyers have

¹⁰³ There are two types of beneficial trades. First, uninformed trades that would not have happened without the Rule, either because of legal risk or because of the restricted timing imposed by blackout windows. These trades increase the liquidity of executive compensation and capital markets, and therefore may be efficient trades for the insider, firms, and society. Second, trades that would have happened anyway and would have been informed trades without the Rule, but because of the Rule are as profitably made as uninformed trades. These trades have the obvious benefits for insiders, firms, and society of being uninformed.

¹⁰⁴ See Safeway Proxy, *supra* note ____.

suggested ways of maximizing the legal prophylaxis of these plans, and the government has hinted that it is going to look more closely at these plans for potential abuse. There is no reason to think that these improvements will not be adopted widely. Firms and insiders now have an incentive to act in the socially welfare maximizing manner since they now know that their usage of the Rule is under scrutiny by monitors (that is, plaintiffs' lawyers, prosecutors, insurers, and, dare we say, academics) with incentives to force firms to internalize the costs of their trades.

Market-based reforms are not only likely but are apt to be preferable for two primary reasons. First, the idiosyncratic nature of compensation means that firm-specific factors are likely to be crucial to an optimal usage of the Rule. For example, for some firms at some times, it may be that allowing termination of plans is unobjectionable, say because the firm has in place other mechanisms to constrain opportunism. Firms are not the same in the characteristics of their employees, the purpose of stock options, and the nature of their governance. Allowing market participants to tailor their usage of the Rule to firm-specific circumstances will avoid the deadweight loss that will come from reforms that will likely be over- and under-inclusive. (This view is consistent with recent Supreme Court jurisprudence suggesting firm-authorized insider trading may be legal.¹⁰⁵)

Second, the introduction of empirical evidence raises the issues, but does not address specific cases. To take the most simple case, it may be that a trade based on a plan that was specifically disclosed is uninformed or informed, and the statistical evidence that we present cannot distinguish between these possibilities. A rule change responding to the statistical data that does not adequately sort between these possibilities will deter both the good and the bad transaction.

Recognizing the limits of a general rule change, we turn to a consideration of some possible reforms. Our limiting function is to find changes that would be analogous to Pareto improvements – that is, at least one informed trade would be deterred and no uninformed trades would be deterred.

B. Improving the Rule

In this part, we consider a variety of potential reforms to the Rule that might decrease the potential for strategic abuse we described above. As a threshold matter, it is important to note that these “reforms” may not be needed at all, as all of them may be implemented by firms through

¹⁰⁵ See, for example, *U.S. v. O'Hagan*, 521 U.S. 642 (1997) (noting that because insider trading (under a prevailing theory) requires misrepresentation and deception, firms may be able to authorize insiders to trade on inside information). This suggested end-run around insider trading law has not been adopted by any firms because it would only undercut one of many insider trading theories the government uses in these cases – nothing would prevent the government or private litigants from prevailing under a variety of other theories, not the least of which is the incredibly broad and powerful mail fraud statute.

contract, either because of internal or external pressure. Nothing prevents a firm from contractually limiting the use of Rule 10b5-1 plans by its executives in the ways we suggest might limit the potential for misuse, and thereby increase the value to the firm from the trading plan.

1. Market failure

In an efficient market for governance, we would expect if reforms were valuable, firms would offer them voluntarily, and there would be no need for SEC reform of the Rule. There are two reasons why this purely efficient market might not obtain in reality. The first is there is heterogeneity in board effectiveness and the size of agency costs across firms. Firms with strong, effective boards might be expected to adopt efficient internal rules for the use of these plans, while firms with very strong managers might not.¹⁰⁶ If this difference is priced by the market for firm shares, then regulatory reforms would still be unnecessary. But the likely impact on firm share price is very small, meaning that it may not be a source of much discipline in the market for corporate control.

In addition, it isn't clear that the efficient solution for boards (or shareholders) would be to fully restrict potentially abusive practices. As noted above, powerful shareholders and boards seem to push for more disclosure in cases in which insiders may be using the Rule opportunistically, suggesting that monitoring of insider trading is imperfect and that the best governance can do is limit the damages that arise from insider trading.

To see this, imagine insiders to have one of two views about the future value of their firm's stock: confidently bearish or uncertainly bearish.¹⁰⁷ A second dimension of the analysis is that there are two types of firms, insider-dominated and board-dominated. (Of course, there is a spectrum, but this allows easier analysis.) The disclosure choices in this framework are shown in the following 2x2 matrix:

¹⁰⁶ This assumes, as noted above, that the benefits of limiting abuse inure to the firm.

¹⁰⁷ A third possibility is obviously bullish, either confidently or uncertainly. If the insiders are bullish, that is, they think the firm's value is going to rise, however, then there is no reason for the insiders to enter into a trading plan to sell stock. The buy-and-hold strategy is superior to all others, and there are no liquidity or diversification needs for sales.¹⁰⁷ This leaves cases in which insiders are certain that the stock price will fall in the near future and in which insiders are uncertain whether it will rise, fall, or stay the same.

		Views about stock price	
		Bearish	Uncertain
Type of firm	Insider-dominated	Specific	Limited/ none
	Board-dominated	Specific	Specific

Figure 5: Likely disclosure choices for insiders

Assuming that specific disclosure serves as a litigation prophylactic but reduces the ability of insiders to terminate plans in an opportunistic manner (the insider insurance termination option), only the two cells in which outcomes are uncertain are interesting. In the bearish case, governance is irrelevant, because both powerful and weak insiders would prefer specific disclosure. This is because in both cases the insiders believe the stock price will fall, so the option value from termination rights is worthless—the insider doesn't see any value from the ability to terminate planned sales since the stock price is expected to fall after sales. Importantly, this means that even well-governed firms may not be able to use the existing Rule to deter insiders from trading on inside information. Although the firm may be indifferent because of the risk-reducing benefits of disclosure under current practices.

So the two interesting cells are the uncertainty cases. In the strong insider case, the insiders prefer and get limited or no disclosure. This preserves the option value of termination and allows the insider to earn abnormal returns in the event that the uncertainty resolves in the bearish direction. In these cases, one might suggest that the SEC rule is not working consistent with its intent. Insiders get the risk-reducing prophylactic benefits of adopting and disclosing without reducing their profit-making opportunities.

The other interesting case is where insiders are uncertain about future prospects, but are forced to disclose plan specifics by powerful outsiders. In this case, the termination option is much more costly, and therefore may be unavailable to insiders trading with plans. This means profit-making opportunities are lower for insiders, and this may inhibit trading under a plan or any trading in the first place.

Here one might infer that the SEC rule is working fairly consistently

with its intent—good governance plus the Rule reduces insiders' ability to profit abnormally. This doesn't mean that these "weak" insiders profit less than non-participating insiders, since they still might be able to use the Rule to insulate them from liability in cases in which they are certain that the firm's stock price is going to fall. This is likely to be a very small set of cases, however, and it may be that the benefits from forcing other insiders to disclose may outweigh the benefits from the application of the current Rule in these cases.

Even in these cases, a second reason why potentially advantageous solutions might not be implemented by contract is that no individual firm might have an incentive to make changes that would benefit all firms. Again, if the benefits of well-governed plans inure in part to other firms, the costs of limiting executives' flexibility in plans falls mostly on the firm, and it is difficult for outsiders to distinguish *ex ante* between good and bad trading plans, then collective action problems are likely to prevent even socially efficient firm-based limitations on trading plans. In this case, an external rule-maker may be needed to implement reforms. This need not be the government, however, as another centrally positioned entity, like the D&O insurance industry, might be sufficiently powerful to cause modifications to the Rule as used in practice. It is important to note that D&O insurance providers (and thus firms) have incentives to act to reduce firm liability even in cases in which the expected costs to the firm are not sufficient to be priced sufficiently in the firm's share price to matter.

With this in mind, we turn to a brief consideration of several potential reforms of the Rule.

2. Disclosure

One knee-jerk response to the problem of insiders misusing a rule used primarily in secret would be to increase disclosure. Disclosure is the fetish of American law. Ever since Louis Brandeis wrote "sunlight is the best disinfectant," disclosure has been the common ground on which most academics, practitioners, and policy makers have founded corporate and securities law reforms. After all, who can be against disclosure? It preserves choice and merely provides information necessary for making reasoned decisions. One problem, however, is that reformers often tout the benefits of disclosure without properly accounting for its costs, both in compliance and potential unintended consequences, such as likely litigation or deterrence of socially useful behavior that would be chilled by disclosure.¹⁰⁸ Another cost that may be underappreciated is the false

¹⁰⁸ A prominent example is the Williams Act, which required *ex ante* disclosure by bidders in certain takeovers of their plans. This unquestionably deters merger activity of this sort on the margin. Another more recent example is the proposals of Henry Hu and Bernie Black regarding the alleged empty voting problem. Hu and Black propose disclosure as a solution, *see* Henry T. C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PENN. L. REV. 625-739 (January 2008), but they do not consider the impact on the overall market for

confidence that may piggyback on disclosure. Investors may wrongly believe disclosure reduces the potential for opportunism, when in fact the opposite may true.

Private contracting alone is also unlikely to lead to better results here because of the ambiguity we show is inherent in disclosure. Faced with the empirical evidence we present above, firms worried about manipulation would likely to push for no disclosure, which reduces the litigation prophylactic, and therefore marginally reduces the potential for abuse. But why would a rational firm do this, since it would only raise expected litigation costs, irrespective of the underlying insider behavior? A board might rationally conclude that insider trading cannot be deterred fully, and that given this, disclosure (and the litigation risk reduction benefits that come with it) is the best corporate policy. Firms might even think that they can offset expected gains in insider trading flexibility for insiders by reducing other forms of compensation. This selfish account is consistent with the empirical data. For example, increasing amounts of institutional investor ownership (and thus monitoring) is consistent with increased disclosure, but only for firms with large stock price volatility and litigation risk, that is, firms in which opportunistic trading is likely.¹⁰⁹ This might be, from the firm's perspective, the efficient compensation contract, even though all firms might be better off with a different policy.

In light of this collective action problem, we might look to a government solution. The SEC could reconsider the proposal it tabled that would have required firms to disclose the existence of a plan used by any executive within two days of adoption using a Form 8-K disclosure. Disclosure sounds benign in the abstract – who can be opposed to having more information about the use of plans – but the data we present suggests that it is likely to backfire and have unintended consequences. Remember that the firms/insiders least likely to be abusing the Rule are the ones not making any disclosures of the existence of their plans. These firms/insiders chose not to disclose for some reason, and therefore requiring them to do so would likely increase their costs of using a plan. We should therefore expect fewer firms/insiders in this group to enter into fewer plans on the margin, with the result of removing some of the benefits of the Rule without changing any of the costs.

Depending on the amount and nature of required disclosures, the same might be true for insiders in the other disclosure partitions we identified above. For example, if firms/insiders making “limited” disclosures are forced to make additional disclosures, the resulting impact on social welfare and efficiency are unknown. Increased disclosure obligations may deter some uninformed insiders from using plans, as in the case of the non-disclosing insiders mentioned above. For those insiders using limited disclosure as a litigation prophylactic with a low-cost termination option, increased disclosure might lower the value of the

corporate control that is likely if hedge funds are forced to divulge proprietary information about their trading strategies.

¹⁰⁹ See, Henderson, SCIENTER DISCLOSURE, *supra* note ____.

termination option and thus reduce the ability to misuse the Rule. But this depends on investor reaction to and judicial treatment of disclosures, among other things. It is impossible to know in advance the impact of a disclosure requirement.

Requiring specific disclosure might be sensible firm policy. As noted in the 2 x 2 matrix, disclosure of plan details raises the cost of termination, and therefore reduces the probability an insider is using a plan as insider insurance. There are several problems with this as a firm strategy. First, insiders may resist for various reasons, both benign and self-serving, and this may reduce firm competitiveness in labor markets. Second, firms may be forced to compensate insiders for the reduced trading opportunities in other ways that are less aligning of manager and shareholder interests, say by increasing cash compensation. Third, specific disclosure puts on firms new monitoring and disclosure obligations, since any deviations from the plan may expose the firm to liability for securities fraud if they are not publicly disclosed. Corporate advisors tell us these costs are likely to be large and significant for firms. Finally, as noted above, insider insurance may be efficient for some firms at some times, in that it may increase an insider's risk preferences, thus better aligning them with shareholder interests.

As government policy, a mandatory disclosure, even specific disclosure designed to overcome the insider insurance problem, is like to be overinclusive, since the firm-specific costs discussed above are likely to vary widely by firm. Requiring specific disclosure for all firms is likely to dramatically reduce the usage of the Rule, perhaps in ways that are socially much worse than the current practice. A far more sensible policy would be to simply highlight these potential costs of specific disclosure, and permit other corporate stakeholders to lobby for better governance along these dimensions. Judges too can be more skeptical, especially when there is some evidence of potential strategic use, such as circumstances in which long-term information is likely to be held by insiders. Judges should continue, however, to decide these cases at the motion to dismiss stage, since postponing a determination about the efficacy of a plan to later in the litigation may defeat the purpose of the defense.

In light of this uncertainty with respect to individuals making limited and specific disclosures, and in light of the inevitable impact on the non-disclosure group, no matter what the current social value of the Rule is, requiring disclosure is likely to reduce it.

3. Termination

Another potential reform would be to limit or completely eliminate the possibility of early termination of plans. As early termination is essential to one potential opportunistic strategy for manipulating the Rule, prohibiting it would reduce the probability of insiders in the "limited" disclosure group trading on inside information. (Insiders in the specific disclosure would still be able to use their strategy, since it is not dependent

on an embedded termination option we call insider insurance.) This is just a replacement for mandatory specific disclosure discussed above, since the effect is similarly to reduce the possibility of insider insurance. Disclosure is, at first blush, preferable, since it puts a cost on the embedded option that provides the insurance, instead of banning it altogether. It also avoids problems of specific disclosure requiring monitoring of insider trading by the firm to avoid liability.

In terms of policy, insider insurance—setting up a plan based on a belief of less than a legal threshold for insider trading—should not be normatively troubling if plans are binding. In other words, if the SEC policy is that to be actionable a belief must more than 50 percent likely to be “knowledge” then insiders should be permitted to set up plans on beliefs of less than or equal to this probability. We are just taking the insider trading analysis for trades without plans and applying it at the time a plan is initiated. This depends, however, on the plan being binding, because it is only if the insider is actually committing to the trade at the time of the plan initiation that the symmetry of legal analysis makes sense. Otherwise beliefs that do not satisfy the SEC threshold for knowledge can still be traded upon with certainty by setting up plans to sell and then canceling if the belief turns out to be untrue. If an insider can initiate a plan to sell based on, say a belief of 20 percent probability, which is not actionable in our example, and have the option of terminating the plan in the event the belief turns out not to be true, then the insider has traded not with 20 percent probability, but with 100 percent probability. As it turns out, this ability to cancel exists in the current enforcement practices of the Rule, but the study provided little strong evidence of this actually occurring.

Limiting termination would also reduce the number of insiders (in the limited disclosure group) using the Rule, even those who did not hope to retain the termination option for reasons counter to the spirit of the Rule. This would be because of a risk aversion with respect to the loss of future options, especially since insiders may believe the future is highly uncertain about both their circumstances and those of the firm and market. Without a sense of the size of the group of individuals in either category—opportunistic or benign—it is difficult to justify a blanket change to the Rule. One option would be for the SEC to experiment, requiring some firms to forbid termination or for all firms to forbid it for certain times. This is unlikely,¹¹⁰ however, so another option would be for the government to learn from firm experimentation – if many firms voluntarily adopt a no-termination policy without reducing insider participation, regulators might conclude that the costs of such a change are low. Of course, there might be heterogeneity across firms in the costs and benefits of various features of the Rule. For example, non-

¹¹⁰ See Michael Abramowicz, *Speeding Up the Crawl to the Top*, 20 YALE J. ON REG. 139 (2003) (arguing firms under experiment because they cannot capture the full benefits of any innovations).

opportunistic termination rights might not be valuable for insiders in some firms but very valuable for others.

In addition, insider insurance may be socially efficient. To be sure, some outsiders will lose when trading against informed insiders (in cases in which pre-planned trades are not terminated and insiders are trading with legally cognizable information asymmetries). This possibility will in turn generate ex ante uncertainty about whether a trade is against an informed insider, thus causing brokers to increase bid-ask spreads to compensate for this risk, leading to a decrease in liquidity for stocks in general and suspect stocks in particular. On the other hand, however, insider insurance reduces the risk of insiders holding equity in the firms where they work, which may have several salutary effects. For one, this may increase the willingness of insiders to engage in risky projects that maximize shareholder value.

To see why insider insurance might be efficient and desirable for shareholders, consider the following example. Sue, the CEO of Acme, Inc., has 100 shares of vested stock; the stock is trading at \$10 per share. Sue has the choice of two projects: Project A has a 70 percent chance of increasing the stock price to \$15 in one year, and a 30 percent chance of decreasing the stock price to \$8 over the same period; Project B has a 70 percent chance of increasing the stock price to \$20, and a 30 percent chance of decreasing the stock price to zero. Diversified, risk-neutral shareholders prefer Project B, since its expected value (\$14) exceeds that of Project A (\$13).¹¹¹ Sue, however, prefers Project A, since the 30 percent chance of failure in Project B will result in not only economic losses, but also likely her job. Here we see classic agency cost problems – managers interests are not fully aligned with those of shareholders.

The early termination option embedded in Rule 10b5-1, however, can help align these incentives by increasing the economic returns to Sue from choosing Project B, perhaps enough to overcome the potential of losing her job. To see this, consider Sue's payoffs from the sale of all her stock at the end of one year. Pre-Rule, Sue would earn \$290 from Project A and \$400 from Project B.¹¹² Although based on purely stock profits Sue would prefer Project B (along with shareholders), as noted above, Sue's risk aversion with respect to her job may mean this monetary difference is insufficient to persuade her to choose Project B.

With the Rule, however, Sue can earn more from Project B, maybe even enough to overcome her expected losses from employment. Her

¹¹¹ These expected values are simply the stock price for each state of the world times the probability of that state of the world (that is, for Project A: $70\% \times \$15 + 30\% \times \$8 = \$13$; and for Project B: $70\% \times \$20 + 30\% \times \$0 = \$14$).

¹¹² For Project A, Sue earns \$500 in the good state of the world ($\$15 - \10×100 shares), which occurs 70 percent of the time; and -\$200 in the bad state of the world ($\$8 - \10×100 shares), which occurs 30 percent of the time. The sum of these is expected values is \$290 ($\$350 + -\$60 = \290). For Project B, Sue earns \$1000 in the good state of the world ($\$20 - \10×100 shares), which occurs 70 percent of the time; and -\$1000 in the bad state of the world ($\$0 - \10×100 shares), which occurs 30 percent of the time. The sum of these expected values is \$400 ($\$700 - \$300 = \400).

payoffs increase to \$350 from Project A but even more so to \$700 from Project B. This is because she can avoid any losses from the 30 percent bad states of the world by planning sales trades in advance and then letting them execute in the bad states of the world or terminating them in the good states of the world.¹¹³ In other words, choosing Project B increases Sue's expected payoffs by 38 percent in the pre-Rule world, but over 100 percent in the world with the Rule. Whether or not this increased economic return will be sufficient to overcome a CEO's risk aversion with respect to employment will vary by firm, by individual, and over time, but *ceteris paribus*, the existence of the Rule helps align shareholder and manager interests.

A related point is insiders may be less likely to surreptitiously unwind equity incentives they have been given through derivatives or other hedging transactions. For these reasons, many of which will be firm-specific, any general reform may be overinclusive and destructive of social welfare.

4. Mandatory

A more radical proposal would be to make the Rule mandatory for all covered insiders or the top five executives at every firm for all sales of equity. The first part of this proposal – ubiquity – is orthogonal to the issues of manipulation, but depends on the Rule not being subject to too much strategic behavior. In other words, if the Rule is socially efficient, the SEC might consider making it mandatory for all sales. A regulatory mandate might not be as far fetched as it first sounds. Few firms require all executives to use Rule 10b5-1 trading plans, but this may be because of a familiar collective action problem. Any firm moving to require all executives to make trades only through these plans may face a disadvantage in the labor market attracting the best talent. This could be true, even if the firm would benefit individually from such a policy and could pass on some of the surplus to its employees, since there would be a period of learning, information may be imperfect on both sides of an employment transaction, and risk aversion may prevent experimentation by firms. A mandatory rule would solve this collective action problem, and might increase the value of all firms.

Such a mandatory rule would be perceived as quite intrusive, in that it would attempt to control the private affairs of individual corporate executives. In addition, it is unclear whether the SEC would have authority to make it mandatory, as it goes to issues of executive compensation and

¹¹³ For Project A, Sue earns the same as in the pre-Rule case for the good state of the world (\$350), but in the bad state of the world, she can avoid the \$60 in expected losses by planning trades at \$10 per share in advance, and letting them execute when the probabilities resolve themselves (but are not publicly disclosed) in a negative way. Sue's expected value from Project A is thus \$350. For Project B, Sue earns the same as in the pre-Rule case for the good state of the world (\$1000), but in the bad state of the world, she can avoid the \$300 in expected losses through insider insurance. Sue's expected value from Project B is thus \$700.

corporate governance that seem tenuously connected to the mandate of ensuring the securities markets are operated in the public interest. It could, however, be implemented through legislation, such as a change to the Internal Revenue Code that eliminated favorable tax treatment for equity grants that did not include a mandatory trading plan sale provision.

Two practical objections are possible. Such a proposal might disadvantage businesses subject to the requirement, say U.S.-based businesses, compared with those that are not. If true, this would cause firms to avoid the requirement by moving to locations or conditions where the rule does not apply. It may be possible to design the rule to avoid this problem, say by linking it to all firms that avail themselves of U.S. capital markets, or, more ambitiously, product markets. And, of course, if the rule does disadvantage firms in labor markets over the medium-run, then it would suggest that the rule is not socially efficient and should be repealed.

Firms might also be tempted to switch to other forms of compensation, like shadow equity in which cash payments are linked to increases in stock price but no stock is issued nor be bought or sold in the market. Such a transition may have much to commend about it, but that is beyond the scope of this paper. The only important point to note here is that a move requiring the use of 10b5-1 plans is likely to cause firms and individuals to evade it, and this dynamic effect on compensation practices should be part of any calculation of a proposed reform's likely costs and benefits.

The second part of the proposal made above – that all sales for insiders using 10b5-1 trading plans be made inside of the plan – is likely to be as contentious, but it is, or should be, less controversial. Already some firms are requiring this exclusivity from insiders in plans, likely because, according to lawyers that defend these cases, it makes the litigation prophylactic much more effective. Market adoption should give us some confidence of its value, at least in some instances. Institutional investors, D&O insurers, and other corporate activists are also agitating for this policy change at other firms. In this sense, the collective action problem seems less severe here, and this suggests that the need for a regulatory mandate is reduced. Any mandatory rule might discourage the adoption of trading plans in the first place, and the question about whether insiders should be permitted flexibility in using the plans seems like a firm-specific issue.

We can imagine, for example, firms adopting rules on how insiders could diversify their holdings within or without of Rule 10b5-1. There are innumerable potential firm-specific rules. (We consider one of these below in the form of a potential SEC rule.) The SEC can learn from market innovation, something that is less likely in the consideration of a ubiquity requirement. Policy makers cannot predict in the abstract the efficient contracts that are yet to be written.

5. A simple solution

A more radical approach would be to abandon the Rule entirely given the costs we've presented herein and the uncertain benefits we've described. Although we have no illusions that our proposal will be adopted anytime soon, it does highlight the features of the Rule that make it controversial and provide a launching off point for rethinking some of the fundamental premises of the executive compensation debate.¹¹⁴

Taking the SEC at its word – that it wants to encourage uniformed, diversification trades – we can imagine a simple alternative rule that would be much more effective. The SEC could require that all insider trades be announced in advance, say on the first day of the year or the quarter, by simply telling the SEC or other third party (privately) how many shares the insider plans to sell or the total dollar amount the insider wants to diversify. The SEC or other party would then divide the total amount into a discrete number of trades and assign the trades to random days throughout the time period. For example, say an insider states on January 1 a desire to sell 100,000 shares over the course of the year. The SEC could have a computer divide these shares into ten 10,000-share blocks, and then pick ten random days throughout the year (perhaps spaced with minimum increments between trades).¹¹⁵ In this way, the insider would not know anything about the timing of the trades, and thus could not plan either the sale dates or corporate policy or company release of information to profit from any inside information. This rule may be politically difficult to enact, but it would achieve the SEC's goal much more effectively, and, after all, there is nothing that prevents firms or insiders from adopting this rule by contract on their own.

C. Insider Trading Policy

1. Insider abstention

The current law on insider trading does not prohibit *not* trading on inside information – what Jesse Fried calls “insider abstention.”¹¹⁶ There

¹¹⁴ For example, why is it that CEOs are able to sell shares at all while employed by the firm. If the purpose of stock options is to align incentives, doesn't allowing CEOs to unwind these defeat the purpose and couldn't the board calibrate new option grants to set the optimal level of diversification instead of giving uncalibrated blocks and letting insiders sell to set the optimal personal diversification level?

¹¹⁵ There are, of course, innumerable alternatives. For example, the total number of trading days for these plans could equal the number of trading days in the year, with the insider agreeing to sell 1/250th of these shares each trading day. In addition, the function of randomization could be preformed by stock exchanges, brokers, or other third parties. In fact, this option exists today, since such a plan would satisfy the requirements of Rule 10b5-1, but to our knowledge no firm has adopted such a plan. This may speak to the perceived efficiency of such plans or to the extent of managerial power in firms. Whatever the case, it is likely that such a rule would be more likely to reduce the number of informed trades by insiders.

¹¹⁶ See Fried, INSIDER ABSTENTION, *supra* note ____.

are statutory and efficiency reasons for this. In terms of statutory authority, section 10(b) of the 1934 Act arguably doesn't cover abstaining from trading based on inside information. According to the SEC's interpretation of the Act, not trading is outside the agency's statutory authority, which is limited to "purchase[s] or sale[s] of any security." The argument is that not trading does not involve either a purchase or sale, and therefore a decision to abstain from trading is outside of the statutory ambit.

This is, of course, not the only plausible reading of the statute. The statute covers all transactions "in connection with" purchases and sales, and the decision not trade is arguably within this broader sweep. The SEC's interpretation permitting insider abstention may turn then on its efficiency. Jesse Fried argues this result is efficient, since insiders cannot earn abnormal returns compared with outsiders by abstaining from trading based on inside information.¹¹⁷ The intuition is straightforward. Allowing insiders to abstain from planned trades (either purchases or sales) is a sort of subsidy for the inability to decide to buy or sell based on inside information. In this way, an insider with uncertainty about the future cannot expect to outperform outsiders, since sometimes the insider will have an advantage (the ability to abstain) while other times the insider will be at a disadvantage (the inability to trade on inside information).

This argument hangs entirely on the symmetry of abstention and deciding to trade. If insiders could legally buy or sell based on inside information under certain circumstances, then insiders who can abstain too would be able to systematically outperform uninformed outsiders. Consider the following two cases. In the first, on September 1, an insider learns that a new drug is going to be approved by the FDA on September 15. The insider is legally forbidden from buying shares based on this private information. If the insider had planned to sell shares on September 14, however, she can legally cancel this trade based on the private information.

In the second, the insider uses a Rule 10b5-1 trading plan, and the dynamic changes. Say the insider believes on January 1 that the drug is 50 percent likely to be approved. At this time, the insider can enter into a 10b5-1 trading plan to sell shares on September 14. In the event that the drug is not approved, the insider can legally let the pre-planned trades execute; in the event the drug is approved, the insider can legally cancel the planned trades. As noted above, the legality of this latter abstention is premised on Fried's argument, which relies on the insider not being able to trade on the information about the drug being a success. Trading plans make this untrue; in fact, they can, when used in this way, make this distinction meaningless. An insider can set up a plan to profit no matter what the result of the drug trial, regardless of the insider's confidence level at the time the plan is put in place. Without symmetry, the case for abstention is significantly weaker.

¹¹⁷ See *id.*

Changing the default rule about abstention in all cases based on the existing Rule is unwarranted, however, since it would be easier and perhaps better to simply reform the Rule. Without a reform to the Rule, say because the benefits of the current formulation outweigh the costs, the policy choice permitting legal abstention warrants reconsideration. But what would this look like? Forbidding insiders to cancel informally planned trades based on inside information would be extremely difficult and costly to enforce. After all, short of requiring all future planned trades to be specifically enumerated so that they could be policed ex post for compliance, a no-abstention rule would be impossible to enforce. Reform of the Rule is likely thus the only sensible alternative.

2. Information-generating function

One response to the criticism of the Rule might be that insider trading is normatively good, and that any rule encouraging informed insiders to trade is likely to make asset prices more accurate and thus capital markets more efficient.¹¹⁸ This long-running debate is interesting but irrelevant, since even if one thinks insider trading should be legal, this type of insider trading is of doubtful normative value.

The argument for insider trading is premised on an assumption that insider trades provide valuable information to the market and therefore lead to more accurate short-term prices for securities. It is puzzling, after all, that those with the most knowledge about a security are the ones forbidden from trading on that information. So, to take a classic example, if an insider knows that a secret geology report shows a large mineral deposit on firm land, allowing the insider to buy undervalued shares moves the price upwards toward the price it will be when the information is revealed. Improved pricing accuracy helps ensure that capital is allocated efficiently in the market and reduces the probability trades made prior to the public revelation of the information are made at inaccurate prices.

These benefits might be especially valuable in the 10b5-1 case, because disclosure of a pre-commitment to trade may provide the insiders' information to the market well in advance of when it otherwise would. The attenuation from the time of the trade may cut the other way, however, since plan initiation is a very noisy signal about values at some unknown future time. When an insider trades based on inside information, an outsider observing this trade may confidently conclude that the price is unlikely to rise in the near future. For pre-commitment trades, however, this is not true, and this fact will diminish the value of the insider's disclosure. For example, if the stock price of Acme Inc. is \$10 on January 1, and the CEO enters into a 10b5-1 plan with planned sales sometime over the next year, it is possible that the CEO knows that the stock is likely to rise to \$30 by June before falling on bad news to \$5 in September. This

¹¹⁸ See, for example, HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

means that it is only the insider's trade, and not the insider's disclosure that is likely to be valuable in the way that proponents of insider trading legalization argue is beneficial.

Any benefits, however, are absent or mostly absent for informed trades made through 10b5-1 trading plans. Consider the two scenarios discussed above – trades based on uncertain future bad news (where limited disclosures are made) and trades based on certain long-term bad news (where specific disclosures are made). In the first scenario, the trades contain no easily discernable information about a firm's future stock price. Remember, an insider with very high (but not perfect) confidence about future good news might use a 10b5-1 trading plan as insurance against even very unlikely bad news. Given the relatively costless option embedded in the current formulation of the Rule, the only thing that can be discerned from the entering into of a plan is that sometime many months in the future, an insider believes there is a non-zero chance that the firm might have some bad news. While this may be somewhat valuable, rarely are outsiders 100 percent confident about a firm's future, and the additional value of a 10b5-1 trading plan is therefore near zero. After all, it might be that the insider believes there is a one percent chance of bad news in six months, which would hardly be enough to move the market price.

This conclusion is supported by the fact that there is no discernable market reaction to insider's disclosure of the existence of 10b5-1 trading plans. The data show the market does not consider the disclosure of a 10b5-1 trading plan a meaningful signal about the value of a firm's future stock price. One-, three-, and five-day cumulative abnormal returns surrounding disclosure are all indistinguishable from zero. This is because disclosure is a very noisy signal. It may be viewed as providing some or all of the following litigation prophylactic benefits, a signal of good governance, a negative prediction about the future value of the firm's stock price that is different from zero, but not measurably so.¹¹⁹

In the other scenario, an insider makes a specific disclosure based on a strong belief about negative news in the future, likely of quite large magnitude. This type of disclosure is much more meaningful in terms of information provided to the market, since it is not an option but a sure bet about the future stock price. There are some problems, however, even with this. First, even these disclosures are noisy, since, as noted above, not all specific disclosures evince a belief about future value. About half of the specific disclosures we observed were benign in nature and provided no prediction about future value. This could be because the insider making the disclosure did so for non-strategic reasons, such as risk aversion or a belief in disclosure as an inherent good. Whatever the case, the value of any disclosure is reduced.

¹¹⁹ There may be some threshold confidence level (of certainty times magnitude) below which entering into a plan is too costly, but given the ease and low cost of entering into these plans, this must be very, very low.

The disclosure might still be valuable, since outsiders could now deduce that there is, say, a 50 percent chance of a large drop in the stock price within one year. But this isn't socially valuable information, although it may be privately valuable to outsiders. The private value is obvious from the data: an outsider could have sold short a portfolio of firms that made specific disclosures, and the data suggest that it would have earned a 12 percent return over 6 months. Without other observable data that would allow an outsider to distinguish between opportunistic and benign disclosures, however, any information gains would be offset (fully or mostly) by information losses from the firms that are not inaccurately priced at the time of disclosure. This would be so if, as it likely is the case, there are costs imposed on individual firms and the market as a whole that are not captured by the net economics of a portfolio of shorting transactions. So, although there may be some information value, its quality will be degraded such that it may be (and is likely to be) insufficient to justify the costs of the Rule.

D. Rules Versus Standards

Consideration of these issues raises a broader question about the efficacy of rules versus standards, especially in the area of insider trading. The experience with Rule 10b5-1 so far suggests several conclusions. First, the rule seems to have encouraged more usage of preplanned trades than the preexisting standard. Although there is no comprehensive data on this point, there were only a handful of I-would-have-traded-anyway cases, compared with the multiple thousand transactions (and billions of dollars) so far used under the Rule. Prior to the issuance of the Rule, nothing prevented insiders from pre-committing to trades, and then using whatever evidence they had, say a written contract with a broker, as a defense in any subsequent litigation. The codification of this potential in a rule made the value of such pre-commitment much higher for the reasons discussed above, including the admissibility of plans filed with the government and the certainty that comes with an official rule.

Although in some contexts standards might be viewed as offering more leeway of interpretation, and therefore more potential applications, in the business law context, the existence of a specific rule reduces uncertainty and allows insiders to perform more accurate calculations about risk. This then leads us back to the questions about efficiency that we raised incompletely above. If we are right and the Rule encouraged much more trading in these plans than would have otherwise happened through other pre-commitments, then it may be that the costs of imprecision in drafting the Rule (and the resulting loopholes it created) are acceptable.

Loopholes or unintended consequences may also be inevitable. The attempt to codify a rule to cover all future practices in a way that is not capable of strategic use by someone at sometime is probably impossible. Drafters of the rule could have, and in fact may have, anticipated some of

the things we've described in this paper, but may have been unable to muster the political support necessary to prevent them. Or, perhaps, the rule represented a bargain among various constituencies on multiple subjects in which compromise was necessary or the loopholes were viewed as efficient, since they would likely be used by a small number of insiders and there were backstops, like the judiciary or private forces like insurers, who could remedy any potential manipulation. In this sense, the Rule in question here has a standard-like safety value embedded in it. If insiders are abusing the Rule, the good faith requirement permits the government to curtail any abuses. Over time, this exception may swallow the Rule, and it is important for prosecutors and courts to be sensitive to this possibility lest they destroy the rules virtues.

The move to a rule instead of a standard here may have been in response to an underlying problem with the existing liability regime. If securities fraud suits or other insider-trading related suits are deterring benign trades by insiders or are arising from benign trades, a rule-based response providing a strong affirmative defense is a potential solution. This seems to be what the SEC was doing. Congress tried to reduce frivolous lawsuits with the PSLRA of 1995, but by 2000 it was clear the changes to burdens, lawyer designation, and pleading standards was not working as intended.¹²⁰ Unable to alter the litigation process or underlying legal standard, the SEC tried to increase the difficulty for plaintiffs to prove an essential element of a fraud suit – scienter. By allowing insiders opportunities to trade that do not create plausible inferences of scienter, the SEC may have expected the number of suits, especially frivolous suits to fall. By and large, this attempt has been successful, as billions of dollars in transactions have taken place, and courts have generally thrown out suits on these grounds. The problems we identify with the Rule, however, call this regulatory strategy into doubt. If governance is ineffective and courts cannot cheaply and quickly distinguish between good and bad use of these plans, then we are right back where we started. It would perhaps be more sensible to address the underlying problems with the liability regime instead of trying to ameliorate it with new rules.

CONCLUSION

We have presented extant empirical evidence showing that Rule 10b5-1 is imperfect: some insiders are using so-called Rule 10b5-1 trading plans to make informed trades. In fact, on average insiders using plans outperform insiders not using plans. We also presented empirical evidence showing how: insiders appear to use two techniques – “scienter disclosure” and “insider insurance” – to strategically exploit the Rule to earn profits at the expense of outsiders. This paper presents the first discussion of these techniques, which have relevance not only to the debate about Rule 10b5-1, but about insider trading and rulemaking more

¹²⁰ See, for example, Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J. L. ECON. & ORG. 598 (2007).

generally.

Scienter disclosure is the disclosure intended to shield rather than reveal conduct. This is captured by the notion of “hiding in plain sight.” Insiders making the most specific disclosures about their future trading plans are the ones most likely to earn abnormal returns suggesting informed trades. This finding casts doubt on increased disclosure as our knee-jerk response to perceived opportunism. It also makes the SEC’s proposal (and similar echoes from investors and activists) to make disclosure mandatory likely to be counter-productive. The investors most likely to be acting well are the ones who are not disclosing now, and making them do so will increase their costs of using these plans resulting in less usage by the non-opportunistic traders.

Insider insurance arises because of a valuable real option embedded in the Rule as the result of an SEC interpretation allowing insiders to cancel trades based on subsequently obtained insider information. This means that insiders can, without costs, reduce the risk of future uncertainty in stock prices by pre-committing to trades that will profit in the event of bad news, knowing that they can be canceled in the event of good news. The existence of this insurance, which we show is most likely used by insiders making limited disclosures, allows insiders to earn abnormal returns by timing sales before stock price drops. Although this practice may impose costs on outsiders against whom insiders trade against (in the case where informed trades execute), it may well be efficient for shareholders in general. Insider insurance reduces the risks of holding firm equity, which may induce insiders to be more risk preferring in their project choices, something all shareholders may benefit from net of losses from trading against informed insiders. Whether it is seems like a firm-specific issue that should be policed by boards, shareholders, insurers, and other corporate stakeholders.

In response to the empirical evidence we have presented, the Director of the SEC’s Division of Division of Enforcement recently expressed concern about insiders’ trade returns within Rule 10b5-1 plans: “We are looking at this—hard.”¹²¹ We believe that the best regulatory course is for a hands-off approach at this point. The mere existence of problem may be sufficient to encourage private and public (non-regulatory) actors to tailor policy at a firm level, and thereby strike the right balance along the various plan characteristics. In the absence of evidence of systematic abuse that cannot be curtailed by market prices and legal mechanisms short of reforming the Rule, the SEC should resist the temptation to make changes that will raise the cost for non-opportunistic traders without certainty that strategic uses of the Rule can be stopped.

¹²¹ Linda Chatman Thomsen, Director, Division of Enforcement, Securities and Exchange Commission, Remarks at the 2007 Corporate Counsel Institute (March 8, 2007), <http://www.sec.gov/news/speech/2007/spch030807lct2.htm>.