



The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1

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The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1

By Allan Horwich*

The SEC adopted Rule 10b5-1 to define what it means to trade securities “on the basis of” material nonpublic information. This was to address decisions and commentary that found no insider trading violation of Rule 10b-5 where the defendant did not “use” inside information in deciding to trade, even if one “possessed” the information when the decision was made. Rule 10b5-1 specifies exclusive affirmative defenses for one charged with trading on the basis of material nonpublic information, the essence of which are that there is no violation if the trade was made pursuant to a pre-arranged plan, even if the seller or buyer later became aware of the information before the trade was made. There is, however, a substantial argument that the SEC exceeded its powers in adopting exclusive criteria for what it means to trade “on the basis of” material nonpublic information, rather than creating a safe harbor. Non-use of inside information in deciding to trade remains a defense even if the trade was not made pursuant to a Rule 10b5-1 plan. Although the SEC abandoned a proposal to require detailed disclosure of some Rule 10b5-1 plans, other SEC rules require disclosure of a plan in some circumstances, although compliance may be deficient. Irrespective of mandated disclosure, there are reasons both for and against voluntary disclosure of a Rule 10b5-1 plan. Some have suggested that Rule 10b5-1 is being misused in that executives establish such plans, know when a trade will occur under the plan and then, in order to maximize their profits when the trade is made, delay or accelerate disclosure of corporate news that would affect the stock price. In most situations, any such timing of corporate disclosure would not violate the securities laws.

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In 2000 the U.S. Securities and Exchange Commission (“SEC”) adopted three rules to address issues that arise in connection with the potential misuse of material nonpublic information in transactions in the stock of public companies.¹ This Article analyzes the background and significant unresolved issues with respect to one of those rules, Rule 10b5-1, which was designed to facilitate lawful trading by corporate insiders.² While many hailed the rule for providing a workable

1. See *infra* text accompanying notes 23–31. In this Article the phrase “public company” means a company whose common stock is registered with the SEC for trading under Section 12 of the Securities Exchange Act of 1934, ch. 404, § 12, 48 Stat. 881, 892 (codified as amended at 15 U.S.C. § 78l (2000 & Supp. IV 2004)) [hereinafter “Exchange Act”], or that is required to file reports with the SEC pursuant to Section 15(d) of the Exchange Act, 48 Stat. at 895 (codified as amended at 15 U.S.C. § 78o(d) (2000)).

2. 17 C.F.R. § 240.10b5-1 (2007), adopted in Selective Disclosure and Insider Trading, SEC Rel. No. 33-7881, 65 Fed. Reg. 51716 (Aug. 24, 2000) [hereinafter “Rule 10b5-1 Adopting Release”]. This Article does not address insider trading under state law, and in particular whether adherence to Rule 10b5-1 provides a defense to a charge based on state law. See, e.g., CAL. CODE REGS. tit. 10, § 260.402 (2001) (providing that compliance with Rule 10b5-1(c) provides a defense to a charge of violating the California statutory prohibition on trading at a time “when the person knows material information about the issuer.”).

mechanism for insiders to diversify their portfolios without running afoul of the prohibition on trading on the basis of material nonpublic information,³ after six years a number of open questions surrounding Rule 10b5-1 remain. Part I of this Article briefly describes the scope of the prohibition on trading in securities on the basis of material nonpublic information that provides the context for the rule. Part I also presents the background of the rule itself, which contains an important definitional element and defenses to a charge of trading based on material nonpublic information. Part II explains how the rule works in practice. Parts III and IV take up several significant questions regarding reliance on the rule, including questions of mandatory and voluntary disclosure of reliance on the rule, the validity of the rule as affording the exclusive defenses to a charge of unlawful trading, and the propriety of timing corporate announcements to maximize trading results when the rule is relied on to determine when transactions occur.

I. INTRODUCTION

A. THE LEGAL THEORIES OF UNLAWFUL TRADING ON THE BASIS OF MATERIAL NONPUBLIC INFORMATION

The SEC and the courts have long struggled with delineating when it is unlawful for a person to trade in securities⁴ when that person knows or possesses nonpublic information that is material to the transaction.⁵ There are two federal theories under which trading on the basis of nonpublic material information may be unlawful, generally referred to here as “insider trading”:⁶ the classical theory and the misappropriation theory.⁷

3. See, e.g., Steven E. Bochner & Leslie A. Hakala, *Implementing Rule 10b5-1 Stock Trading Plans*, 15 *INSIGHTS* 2, June 2001, at 8 (“Rule 10b5-1 provides companies, insiders, and their securities lawyers with an elegant solution to a common, yet difficult, problem: how to facilitate diversification and liquidity in company stock, while reducing the risk of insider-trading allegations.”) [hereinafter “Bochner & Hakala”].

4. The legal theories discussed in this Article focus on trading in common stock. The extent to which these theories apply to other securities, such as debt instruments, is not addressed here. See, e.g., WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 5:2.6[C] (2d ed. 2006) (discussing application of the theories of unlawful insider trading to transactions in debt securities) [hereinafter “WANG & STEINBERG”].

5. For comprehensive discussions of the law of insider trading under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007), see generally WANG & STEINBERG, *supra* note 4, at chs. 4–5; DONALD C. LANGEVOORT, *INSIDER TRADING: REGULATION, ENFORCEMENT AND PREVENTION* chs. 1–7 (2007) [hereinafter “LANGEVOORT”].

6. It is not inherently unlawful for an insider of a company, such as a director or officer, to trade in the securities of the company. In this Article, the phrase “insider trading” refers to trading on the basis of material nonpublic information in violation of Rule 10b-5. Trading on the basis of information that others do not have is not unlawful unless other elements are also present. *Chiarella v. United States*, 445 U.S. 222, 233 (1980) (“neither the Congress nor the [SEC] ever has adopted a parity-of-information rule”). There are many situations where someone is not prohibited by law from trading based on, or while in possession of, material nonpublic information. See, e.g., Allan Horwich, *The Clinical Trial Research Participant as an Inside Trader: A Legal and Policy Analysis*, 39 *J. HEALTH L.* 77, 82–100 (2006) (concluding that a patient-participant in a clinical drug trial is not inherently prohibited from trading while aware of material nonpublic information about that trial) [hereinafter “Horwich, *Clinical Trial*”].

7. The following discussion is adapted from Horwich, *Clinical Trial*, *supra* note 6, at 78–81. This overview does not address the more complex issues under the two theories, such as the possession/use dichotomy discussed in Part I.B of this Article.

Under the classical, or traditional, theory an insider of a company, such as a director or officer,⁸ cannot trade in the securities of the company on the basis of material nonpublic information about that company.⁹ The classical theory has also been applied to a corporation's transactions in its own securities; that is, it is unlawful for a corporation to trade in its own securities when it is in possession of material nonpublic information regarding itself.¹⁰ Under the more sweeping misappropriation theory it is unlawful to trade in securities in "breach of a duty owed to the source of the information."¹¹

Under both theories the prohibition applies only where the information on which the trading decision is based is "material." This is information as to which there is a substantial likelihood a reasonable shareholder would consider it important in making an investment decision.¹² The prohibition applies only when the information is nonpublic.¹³ Information is nonpublic unless either there has been broad dissemination of it to the investing public generally or it is known to enough persons so that their trading has caused the information to be fully reflected in the price of the stock.¹⁴

As the judicial development of these issues matured, it became clear that a fundamental issue in insider trading under either theory is whether some duty is breached in connection with a securities trade. Under the classical theory the duty to disclose before trading arises out of the relationship of the securities

8. The concept of an "insider," and thus the prohibition, extends not only to directors and officers of the company, but also to "temporary insiders." This term is shorthand for a category of persons described in *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983), and *SEC v. Lund*, 570 F. Supp. 1397, 1403 (C.D. Cal. 1983). That is, "where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders." *Dirks*, 463 U.S. at 655 n.14 (emphasis added).

9. *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997) (quoting *Chiarella*, 445 U.S. at 228) ("Under the 'traditional' or 'classical theory' of insider trading liability, § 10(b) [of the Exchange Act] and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a 'deceptive device' under § 10(b), we have affirmed, because 'a relationship of trust and confidence [exists] between the shareholders of the corporation and those insiders who have obtained confidential information by reason of their position with that corporation.'").

10. See, e.g., *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1204 (1st Cir. 1996) ("Just as an individual insider with material nonpublic information about pending merger or license negotiations could not purchase his company's securities without making disclosure, the company itself may not engage in such a purchase of its own stock, if it is in possession of such undisclosed information.") (dictum) (emphasis in original); see also *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 435 (7th Cir. 1987) (holding that privately held corporation has a duty to disclose material nonpublic information when purchasing its shares). For a recent analysis that a corporation violates Rule 10b-5 when it trades in its own securities based on material nonpublic information, see Mark J. Loewenstein & William K.S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45 (2005).

11. *O'Hagan*, 521 U.S. at 652.

12. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

13. *O'Hagan*, 521 U.S. at 651-52; *Dirks*, 463 U.S. at 654.

14. *SEC v. Mayhew*, 121 F.3d 44, 50 (2d Cir. 1997). The SEC appears to prefer the former concept, which is easier to apply. See Rule 10b5-1 Adopting Release, *supra* note 2, *passim*. Thus, in proposing Regulation FD, 17 C.F.R. pt. 243 (2007), *infra* note 24, the SEC stated:

It is well established that information is nonpublic if it has not been disseminated in a manner making it available to investors generally. In order to make information public, "it must be

trader to the corporation whose securities are being traded. As stated in *Chiarella*, there is a “relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose...”¹⁵ The duty that is breached by the misappropriator arises out of a relationship of loyalty and confidentiality to the source of the information.¹⁶ Thus, “if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for a breach of a duty of loyalty.”¹⁷

B. THE “POSSESSION” VERSUS “USE” DEBATE

There was a difference of opinion expressed in the academic literature over whether an element of a violation under either the classical or misappropriation theory of insider trading was that the trader consciously “used” the nonpublic information in deciding to trade securities, or whether it was sufficient that she merely “possessed” (or “knew”) the information at the time of the transaction or when making the decision to trade.¹⁸ In this author’s contribution to the debate, he posited several hypotheticals to crystallize the distinction:

An executive of a public company instructs his stockbroker on Friday, after the market closes, to sell some of his company stock at the opening on Monday, to generate cash to pay his daughter’s college tuition. Between placing the order and its execution, the executive learns nonpublic negative material information about the company. A second executive, nearing retirement, begins a regular program to liquidate her large holding of company stock in order to diversify her portfolio, instructing

disseminated in a manner calculated to reach the securities market place in general through recognized channels of distribution....”

Selective Disclosure and Insider Trading, SEC Rel. No. 33-7787, 64 Fed. Reg. 72590, 72595 (Dec. 28, 1999) (footnote omitted) (quoting *In re Fabrege, Inc.*, 45 S.E.C. 249, 255 (1973)) [hereinafter “Rule 10b5-1 Proposing Release”].

15. 445 U.S. at 228 (emphasis added) (footnote omitted).

16. *O’Hagan*, 521 U.S. at 652.

17. *Id.* at 655. Although the theories differ, both could apply to the same facts. For example, an insider who traded in his or her company’s stock based on material nonpublic information about the company is liable not only under the classical theory, but also under the misappropriation theory if he or she traded without disclosing the intent to trade to appropriate superiors in the corporation (with whom he or she inherently has a relationship of loyalty and confidentiality). Even if he or she were to disclose his or her intent to an appropriate corporate superior, however, thereby avoiding a deceptive act that is actionable under the misappropriation theory, the trading would still be unlawful under the classical theory.

18. For a pre-Rule 10b5-1 analysis that *conscious* use of the information was an element of the violation of the prohibition, see Allan Horwich, *Possession v. Use: Is there a Causation Element in the Prohibition on Insider Trading*, 52 BUS. LAW. 1235 *passim*, 1268–78 (1997) [hereinafter “Horwich, Possession”]. For an analysis that diverged in some respects from the analysis in Horwich, *Possession*, see Donna M. Nagy, *The “Possession vs. Use” Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never be Golden*, 67 U. CINN. L. REV. 1129, 1135 (1999) (“although ‘knowing possession’ should be the requisite test in the context of securities trading by traditional insiders, a ‘use’ test should be applied” to trading by temporary insiders and tippees) [hereinafter “Nagy”]. Compare 5C ARNOLD S. JACOBS, DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS § 12:143, at 12-674–75 (2007)

her broker to sell 1000 shares on the first of each month. During the program, the executive learns nonpublic negative material information about the company. A third executive is a long-time participant in his company's dividend reinvestment plan. He learns nonpublic positive material information about the company on the eve of a regular dividend payment. A fourth executive places her entire stock portfolio with an investment adviser, giving him full discretion to buy and sell. The adviser tells the executive that to achieve diversification he may sell some of the stock the executive owns in her employer. Before any action is taken by the adviser, the executive learns nonpublic negative material information about her company. A fifth executive places an order to buy stock in the company. Before the order is executed, he learns nonpublic positive information about the company.

None of these executives takes any action to halt the impending transactions. The purchases and sales proceed. Have any of them engaged in unlawful insider trading? While each individual possessed inside information when the transactions were executed, none of them used the inside information when they first decided to sell or buy. Indeed, the fourth executive did not herself make any decision to trade. [The issue is] where, if at all, the federal securities law prohibition on insider trading is violated when an insider trades while in possession of inside information without affirmatively using the information in first deciding to trade.¹⁹

Few cases had directly addressed the issue prior to 1998, though dictum abounded.²⁰ Then two courts of appeal adopted the "use" requirement.²¹ Those decisions, which favored defendants, spurred the SEC to action.²²

C. THE SEC'S EFFORT TO END THE POSSESSION VERSUS USE DEBATE

The SEC sought to "resolve" the possession versus use debate through interpretive rulemaking.²³ It adopted Rule 10b5-1,²⁴ which provides that one of the

(stating that prior to the effective date of Rule 10b5-1 an element of the violation was that actual use of the material nonpublic information was a factor in the decision to trade); with *LANGVOORT*, *supra* note 5, § 3:13, at 3-30 (concluding that the "possession test seems well grounded"). The background of this debate, with extensive citations to the literature and to the few cases that had addressed the issue, is presented in *WANG & STEINBERG*, *supra* note 4, § 4:4.5, at 4-102 to 4-120, and 3 *ALAN R. BROMBERG & LEWIS LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD* §§ 6:245-6:268 (2d ed. 2007). For a defense of the possession standard, see *Jesse M. Fried, Insider Abstention*, 113 *YALE L.J.* 455, 485-86 (2003) (advocating the "possession" standard based on an economic analysis of a legal "regime where insiders are able to abstain on nonpublic information, but unable to trade while in possession of such information [which] levels the playing field between insiders and public shareholders").

19. *Horwich, Possession*, *supra* note 18, at 1235.

20. *Id.* at 1245-54.

21. *United States v. Smith*, 155 F.3d 1051, 1066-69 (9th Cir. 1998) (requiring proof of use of the information by the government in a criminal prosecution), *cert. denied*, 525 U.S. 1071 (2000); *SEC v. Adler*, 137 F.3d 1325, 1337-39 (11th Cir. 1998) (adopting the use requirement in a civil action but applying a "strong inference" of use from proof of possession of the information when trading).

22. See Rule 10b5-1 Proposing Release, 64 Fed. Reg. at 72600.

23. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727. The SEC found authority for its action in, *inter alia*, Sections 3, 10, and 23 of the Exchange Act, *supra* note 1, 48 Stat. at 882, 891, and 901 (codified as amended at 15 U.S.C.A. §§ 78c, 78j, and 78w (West 1997 & Supp. 2007)). Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51737. Under Section 3(b) of the Exchange Act, the SEC has the power to "define technical, trade, accounting, and other terms used" in the Exchange Act "consistently with the provisions and purposes of" the Act. Exchange Act, *supra* note 1, § 3(b), 48 Stat. at 882

crucial requirements for insider trading is satisfied by a showing of “awareness” of material nonpublic information, so that—at least superficially—proof of actual use of the information is not necessary.²⁵ Rule 10b5-1 states that Section 10(b) of the Exchange Act²⁶ and Rule 10b-5²⁷ prohibit

the purchase or sale of a security of any issuer, *on the basis of* material nonpublic information about that security or issuer, in breach of a duty of trust and confidence that is owed directly, or indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.²⁸

To this extent, the SEC’s interpretation at least arguably accurately reflected the prevailing judicial interpretations.²⁹ Rule 10b5-1 then defines trading “on the basis of” material nonpublic information for purposes of both the classical and misappropriation theories—that the person was “aware of the material nonpublic information when the person made the purchase or sale”³⁰—and sets forth what purport to be the only available affirmative defenses to a charge of unlawful trading while a person is “aware” of material nonpublic information.³¹

(codified as amended at 15 U.S.C. § 78c(b) (2000)). Under Section 10(b), the SEC has the authority to prescribe rules that identify unlawful manipulative or deceptive devices or contrivances. Section 10(b), 48 Stat. at 891 (codified as amended at 15 U.S.C.A. § 78j(b) (2000)). Under Section 23(a)(1), the SEC has “power to make such rules and regulations as may be necessary or appropriate to implement the provisions” of the Exchange Act, including classifying transactions and prescribing “greater, lesser, or different requirements for different classes thereof.” Exchange Act, *supra* note 1, § 23(a)(1), 48 Stat. at 901 (codified as amended at 15 U.S.C. § 78w(a)(1) (2000)).

24. 17 C.F.R. § 240.10b5-1 (2007). Rule 10b5-1 was part of a package of three rules pertaining to the disclosure and possible misuse of material nonpublic information. Regulation FD, 17 C.F.R. §§ 243.101–.103 (2007), addresses selective disclosure of material nonpublic information, mandating public disclosure in certain situations when a corporation or senior corporate official makes nonpublic disclosure of material information. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51716–26. Rule 10b5-2 defines “duties of trust or confidence” for the limited purpose of applying the misappropriation theory of insider trading. 17 C.F.R. § 240.10b5-2 (2007). Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51729–30. It has been reported that executives at Standard & Poor’s 500 companies sold more than \$8.5 billion in stock in 2006 in reliance on Rule 10b5-1. Dionne Searcey & Kara Scannell, *SEC Now Takes a Hard Look at Insiders’ “Regular” Sales*, WALL ST. J., Apr. 4, 2007, at C3 (quoting report by InsiderScore.com).

25. In reality, however, SEC actions to enforce the prohibition on unlawful trading, and the actual application of Rule 10b5-1, appear to depend upon whether the information in question actually was used in the decision to trade. *See infra* text accompanying notes 61–64.

26. Exchange Act, *supra* note 1, § 10(b), 48 Stat. at 891 (codified as amended at 15 U.S.C. § 78j(b) (2000)).

27. 17 C.F.R. § 240.10b-5 (2007).

28. Rule 10b5-1(a), 17 C.F.R. § 240.10b5-1(a) (2007) (emphasis added).

29. *See supra* text accompanying notes 19–21 and WANG & STEINBERG, *supra* note 4, at § 4:4.5.

30. Although Rule 10b5-1 provides definitions applicable to insider trading, the rule does not define “aware.” The SEC stated that “aware” is “a commonly used and well-defined English word, meaning ‘having knowledge; conscious; cognizant,’” that is “much clearer” than “‘knowing possession,’ which has not been defined by case law.” Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727 n.105.

31. Rule 10b5-1(b) and (c)(1), 17 C.F.R. § 240.10b5-1(b) and (c)(1) (2007):

(b) Definition of “on the basis of.” Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is “on the basis of” material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.

D. THE MEANING OF RULE 10b5-1

1. The SEC's Rationale for and Explanation of the Provisions of Rule 10b5-1

Rule 10b5-1 presents a seemingly straightforward approach to delineating when a person violates the prohibition on trading on the basis of material nonpublic information in those circumstances where the requisite duty element—that of the insider

(c) Affirmative defenses.

(1)(i) Subject to paragraph (c)(1)(ii) of this section, a person's purchase or sale is not "on the basis of" material nonpublic information if the person making the purchase or sale demonstrates that:

(A) before becoming aware of the information, the person had:

(1) entered into a binding contract to purchase or sell the security,

(2) instructed another person to purchase or sell the security for the instructing person's account, or

(3) adopted a written plan for trading securities;

(B) the contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section:

(1) specified 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) included a written formula or algorithm, or computer program, 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 person to exercise any subsequent influence over how, when, or whether to effect purchases or sales;

provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and

(C) the purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated 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 entered into or altered a corresponding or hedging transaction or position with respect to those securities.

(ii) Paragraph (c)(1)(i) of this section is applicable only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section.

(iii) This paragraph (c)(1)(iii) defines certain terms as used in paragraph (c) of this section.

(A) Amount. "Amount" means either a specified number of shares or other securities or a specified dollar value of securities.

(B) Price. "Price" means the market price on a particular date or a limit price, or a particular dollar price.

(C) Date. "Date" means, in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). "Date" means, in the case of a limit order, a day of the year on which the limit order is in force.

This Article does not address another aspect of Rule 10b5-1, the recognition of the so-called "Chinese wall" or information barrier as a defense to a charge of unlawful insider trading by an entity when the entity was aware of the material nonpublic information but the "individual making the investment decision on behalf of the [entity] to purchase or sell the securities was not aware of the information." Rule 10b5-1(c)(2), 17 C.F.R. § 240.10b5-1(c)(2)(i) (2007); see Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51728. For a comprehensive discussion of this topic, see WANG AND STEINBERG, *supra* note 4, at § 13:5.2.

or misappropriator—is present.³² As the rule itself states,³³ the apparent trend in the judicial decisions was to apply the prohibition when the trading was “on the basis of” material nonpublic information.³⁴ The purpose of Rule 10b5-1 was to define this phrase.³⁵ In so doing, however, the SEC may have indulged in some linguistic legerdemain, by arguably transforming a phrase that connotes a deliberate act—to act “on the basis of”—into something less. Specifically, the SEC decreed that trading “on the basis” of means—subject to specified affirmative defenses—to make the purchase or sale when the person is “aware of the material nonpublic information.”³⁶ The SEC did not define “aware,” suggesting it connotes some degree of knowledge,³⁷ thus leaving it to the courts to clarify just what that means.³⁸

While to be “aware” of information appears to entail something more than merely to “possess” it,³⁹ awareness surely can entail something less than (though is not inconsistent with) deliberately taking the information into account in deciding whether to make a trade.⁴⁰ The SEC chose to use the test of being “aware” based on its view that “the goals of insider trading prohibitions—protecting investors and the integrity of the securities markets—are best accomplished by a standard closer to the ‘knowing possession’ standard than to the ‘use’ standard.”⁴¹ Taken in isolation, this rationale simply says that lowering the threshold of liability will reach more conduct.⁴² Confronting the possession versus use issue head on, the

32. See *supra* text accompanying notes 9–11 and 15–17.

33. See *supra* text accompanying note 28.

34. See, e.g., *O'Hagan*, 521 U.S. at 652–53, 655, 656, 659.

35. Rule 10b5-1, Preliminary Note, 17 C.F.R. § 240.10b5-1 (2007).

36. Rule 10b5-1(b), 17 C.F.R. § 240.10b5-1(b) (2007). One author, while generally advocating the approach taken in Rule 10b5-1 (described as “the modified possession standard”), referred to substituting the “awareness” test for a “possession” test as a “tactical linguistic trick” because “[t]he terms ‘aware’ and ‘possession’ are used interchangeably by the SEC and mean the same thing in the SEC’s lexicon.” Hui Huang, *The Insider Trading “Possession Versus Use” Debate: An International Analysis*, 34 SEC. REG. L.J. 130, 134, 146 (2006) (footnote omitted).

37. See *supra* note 30.

38. When courts are left to define words in interpreting agency rules, however, the issue may lead to a debate over which dictionary to use. See, e.g., *MCI Telecomm. Corp. v. Am. Tel. & Tel. Co.*, 512 U.S. 218, 225–28 (1994) (addressing what dictionaries to use in interpreting a word in a federal statute).

39. Awareness entails consciousness or knowledge of the information. See, e.g., WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 152 (2002) (defining “aware” as “marked by realization, perception, or knowledge”). However, possession may mean only to have the information in hand without being cognizant of its existence. *Id.* at 1770 (defining “possess” as meaning “to have,” albeit one can possess knowledge); see also 1 SHORTER OXFORD ENGLISH DICTIONARY ON HISTORICAL PRINCIPLES 160 (5th ed. 2002) (defining “aware” to mean “[c]onscious, sensible, not ignorant, having knowledge”).

40. Thus, in the cases cited *supra* note 21, defendants appeared to be aware of the material nonpublic information in that they possessed it, but that did not resolve the question of whether they had used it in making the trading decision. *Smith*, 155 F.3d at 1066–69 (noting defendant’s possession of the information but also requiring proof of use of the information); *Adler*, 137 F.3d at 1337–39 (noting various defendants’ possession of the information and then applying a “strong inference” of use from proof of possession of the information when trading).

41. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727 (footnote omitted). Thus, the SEC sought to approach (“closer” to) a “knowing possession” standard but chose not to adopt it. This may suggest that to be “aware” entails something less than knowing possession, such as less consciousness of the information.

42. Similarly, a parity of information rule would encompass more conduct, but this was explicitly rejected by the U.S. Supreme Court as beyond the scope of the prohibition in Rule 10b-5. See *supra* note 6. See also *infra* text accompanying notes 149–77 (addressing validity of Rule 10b5-1).

SEC stated, without addressing contrary arguments, that Rule 10b5-1 “reflects the common sense notion that a trader who is aware of inside information when making a trading decision *inevitably* makes use of the information.”⁴³

In response to comments that the rule as proposed would eliminate the requisite element of scienter in actions under Rule 10b-5,⁴⁴ the SEC stated:

Some commenters stated that an awareness standard might eliminate the element of scienter from insider trading cases, contrary to the requirements of Section 10(b) of the Exchange Act, and that we therefore lack the authority to promulgate the rule. These comments misconstrue the intent and effect of the rule. As discussed in the Proposing Release and expressly stated in the Preliminary Note, Rule 10b5-1 is designed to address only the use/possession issue in insider trading cases under Rule 10b-5. The rule does not modify or address any other aspect of insider trading law, which has been established by case law. Scienter remains a necessary element for liability under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Rule 10b5-1 does not change this.⁴⁵

A number of commentators have discredited this explanation, concluding that applying Rule 10b5-1 as written *would* eliminate scienter as an element of an insider trading violation of Rule 10b-5.⁴⁶ While this author substantially agrees with these criticisms of Rule 10b5-1, it is not the purpose of this Article to restate or elaborate on those arguments. Even if the criticisms are not well-founded, none of the issues addressed here would disappear.⁴⁷

2. The Rule 10b5-1 Affirmative Defenses

The apparent harshness of the “awareness” standard imposed by Rule 10b5-1 was “balance[d]” with “several carefully enumerated affirmative defenses.”⁴⁸ There are three defenses, set forth in Rule 10b5-1(c)(1)(i)(A): before becoming aware of

43. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727 (emphasis added) (footnote omitted). For this proposition, the SEC cited a statement from *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir.), cert. denied, 510 U.S. 976 (1993), that has been generally recognized as dictum. See, e.g., Horwich, *Possession*, *supra* note 18, at 1250; Nagy, *supra* note 18, at 1146. Indeed, the SEC describes the case as only “suggesting” that “knowing possession”—without reference to “awareness”—is sufficient. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727 n.97. By contrast, the court in *Adler* observed that when a person trades while in possession of material nonpublic information “a strong inference arises that such information was used.” 137 F.3d at 1337. The court implicitly rejected the concept of inevitability.

44. Scienter is an element of any action based on a violation of Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976) (holding that scienter, meaning “a mental state embracing intent to deceive, manipulate, or defraud,” is an element of any violation of Section 10(b) of the Exchange Act and thus of any rule thereunder, such as Rule 10b-5). The scope of a rule adopted under the authority granted by Section 10(b) “cannot exceed the power granted the [SEC] by Congress under § 10(b),” so that the SEC cannot adopt a rule under that section that prohibits conduct that does not involve the scienter that is required by that section. *Id.* at 214.

45. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727 (footnotes omitted).

46. See *infra* text accompanying note 154.

47. In particular, one of the concerns addressed in this Article is whether the exclusivity element of the affirmative defenses, which are described *infra* text accompanying notes 48–51, is valid. Even if Rule 10(b)5-1 is valid in rejecting the “use” test in defining one element of insider trading, the question nevertheless remains whether evidence of the *absence* of conscious use of the information that did not meet the tests of the affirmative defenses would result in exoneration. See *infra* text accompanying notes 149–77.

48. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727 (footnote omitted).

the material nonpublic information the person (i) entered into a binding contract to purchase or sell the security, (ii) instructed another person to purchase or sell the security for the first person's account, or (iii) adopted a written plan for trading in the securities.⁴⁹ In this Article a contract, instruction, or plan established pursuant to Rule 10b5-1 is referred to as a "Plan." Rule 10b5-1(c)(1)(i)(B) specifies the requirements that a Plan must satisfy⁵⁰ and, of course, the actual transaction must conform to the Plan.⁵¹

3. The Rule 10b5-1 Affirmative Defenses Contrasted with Safe Harbors

The SEC has often adopted rules that provide so-called "safe harbors" so that if a person complies with each element of the safe harbor the person will be deemed not to have violated some statutory provision.⁵² For example, the SEC has granted safe harbors in Rule 144⁵³ for secondary sales of securities exempt from the registration requirements of Section 5 of the Securities Act of 1933;⁵⁴ in Rule 506 for primary sales of securities exempt from those registration requirements;⁵⁵ and in Rule 10b-18 for a corporation's repurchase of its own securities in a manner that is deemed not to be manipulative in violation of the Exchange Act.⁵⁶ Each of these safe harbors is non-exclusive, in that failure to comply with the terms of the safe harbor does not foreclose an argument that there was no violation of the substantive provision for which the safe harbor was adopted.⁵⁷

49. 17 C.F.R. § 240.10b5-1(c)(1)(i)(A) (2007), which is set out verbatim *supra* note 31.

50. 17 C.F.R. § 240.10b5-1(c)(1)(i)(B) (2007).

51. Rule 10b5-1(c)(1)(i)(C), 17 C.F.R. § 240.10b5-1(c)(1)(i)(C) (2007).

52. A "safe harbor" is "[a] provision (as in a statute or regulation) that affords protection from liability or penalty." BLACK'S LAW DICTIONARY 1363 (8th ed. 2004).

53. 17 C.F.R. § 230.144 (2007). One who satisfies the provisions of the rule is deemed not to be engaged in a distribution of securities and therefore not an "underwriter," so that the exemption from registration provided by Section 4(1), Securities Act of 1933, ch. 38, 48 Stat. 74, 77 (codified as amended at 15 U.S.C. § 77d(1) (2000)), is available. Rule 144(b), 17 C.F.R. § 230.144(b) (2007). The interaction between Rules 10b5-1 and 144 is discussed *infra* notes 76–81, especially as Rule 144 pertains to sales by an "affiliate" of the issuer, as provided by Rule 144(b), 17 C.F.R. § 230.144(b) (2007). An "affiliate" of an issuer is "a person that directly, or indirectly, through one or more intermediaries, controls, or is under common control with, such issuer." Rule 144(a)(1), 17 C.F.R. § 230.144(a)(1) (2007). For these purposes, "control" means "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." Rule 405, 17 C.F.R. § 230.405(2) (2007). For a comprehensive discussion of the concept of affiliate status, see J. WILLIAM HICKS, 7A EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 §§ 10:37–10:42.1 (2d ed. 2007) [hereinafter "HICKS"].

54. Securities Act of 1933, ch. 38, § 5, 48 Stat. 74, 77 (codified as amended at 15 U.S.C. § 77e (2000)).

55. 17 C.F.R. § 230.506 (2007).

56. 17 C.F.R. § 240.10b-18 (2007).

57. See Rule 144(j), 17 C.F.R. § 230.144(j) (2007) (providing that Rule 144 "does not eliminate or otherwise affect the availability of any exemption for resales under the Securities Act that a person or entity may be able to rely upon"); SEC Regulation D, Preliminary Note 3, 17 C.F.R. § 230.501 (2007) ("attempted compliance with any rule in Regulation D [which includes Rule 506] does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption" from the registration requirement); Rule 10b-18(d), 17 C.F.R. § 240.10b-18(d) (2007) ("No presumption shall arise that an issuer or an affiliated purchaser violated the anti-manipulation provisions [of the

The SEC's approach in Rule 10b5-1 is notably and deliberately different. The SEC rejected suggestions that the affirmative defenses be non-exclusive safe harbors or that the SEC add a catch-all defense to allow a person to establish that he or she did not actually use the information in deciding to trade.⁵⁸ The affirmative defenses in Rule 10b5-1(c)(i)(A) are "exclusive."⁵⁹ That is, applying Rule 10b5-1 as written, one who, while aware of material nonpublic information, engages in a trade that satisfies all of the other elements of a cause of action for insider trading could defend by arguing that he or she did not "use" the information in deciding to trade *only if* non-use is established by trades executed strictly in accordance with a Plan.⁶⁰

4. The Functional Import of the Rule 10b5-1 Definition and Defenses

Although Rule 10b5-1 adopts an awareness standard for imposing liability,⁶¹ the affirmative defenses are in effect criteria for establishing lack of "use" of the information by the insider. Moreover, the overall structure and rationale for the rule suggest that the SEC recognized that a "use" test was the fairest one,⁶² even

Exchange Act], if the Rule 10b-18 purchases of such issuer or affiliated purchaser do not meet the conditions specified [in Rule 10b-18]").

58. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727. Stanley Keller in one comment letter on the proposed rules advocated:

In order to avoid impermissibly shifting the burden to defendants and respondents to disprove elements of a Rule 10b5-1 charge, the Ad Hoc Task Force submits that the Commission could re-designate the "affirmative defenses" within the Proposed Rule as non-exclusive safe harbors. In the alternative, the Ad Hoc Task Force recommends that the Commission amend Proposed Rule 10b5-1 to provide a catch-all affirmative defense for persons other than those encompassed within paragraphs (c)(1)(i)(A)-(D), who can demonstrate that they reached a decision to make a particular trade without knowledge of material nonpublic information, and subsequently acted in accordance with that decision.

Comments of Stanley Keller, Chair, Federal Regulation of Securities Committee of the Section of Business Law of the American Bar Association, at 5 (May 8, 2000) (footnote omitted), *available at* <http://www.sec.gov/rules/proposed/s73199/keller1.htm>.

59. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727. Nevertheless, the Rule 10b5-1 defenses are frequently mischaracterized as "safe harbors." *See, e.g.,* SEC v. Lipson, 278 F.3d 656, 660 (7th Cir. 2002); JOHN C. COFFEE, JR., JOEL SELIGMAN & HILLARY A. SALE, *SECURITIES REGULATION CASES AND MATERIALS* 1174 (10th ed. 2007).

60. As explained *infra* in text accompanying notes 61–64, the effect of Rule 10b5-1 is to impose liability for trading while the trader is aware of material nonpublic information unless the trader can establish non-use through application of a Plan, so that in practice Rule 10b5-1 *effectively* adopts a "use" test with the burden on the trader to establish non-use, albeit limited to the specific alternatives afforded by the express affirmative defenses.

61. *See supra* text accompanying notes 36–41.

62. In proposing Rule 10b5-1, the SEC effectively acknowledged that it had crafted the rule so that someone who knew but did not use the information would not be held liable:

Sometimes a person may reach a decision to make a particular trade without any awareness of material nonpublic information, but then come into possession of such information before the trade actually takes place. A rigid "knowing possession" standard would lead to liability in that case. We believe, however, that for many cases of this type, a reasonable standard would not make such trading automatically illegal.

Rule 10b5-1 Proposing Release, 64 Fed. Reg. at 72600.

though explicit application of that standard was not something the SEC could support as a matter of policy.⁶³ In other words, taken as a whole, Rule 10b5-1 calls for the application of an awareness test to satisfy the “on the basis of” criterion in a case of alleged insider trading, subject to specified demonstrations that neither the trader nor anyone acting on his or her behalf actually used material nonpublic information in the securities trade.⁶⁴

II. THE OPERATION OF RULE 10b5-1 PLANS

A. THE BASIC ELEMENTS OF A RULE 10b5-1 PLAN

After Rule 10b5-1 was adopted many broker-dealers developed prototype Plans that are essentially a contract between the broker-dealer and its customer in which the customer gives specific instructions to the broker-dealer regarding the purchase or sale of securities in a manner that satisfies one or another of the types of

63. Thus, in proposing the rule, the SEC also said:

Whenever a person purchases or sells a security while aware of material nonpublic information that has been improperly obtained, that person has the type of unfair informational advantage over other participants in the market that insider trading law is designed to prevent. As a practical matter, in most situations it is highly doubtful that a person who knows inside information relevant to the value of a security can completely disregard that knowledge when making the decision to purchase or sell that security. In the words of the Second Circuit, “material information can not lay idle in the human brain.” Indeed, even if the trader could put forth purported reasons for trading other than awareness of the inside information, other traders in the market place would clearly perceive him or her to possess an unfair advantage.

Rule 10b5-1 Proposing Release, 64 Fed. Reg. at 72600 (footnotes omitted) (quoting *Teicher*, 987 F.2d at 120).

64. In adopting Rule 10b5-1 the SEC stated that the affirmative defenses are “designed to cover situations in which a person can demonstrate that the material nonpublic information was *not a factor in the trading decision*.” Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51728 (emphasis added). It is difficult to distinguish this concept from proving lack of use, so that the issue becomes not whether “use” is the test but on whom the burden of proof regarding use is placed.

The director of the SEC’s Division of Enforcement has effectively acknowledged that a use test is applied in proving insider trading cases:

The challenge [in proving insider trading] is not to establish facts that show suspicious trading—the surveillance records alone are often sufficient to establish that much. The real challenge is to establish that a particular individual was in possession of material non-public information and *in fact traded on it* in breach of a duty, and to establish those facts based on admissible evidence that can withstand challenge at trial.

Piecing together an insider trading case can be a complex and painstaking process. It is rare to find a “smoking gun”; virtually all insider trading cases hinge on circumstantial evidence. *It is quite common for insider traders to come up with alternative rationales for their trading*—rationales that the staff must refute with inferences drawn from the timing of trades, the movement of funds and other facts and circumstances.

Linda Chatman Thomsen, Testimony Concerning Insider Trading Before the U.S. Senate Committee on the Judiciary (Oct. 5, 2006) (as amended), available at <http://www.sec.gov/news/testimony/2006/ts092606lct.htm>; see Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scientoer*, 52 U. KAN. L. REV. 147, 200 (2003) (“the fact that the SEC presents affirmative defenses at all is a concession that when defendants distance themselves from actual use of the inside information, they should not be liable”).

Plans recognized by the rule.⁶⁵ Two principal features of a Plan, as required by the rule, are that a Plan can be established only when the person establishing the Plan is not aware of material nonpublic information, and under the Plan the person on whose behalf the transactions will be conducted relinquishes any subsequent influence over the transactions that are executed pursuant to the Plan.⁶⁶

The exact scope of the criterion of lack of current awareness of material nonpublic information is unclear. Could a person establish a valid Plan while aware of material nonpublic information but design the Plan so that no transaction would be implemented under the Plan until *that* information was disclosed or no longer material? This approach would be especially useful for someone, such as the chief executive officer of a smaller public company who may almost always be in possession of *some* material nonpublic information,⁶⁷ inasmuch as a very literal, or at least conservative, interpretation of the rule would preclude such executives from ever taking advantage of Rule 10b5-1. Commentators propose that Plans provide for an interval between creation of the Plan and the first transaction, so that the person creating the Plan cannot benefit from any material nonpublic information of which he or she was aware when the Plan was created.⁶⁸ While this provides some protection in the event the person was aware of material nonpublic information at the time the Plan was created, so that there could be no showing of profit realized as a result of *that* information in violation of Rule 10b-5, it does not directly address whether a Plan can be established with awareness of information that, by the express terms of the Plan, cannot be exploited by any transaction under the Plan.⁶⁹ The

65. See, e.g., http://www.williamblair.com/Pages/ces_10b5-1plan_procedure.asp (advertising that investment management firm William Blair & Company has a "Model Rule 10b5-1 Plan" available for review in establishing a Plan with that firm). A sample plan is provided in Exhibit A to Alan D. Jagolinzer, *Do Insiders Trade Strategically within the SEC Rule 10b5-1 Safe Harbor?* (Dec. 6, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=541502 [hereinafter "Jagolinzer"].

66. Rule 10b5-1(c)(1)(i)(A) and (B)(3), respectively, 17 C.F.R. § 240.10b5-1(c)(1)(i)(A) and (B)(3) (2007).

67. See, e.g., Paul Atkins, Commissioner, SEC, Remarks Before the International Corporate Governance Network 11th Annual Conference, at 6 (June 6, 2006), available at <http://www.sec.gov/news/speech/2006/spch070606psa.htm> (stating, in the context of decisions by boards of directors when granting stock options to corporate employees, that "corporate boards are almost always in possession of material nonpublic information").

68. See, e.g., Bochner & Hakala, *supra* note 3, at 5; Sharon J. Hendricks, *Stock Trading Plans under Rule 10b5-1, Pre-Arranged Periodic Stock Trading Plans for Company Insiders who have Frequent Access to Material Nonpublic Information*, in PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2005, 1464 PLI/Corp 957, 960 (Jan. 2005).

69. One arguable concern about allowing creation of a Plan when a person has material nonpublic information even where no trade will occur until after some reasonable time after *that* information becomes public (or, alternatively, the information is no longer material) may be that the executive has set up the Plan so that it will provide for a sale of his or her stock soon after disclosure of some positive, price-increasing development that only certain insiders know is impending. There is nothing wrong with that vis-à-vis Rule 10b-5 because the actual sale will not take place until after the market price has reflected the new information. Ordinarily, the chief executive would be able to sell his or her stock at that time anyway, i.e., after public disclosure (*see supra* text accompanying note 14), irrespective of Rule 10b5-1, to take advantage of the effect on the stock price of the newly released information (assuming that, at that time, he or she has not learned *new* material nonpublic information). Thus, a person is *not* taking advantage of the earlier information in a manner that is prohibited by the classical

author is unaware of any SEC staff interpretive guidance on this reading of Rule 10b5-1.⁷⁰

Many publications discuss the practicalities of and best practices for establishing a Plan and complying with the requirements of Rule 10b5-1.⁷¹

A Plan can be amended, so long as the creator of the Plan is not “aware” of material nonpublic information at the time of the amendment.⁷² The person who established the Plan can direct the person who implements the Plan *not* to engage in a transaction that would otherwise have taken place in accordance with the

theory of insider trading, albeit because he or she knows that there is such information and that it may soon become public, if the person is able to put a Plan in place to benefit from the information when it is appropriate to do so—assuming that the other criteria for establishing a Rule 10b5-1 Plan are satisfied.

The conventional solution for the person who almost always has some at least arguably material information is that when the public company that issued the stock in question files its Form 10-K or Form 10-Q with the SEC, which is when all material information about the company's business is most likely to be disclosed, is the ideal time to establish a Plan. The requirements of these periodic reports are found at <http://www.sec.gov/about/forms/secforms.htm#1934forms>. This is the import of the suggestion offered by the commentators cited *supra* note 68. This assumes that the combination of responsiveness to the specific items of Forms 10-K and 10-Q and compliance with the requirement of Rule 12b-20, 17 C.F.R. § 240.12b-20 (2007), that “[i]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading,” result in full disclosure of all material facts. There are, however, exceptions, and so the situation must be evaluated in each case.

Another alternative is to encourage establishment of a Plan during a trading “window” under the issuer's insider trading policy. A “window” is a limited period (usually several weeks) when trading in the company's securities is generally permitted by senior management and directors, usually beginning shortly after the announcement of quarterly or annual earnings, on the assumption that upon issuance of the earnings press release there will be no undisclosed material information. See 3 ALAN R. BROMBERG & LEWIS LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 6:286 (2d ed. 2007) (defining “window” period).

70. See John F. Olson et al., *Recent Developments in Federal Securities Regulation of Corporate Finance*, in ALI-ABA COURSE OF STUDY: POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW, SJO14 ALI-ABA 1, 148 (2003) (stating that the SEC staff has not been willing to take a position on whether the affirmative defense under the rule is available where the insider established the Plan before becoming aware of material nonpublic information that the insider knows at the time of the trade, the insider was aware of *other* material nonpublic information when the Plan was established, or the material information the insider knew when the Plan was established is publicly disclosed before the first trade occurred under the Plan).

71. See, e.g., Larry Spigel, *Frequently Asked Questions: Rule 10b5-1*, Part C (Apr. 2004), available at <http://www.realcorporatelawyer.com/faqs/faq10b5-1.html>; Peter J. Romeo & Alan L. Dye, *Insider Trading under Rule 10b5-1 and 10b5-2*, in ALI-ABA COURSE OF STUDY: POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW, SH013 ALI-ABA 893, 903–916 (2002) [hereinafter “Romeo & Dye”]; Bochner & Hakala, *supra* note 3, at 2.

While the focus of this Article is the impact of Rule 10b5-1 on individuals, one of the express reasons for adopting the rule was to facilitate repurchases of stock by public corporations. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51728. This concern recognizes that a corporation is subject to the prohibition on insider trading imposed by Rule 10b-5. *Supra* text accompanying note 10. Corporate repurchases are often carried out in accordance with the manipulation safe harbor provided by Rule 10b-18, 17 C.F.R. § 240.10b-18 (2007). See Romeo & Dye, *supra*, at 931.

72. See Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51728 n.111:

a person acting in good faith may modify a prior contract, instruction, or plan before becoming aware of material nonpublic information. In that case, a purchase or sale that complies with the modified contract, instruction, or plan will be considered pursuant to a new contract, instruction, or plan.

terms of the Plan; that is, aborting a transaction is not a violation of Rule 10b-5.⁷³ However, exercising this kind of control over a Plan may undermine, or even eliminate, the effectiveness of the Plan as an affirmative defense.⁷⁴ Indeed, cancellations may be deemed a termination of the Plan.⁷⁵

B. THE INTERACTION OF RULE 10b5-1 AND DISCLOSURE REQUIREMENTS UNDER THE SECURITIES LAWS

Compliance with Rule 10b5-1 and the establishment of a Plan have implications for compliance with disclosure requirements under the federal securities laws. The more significant ones are discussed in the following subparts of this Article.

1. SEC Rule 144

As noted earlier, SEC Rule 144 can be used to effectuate secondary sales without registration under the Securities Act.⁷⁶ In order to comply with Rule 144 for

73. The SEC staff position was expressed as follows:

After the written trading plan . . . has been in effect for several months, the person terminates the selling plan by calling the broker and canceling the limit order.

(a) Does the act of terminating a plan while aware of material nonpublic information result in liability under Section 10(b) and Rule 10b-5?

No. Section 10(b) and Rule 10b-5 apply "in connection with the purchase or sale of any security."

Thus, a purchase or sale of a security must be present for liability to attach. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

U.S. Securities & Exchange Commission, SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fourth Supplement, Item 15(a) (Additional Interpretations Issued May 2001), available at <http://www.sec.gov/interps/telephone/phonesupplement4.htm>.

One commentator has interpreted this advice as applying only to pre-arranged trading plans using a formula or algorithm, and not to cancelling the grant of discretion to a third party to place trades on behalf of the stockholder or cancelling an otherwise binding contract to trade. Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 487–91 (2003). In light of the rationale for recognizing that there is no violation of Rule 10b-5 when a pre-arranged plan is cancelled, if the grant of discretion to a third party was revocable or the "binding" contract contained a cancellation provision, there is no apparent reason to distinguish among the three types of Plans for this purpose.

74. Securities & Exchange Commission, SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fourth Supplement, Item 15(b) (Additional Interpretations Issued May 2001), available at <http://www.sec.gov/interps/telephone/phonesupplement4.htm> ("Termination of a plan, or the cancellation of one or more plan transactions, could affect the availability of the Rule 10b5-1(c) defense for prior plan transactions if it calls into question whether the plan was 'entered into in good faith and not as part of a plan or scheme to evade' the insider trading rules within the meaning of Rule 10b5-1(c)(1)(ii). The absence of good faith or presence of a scheme to evade would eliminate the Rule 10b5-1(c) defense for prior transactions under the plan."). Furthermore, the ability to direct the person who implements the Plan not to trade may undermine the essential element of a valid Plan that the person who established the Plan had relinquished control over the transactions, as required by Rule 10b5-1(c)(i)(B)(3), 17 C.F.R. § 240.10b-5(c)(1)(B)(3) (2007).

75. Securities & Exchange Commission, SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fourth Supplement, Item 15(c) (Additional Interpretations Issued May 2001), available at <http://www.sec.gov/interps/telephone/phonesupplement4.htm>.

The cancellation of one or more plan transactions would be an alteration or deviation from the plan, which would terminate that plan. The Rule 10b5-1(c) defense would be available for transactions following the alteration only if the transactions were pursuant to a new contract, instruction or plan that satisfies the requirements of Rule 10b5-1(c).

76. *Supra* note 53. The rule applies to sales of restricted securities of the issuer by an affiliate or non-affiliate of the issuer and any sale by another person, such as a broker, for the account of an

any substantial sale of securities, a Form 144 signed by the person on whose behalf the sale is made must be filed with the SEC and with any exchange where the securities are traded no later than concurrently with either placing an order with a broker or execution directly with a market maker.⁷⁷ The form requires that the seller attest that by signing the notice “he [represents] that he does not know any material adverse information in regard to the current and prospective operations of the Issuer of the securities to be sold which has not been publicly disclosed,”⁷⁸ i.e., that the sale is not made at a time when he is aware of adverse material nonpublic information regarding the issuer. Of course, the very purpose of Rule 10b5-1 is to allow a sale to be made when the person for whose account the securities are sold *may* or even *does* have such information. Apart from the fact that many Plans entail granting a power of attorney to the selling broker to sign the Form 144 on behalf of the selling stockholder,⁷⁹ the staff of the SEC has offered a solution to the anomaly presented by the text of the form:

The seller should state in the Remarks section of the Form 144 that the sale is being made pursuant to a previously adopted plan or previously given trading instructions intended to comply with Rule 10b5-1(c). The seller should include the date the person adopted the plan or gave the trading instructions and indicate that the representation regarding the seller's knowledge of material information speaks as of that plan adoption or instruction date.⁸⁰

This effectuates compliance with Rule 144. Additionally, the filing of the form achieves some element of public disclosure that the prospective seller has a Plan in effect,⁸¹ although that disclosure provides no details of the terms of the Plan.

2. SEC Form 4

Whenever the beneficial owner of more than ten percent of a class of equity securities registered under Section 12 of the Exchange Act,⁸² or a director or officer

affiliate of the issuer. Rule 144(b), 17 C.F.R. § 230.144(b) (2007). For a comprehensive discussion of Rule 144, see Hicks, *supra* note 53, at ch. 10.

77. Rule 144(h), 17 C.F.R. § 230.144(h) (2007) (requiring form if the amount of securities to be sold in reliance on Rule 144 during any three month period exceeds 500 shares or the aggregate sale price will exceed \$10,000). The SEC has proposed increasing these thresholds. SEC, Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates, SEC Rel. No. 33-8813, 72 Fed. Reg. 36822, 36830 (July 5, 2007) (Section II.D) [hereinafter “Rule 144 Revision Release”]. See generally Hicks, *supra* note 53, at §§ 10:230–10:235 (describing requirements pertaining to Form 144).

78. See text of Form 144 at <http://www.sec.gov/about/forms/secforms.htm#1933forms>.

79. See Romeo & Dye, *supra* note 71, at 912 (reporting that a common provision of a Plan is a requirement that the insider “provide a power of attorney or signed blank forms to enable the broker to make Form 144 filings on the insider's behalf”).

80. U.S. Securities & Exchange Commission, SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fourth Supplement, Form 144, Item 2 (Additional Interpretations Issued Dec. 2000), available at <http://www.sec.gov/interps/telephone/phonesupplement4.htm>. The SEC has proposed to codify this practice by revising Form 144. Rule 144 Revision Release, *supra* note 77, at 36833 (Section II.E.7).

81. Many forms filed with the SEC must be filed electronically, and they then become available almost immediately on the SEC's website at <http://www.sec.gov/edgar.shtml>. 17 C.F.R. § 232.101(a) (2007). Form 144, however, may be but is not required to be filed electronically. *Id.* § 232.101(b)(4).

82. 48 Stat. at 892 (codified as amended at 15 U.S.C. § 78l (2000 & Supp. IV 2004)).

of such a company,⁸³ buys or sells the security a report must be filed electronically with the SEC on Form 4 before the end of the second business day after the transaction.⁸⁴ While ordinarily for purposes of this filing requirement the “transaction” occurs when the sale or purchase is made, where the transaction is carried out pursuant to a Plan and the reporting person did *not* select the date of execution (e.g., by specifying the exact date to trade in the Plan) then the date on which the broker “notifies the reporting person of the execution of the transaction is deemed the date of execution of the transaction” for purposes of determining when the Form 4 must be filed.⁸⁵ Nevertheless, the “Transaction Date” that is entered under column 2 of

83. This requirement applies only to certain officers of the issuer. SEC Rule 16a-1(f), 17 C.F.R. § 240.16a-1(f) (2007).

84. See Exchange Act, *supra* note 1, § 16(a), 48 Stat. at 896 (codified as amended at 15 U.S.C. § 78p(a)(4) (2000 & Supp. IV 2004)); see also Rule 16a-3, 17 C.F.R. § 240.16a-3 (2007). The form must also be sent to at least one stock exchange on which the securities are listed and to the issuer (Section 16(a)(1) and Rule 16a-3(c), 17 C.F.R. § 240.16a-3(c) (2007)), and if the issuer whose securities are sold has a website, the Form 4 must be posted there by the issuer by the end of the next business day after the form has been filed with the SEC (Rule 16a-3(k), 17 C.F.R. § 240.16a-3(k) (2007)). Form 4 is found at <http://www.sec.gov/about/forms/secforms.htm#1934forms>. For detailed discussions of the reporting requirements under Section 16(a), see Arnold S. Jacobs, SECTION 16 OF THE SECURITIES EXCHANGE ACT §§ 2:71–2:100, 2:115.10–2:122, 2:135–148, and ch. 8 (2006), and Peter J. Romeo & Alan L. Dye, *Comprehensive Section 16 Outline*, in ROMEO’S AND DYE’S SECTION 16 ANNUAL SERVICE, ch. II.E.8 (2005).

When a person first becomes subject to the reporting requirements under Section 16(a) by becoming a director or officer, an initial report of the person’s beneficial stock ownership is to be filed on a Form 3 within ten days after the person becomes a director or officer. Exchange Act, *supra* note 1, § 16(a)(2)(B), 48 Stat. at 896 (codified as amended at 15 U.S.C. § 78p(a)(2)(B) (2000 & Supp. IV 2004)); Rule 16a-3(a), 17 C.F.R. § 240.16a-3(a) (2007).

85. Rule 16a-3(g)(2), 17 C.F.R. § 240.16a-3(g)(2) (2007). If, however, the notification date is *later* than the third business day following the trade date, for purposes of determining when the Form 4 must be filed, the date of execution of the trade is deemed to be the third business day following the trade date. Rule 16a-3(g)(4), 17 C.F.R. § 240.16a-3(g)(4) (2007). As the SEC explained in adopting these rules:

In each case, a reporting person must report the transaction on Form 4 before the end of the second business day following the deemed date of execution, as calculated under the applicable rule, for the transaction. Defining the date of execution as the notification date enables a reporting person to report on Form 4 a transaction of which he or she otherwise would not have notice. However, neither exception will be available if the reporting person has selected the date of transaction execution, for example where a Rule 10b5-1(c) arrangement provides for a sale on the first business day of each month.

The three-business day period provides reasonable time for notification to be made, and is consistent with the Act’s purpose to expedite reporting. For both Rule 10b5-1(c) transactions and Discretionary Transactions, we expect the reporting person will make specific arrangements for the broker, dealer or plan administrator to provide the reporting person actual notice of transaction execution as quickly as feasible. By deeming the notification date to be the third business day following the trade date if actual notification does not occur by then, the rule limits the potential delay permitted for reporting these transactions on a timely basis.

The broker, dealer or plan administrator may use any means of communication, including oral, paper or electronic means, to notify the reporting person that the transaction has been executed. While a broker or dealer also will have an obligation to provide the reporting person with a transaction confirmation under Exchange Act Rule 10b-10, the confirmation may not arrive soon enough to give the reporting person the information he or she needs for Section 16(a) reporting purposes. For example, a confirmation sent through the mail could take several days to arrive. We would, therefore, usually expect brokers and dealers to provide the information needed for Section 16(a) reporting purposes to the reporting person either electronically or by telephone.

the Form 4 should be the actual date of the transaction, not the “deemed” date of execution for purposes of determining the deadline for filing the form.⁸⁶

Nothing in the Form 4 itself or the related statutory or rule provisions, however, requires any disclosure that the transaction was pursuant to a Plan. If the reporting person avails him or herself of the dispensation to file later than the second business day after the transaction where the transaction is pursuant to a Plan,⁸⁷ however, then the person would enter the “deemed execution date” in column 2A of Form 4, thereby *effectively* disclosing that the transaction was pursuant to Plan and that the reporting person had a Plan in effect. Moreover, a seller who wishes to make known that the sale was pursuant to a Plan can include a reference to the Plan in the open space provided under Table I of Form 4.

3. SEC Schedule 13D

Under Section 13(d) of the Exchange Act,⁸⁸ any person who is directly or indirectly the owner of more than five percent of a class of equity securities registered under Section 12(d) of the Exchange Act must, within ten days after passing the five percent beneficial ownership threshold, file a report with the SEC, with the issuer of the securities that provides the information required by Schedule 13D, and with each exchange where the securities are traded.⁸⁹

Item 4 of Schedule 13D requires disclosure of any “plans or proposals which the reporting persons may have which relate to or would result in: (a) The acquisition by any person of additional securities of the issuer, or the disposition of securities of the issuer. . . .”⁹⁰ By these express terms the schedule can fairly be read as requiring disclosure by a reporting person of any *specific* plan to buy or sell the securities,⁹¹ and thus of any Rule 10b5-1 Plan. Item 7 of Schedule 13D requires

Regarding Rule 10b5-1(c) transactions, the new rule will be available broadly to any transaction that satisfies the affirmative defense conditions of Rule 10b5-1(c), including transactions pursuant to employee benefit plans and dividend or interest reinvestment plans that are not exempt from Section 16(a) reporting.

Ownership Reports and Trading by Officers, Directors and Principal Security Holders, SEC Rel. No. 34-46421, 67 Fed. Reg. 56462, 56464 (Sept. 3, 2002) (footnotes omitted).

86. Romeo & Dye, *supra* note 84, at 43 (stating that for a Rule 10b5-1 transaction “the trade date would continue to be the execution date of the transaction for purposes of Section 16”).

87. See *supra* text accompanying note 85.

88. 48 Stat. at 894 (codified as amended at 15 U.S.C. § 78m(d) (2000)). For a detailed discussion of the requirements of Section 13(d), see 5 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2169–95 (3d ed. rev. 2001).

89. 17 C.F.R. § 240.13d-101 (2007). The filing with the SEC must be made electronically. 17 C.F.R. § 232.101(a)(1)(iii) (2007).

90. Schedule 13D, Item 4, 17 C.F.R. § 240.13d-101 (2007).

91. *Cf.*, e.g., *Saunders Leasing Sys. v. Société Holding Gray D’Albion S.A.*, 507 F. Supp. 627, 633–34 (N.D. Ala. 1981) (holding that ultimate purpose to acquire a specified percentage of the issuer’s shares must be disclosed under Item 4(a) of Schedule 13D where the contemplated acquisition would have resulted in control of the issuer). While Item 4 literally requires disclosure of *any* plan or proposal to acquire or dispose of shares, the reported cases, such as *Saunders Leasing*, focus on the relationship between any such plans and the acquisition or disposition of control of the company, which relates back to the primary disclosure required by Item 4, to “[s]tate the purpose or purposes of the acquisition of securities of the issuer.” 17 C.F.R. § 240.13d-101 (2007).

filing as an exhibit to the schedule any "contracts, arrangements, understandings [or] plans" relating to, among other things, "any matter as disclosed in Item 4."⁹² This requirement can likewise be read to mean that someone with a Plan who files a Schedule 13D must provide the Plan as an exhibit to the filed schedule.⁹³ Under Section 13(d) and Schedule 13D,⁹⁴ the filing person must disclose any "material change" in the facts set forth in the schedule.⁹⁵ Thus, if a Plan was disclosed in a Schedule 13D, any material amendment to the Plan, including cancellation of the Plan, should be disclosed.

Judicial decisions are split on whether the requirements of Section 13(d) are strictly applied to insiders, such as officers and directors, who own more than five percent of the equity securities of their companies.⁹⁶ Few insiders appear to file the Schedule 13D except in the context of a takeover contest, and even then some

92. Schedule 13D, Item 7, 17 C.F.R. § 240.13d-101 (2007).

93. A survey of Schedules 13D referring to Rule 10b5-1, using the search function on the SEC website, indicates that most persons filing the schedule do not fully describe, much less attach a copy of, any Plan. Nevertheless, some filers do provide copies of the Plan. *See, e.g.,* Ralcorp Holdings, Inc. and RH Financial Corporation (Schedule 13D) (Nov. 30, 2005) (regarding the securities of Vail Resorts, Inc. and attaching a Rule 10b5-1 Plan as Exhibit 99.5), available at <http://www.sec.gov/Archives/edgar/data/812011/000095013805001157/schl3da.htm>; Maurice Marciano (Schedule 13D) (June 21, 2004) (regarding the securities of Guess?, Inc. and attaching a Rule 10b5-1 Plan as Exhibit 5 to Item 7), available at http://www.sec.gov/Archives/edgar/data/912463/000090259504000028/form13d_1046434.txt. *See also, e.g.,* Richard L. Scott (Schedule 13D) (Nov. 21, 2006) (regarding the securities of Media Sciences International, Inc. and disclosing open market sales in accordance with Plan but not attaching the full text of the Plan), available at <http://www.sec.gov/Archives/edgar/data/915477/000095014406011100/g04469a3sc13dza.htm>.

94. *Supra* text accompanying notes 88–89.

95. Exchange Act, *supra* note 1, § 13(d)(2), 48 Stat. at 894 (codified as amended at 15 U.S.C. § 78m(d)(2) (2000)); Rule 13d-2(a), 17 C.F.R. § 240.13d-2(a) (2007).

96. The principal cases to address whether members of management who meet the stock ownership threshold under Section 13(d) must file a Schedule 13D are *Corenco Corp. v. Schiavone & Sons, Inc.*, 488 F.2d 207, 218 (2d Cir. 1973) (holding that members of management were not required to file a Schedule 13D when they agreed to pool their interests to fight a threatened takeover in light of their compliance with the disclosure requirements imposed by another provision of the Exchange Act that required disclosure of certain information when opposing a hostile tender offer; the court stated that "it would be pointless to superimpose requirements found in another section, which does not deal specifically with management disclosures"); *Warner Commc'ns, Inc. v. Murdoch*, 581 F. Supp. 1482, 1499–1500 (D. Del. 1984) (holding that corporate officers and directors are not generally required to comply with Section 13(d), as their stock ownership is already publicly disclosed, but compliance is required if a management group is engaged in a voting or pooling arrangement with third parties, such as in fending off an attempted takeover of the company); *Bayly Corp. v. Marantette*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,834, at 94,292 (D.D.C. Oct. 19, 1982) (holding insider defendants failed to file required Schedule 13(d) to disclose formation of a group to purchase additional stock in the company); *Podesta v. Calumet Indus., Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,433, at 93,559–60 (N.D. Ill. May 9, 1978) (holding that a management group was required to comply with Section 13(d), at least outside the context of an outside tender offer); *Applied Digital Data Sys. Inc. v. Milgo Electronic Corp.*, 425 F. Supp. 1145, 1161 (S.D.N.Y. 1977) (stating in dictum, following *Corenco*, that in the context of a pending tender offer where disclosure of management's position is otherwise required by law, Section 13(d) does not apply to a management group which has aligned with others to oppose the offer); *Jewelcor Inc. v. Pearlman*, 397 F. Supp. 221, 243–44 (S.D.N.Y. 1975) (holding that Section 13(d) applies to management groups even when there is no alignment with any third party, at least where there has not yet been a tender offer requiring other disclosures); and *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 61–63 (D.N.J. 1974) (holding that management group was not required to file Schedule 13D where disclosures had been made under the proxy rules, following *Corenco*). *See also* Dennis J. Block & Neal Schwarzfeld, *Management Groups under the Williams Act*,

courts may not require compliance, if other disclosure suffices.⁹⁷ Some of the cases⁹⁸ focus more on whether members of management have formed a “group” with others that must report as such under Section 13(d)(3) of the Exchange Act⁹⁹ and Rule 13d-5(b)(1).¹⁰⁰ The SEC staff, however, has taken a clear position that a member of management or a director who has satisfied the stock ownership threshold under Section 13(d) is required to file a Schedule 13D, irrespective of any other disclosure of that ownership and irrespective of whether the person(s) in question already control the company.¹⁰¹

Accordingly, the courts and the SEC seem largely to be satisfied if the *stockholdings* of directors and management are disclosed, such as in the annual proxy statement¹⁰² or through Forms 3 and 4 filed in compliance with Section 16(a).¹⁰³ This is so even though the additional information that would be required by a Schedule 13D, such as plans for acquiring more securities, are not disclosed in those contexts.¹⁰⁴ As a practical matter, therefore, it is unlikely that a significant number of Plans will be disclosed through Schedule 13D filings.

III. DISCLOSURE OF RULE 10B5-1 PLANS

Part II.B of this Article described circumstances when the existence of a Plan might be or must be disclosed to comply with some specific provision of the

5 SEC. REG. L.J. 69, 82 (1977) (discussing cases decided to date and observing that “the statute itself makes no distinction between a management group or any other group”).

97. See, e.g., *Corenco*, 488 F.2d at 218; *Applied Digital Data*, 425 F.Supp. at 1161.

98. See, e.g., *Warner Comm'cns*, 581 F.Supp. at 1499–1500.

99. 48 Stat. at 894 (codified as amended at 15 U.S.C. § 78m(d)(3) (2000)).

100. 17 C.F.R. § 240.13d-5(b)(1) (2007). For a general discussion of the issues surrounding whether a “group” has been formed, see 5 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 2177–81 (3d ed. rev. 2001).

101. *Tony Lama Co.*, SEC No-Action Letter, [1974–75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,901, at 84,313 (May 14, 1974). Notwithstanding this definitive position, it is not apparent that the SEC has actively enforced compliance with Section 13(d) in this regard. Arguably this is because in fact the basic information about insider stockholdings is otherwise disclosed and, in the absence of an egregious violation of Section 13(d), the SEC's limited enforcement resources are better directed elsewhere. See, e.g., *In the Matter of Citizens Trust Company*, Exchange Act Release No. 22,802, [1982–87 Accounting and Auditing Enforcement Releases Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,484 (Jan. 15, 1986) (reporting settlement of charges for failure to file a Schedule 13D by president of company who was involved in stock accumulation program to fend off a takeover; the Commission “remind[ing] management of registered issuers of the need to ascertain whether stock acquisitions undertaken in response to proposed mergers or acquisitions necessitates the filing of a Schedule 13D. Concerted activities by a management-led group . . . may create a Section 13(d)(3) group and a need to make public disclosures on Schedule 13D if the group owns the requisite amount of securities.”). Even here, however, the focus is on the presence of a group and not the obligation of a single shareholder who alone owns more than five percent of the stock.

102. Item 6(d) of Schedule 14A (17 C.F.R. § 240.14a-101 (2007)) for proxy statements requires the disclosures prescribed by Item 403 of Regulation S-K. 17 C.F.R. §§ 229.403(a), (b) (2007). Those sections require disclosure of the holdings of any person, including any group, with beneficial ownership of more than five percent of any class of the company's voting securities and the individual beneficial security ownership of directors and named executive officers.

103. See *supra* text accompanying notes 82–86.

104. Annual proxy statements must disclose information regarding granted but unexercised stock options (Items 402(f) (as required by Item 10 of Schedule 14A) and 403(b) of Regulation S-K, 17 C.F.R. §§ 229.402(f) and 229.403(b) (2007)), but there is no requirement to disclose the executive's

federal securities laws. This Part of the Article addresses other issues regarding disclosure of a Plan.

A. THE SEC PROPOSAL TO REQUIRE DISCLOSURE OF 10b5-1 PLANS ON FORM 8-K

The SEC had proposed that certain Plans be disclosed on Form 8-K, the form that is used for making current disclosure of specified corporate events.¹⁰⁵ The rule as proposed would have required that the issuer of the securities in question disclose "[e]ach director's and executive officer's adoption, modification or termination of a contract, instruction or written plan for the purchase or sale of company equity securities intended to satisfy the affirmative defense conditions of Exchange Act Rule 10b5-1(c)."¹⁰⁶ The rationale was that

current reports disclosing that a director or executive officer has entered into, modified or terminated a Rule 10b5-1 contract, instruction or written plan for the purchase or sale of company equity securities *may provide investors with more extensive disclosure of potentially useful information as to management's views of the performance and prospects of the company*.¹⁰⁷

This proposal has never been adopted. Indeed, when the SEC adopted sweeping changes to Form 8-K that substantially increased the number of events that must be disclosed as they occur and shortened the time for disclosure of those events,¹⁰⁸ the SEC did not even mention the proposal regarding the disclosure of

or director's plans for exercising the options, much less for disposition of the shares acquired upon exercise.

105. Form 8-K Disclosure of Certain Management Transactions, SEC Rel. No. 33-8090, 67 Fed. Reg. 19914, 19915, 19923 (Apr. 23, 2002).

106. *Id.* at 19915.

107. *Id.* at 19916 (emphasis added). The SEC further explained that under its proposal:

When the director or executive officer later terminates or modifies a contract, instruction or written plan, the company would report:

- The date of the termination or modification; and
- A description of the modification, including any modification to the duration, the aggregate number of securities to be purchased or sold, the interval at which securities are to be purchased or sold, the number of securities to be purchased or sold in each interval, the price at which securities are to be purchased or sold, and the identity of the counterparty or agent.

A director's or executive officer's termination or modification of a Rule 10b5-1 arrangement *may indicate a change regarding the company's prospects, and thus may be valuable information to investors*. Although we have not proposed to require reports that a director or executive officer has entered into a Rule 10b5-1 arrangement to disclose the prices and intervals at which transactions would occur, or the number of securities to be purchased or sold per interval, we believe that modifications to these terms should be reportable. We would require such modifications to be reported in general terms, such as an increase in the applicable limit order price, or a decrease in the number of shares to be sold periodically under the arrangement, without requiring disclosure of the specific price, number of securities, or duration of interval.

Id. at 19921 (emphasis added).

108. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, SEC Rel. No. 33-8400, 69 Fed. Reg. 15594 (Mar. 25, 2004) [hereinafter "2004 8-K Adopting Release"]. Most of these changes were first proposed in Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, SEC Rel. No. 33-8106, 67 Fed. Reg. 42914 (June 25, 2002). For a general discussion of the 2004

Plans.¹⁰⁹ Thus, the proposal for required disclosure of Plans, though never formally withdrawn, appears to have been consigned to oblivion.¹¹⁰ Therefore, apart from the situations described in Part II.B of this article involving Form 144¹¹¹ and possibly Schedule 13D,¹¹² no SEC rule directly or indirectly compels disclosure of any Plan. Nor is there any requirement that a corporation that uses a Plan to effectuate corporate repurchases of its stock pursuant to Rule 10b-18 disclose that it has a Plan in effect for that purpose.¹¹³

changes to Form 8-K, see Allan Horwich, *New Form 8-K and Real-Time Disclosure*, 37 REV. OF SEC. & COM. REG. 109 (2004). Subsequent changes have been made to clarify and expand the requirements of Form 8-K. See, e.g., Executive Compensation and Related Person Disclosure, Securities Act Release No. 8,732, [2006 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,620, at 83,443–47 (Aug. 11, 2006) (as amended to conform to publication in the Federal Register, at SEC Rel. No. 33-8,732A, 71 Fed. Reg. 53158 (Sept. 8, 2006)). The SEC did not refer to Rule 10b5-1 in proposing or adopting any of these further changes.

109. When it adopted the significant changes in 2002, the SEC did, however, discuss a number of other previously proposed additions to Form 8-K that were not adopted. 2004 8-K Adopting Release, *supra* note 108.

110. It has been reported that the proposal has been “tabled indefinitely.” Jagolinzer, *supra* note 65, at 6 (reporting contact with SEC staff on October 30, 2006). Because the SEC has not commented on why the proposal for disclosure of Plans was not adopted one can only speculate on the reasons. Comments on the proposal varied. Compare Stanley Keller (American Bar Association Committee on Federal Regulation of Securities), Form 8-K Disclosure of Certain Management Transactions, at 21 (Dec. 31, 2002), available at <http://www.sec.gov/rules/proposed/s70902/skeller.htm> (“We do not believe there is a general expectation of privacy with respect to the existence of a Rule 10b5-1 Plan”) with John A. Seethoff (Microsoft Corporation), Proposed Form 8-K Disclosure of Management Transactions, at 4 (June 24, 2002), available at <http://www.sec.gov/rules/proposed/s70902/jaseethoff1.htm> (“We believe that the market could misunderstand that reports about an executive officer or director entering into 10b5-1 plans would not involve actual trading, especially in view of the independent requirement to report those trades. We also question the usefulness of that information to investors and believe officers and directors are entitled to a degree of privacy regarding entering into these plans.”). One commenter stated:

Rule 10b5-1 was adopted in recognition of the fact that there may be situations in which the company's future prospects do not factor into the purchase or sale of securities. For example, the seller of securities may have a need to fund a particular commitment such as a child's college expenses through the ongoing sale of securities. Further, Rule 10b5-1 requires that the arrangement be entered into at a time when the individual is not in possession of material inside information. Consequently, any subsequent transactions effected pursuant to a 10b5-1 plan or arrangement does not reflect the officer or director's view at that time regarding the business or prospects of the company. Accordingly, inclusion of Rule 10b5-1 arrangements within the scope of proposed Item 10 does not further the Commission's stated goal of providing investors with information regarding management's view of the company's performance and prospects.

Cary Klafter (Intel Corporation), Form 8-K Disclosure of Certain Management Transactions, at 5 (June 24, 2002), available at <http://www.sec.gov/rules/proposed/s70902/srvikar1.txt>.

111. *Supra* text accompanying notes 76–80.

112. *Supra* text accompanying notes 88–104.

113. See *supra* text accompanying note 56. Some aspects of corporate stock repurchase plans are, however, required to be disclosed. Both the quarterly Form 10-Q (Item 2(c)), available at <http://www.sec.gov/about/forms/secforms.htm#1934forms> (hyperlink to Form 10-Q), and the annual Form 10-K (Item 5(c)), available at <http://www.sec.gov/about/forms/secforms.htm#1934forms> (hyperlink to Form 10-K), require that the public company filing the form make the disclosures required by Item 703 of Regulation S-K, 17 C.F.R. § 229.703 (2007). This Item requires tabular presentation of stock repurchases made and to be made. Disclosure is to be made of repurchases “made pursuant to publicly announced plans or programs and those not made pursuant to publicly announced plans or programs.” The issuer is to “disclose, by footnote to the table, the number of shares purchased other than through a publicly announced plan or program and the nature of the transaction (e.g., whether the purchases were made in open-market transactions, tender offers, in satisfaction of the company's obligations

B. THE PROS AND CONS OF DISCLOSING A RULE 10b5-1 PLAN¹¹⁴

Anyone who establishes a Plan may voluntarily disclose the existence of his Plan, and so much of the terms of the Plan as he or she chooses. This could be done by a press release¹¹⁵ or in a Form 8-K filed by the issuing corporation.¹¹⁶ There are reasons both for and against making disclosure of a Plan prior to the execution of any transactions under the Plan.¹¹⁷

1. Reasons to Make Voluntary Disclosure of a Plan

Many corporate executives of successful companies find that as a result of appreciation of company stock they have acquired through the exercise of stock options and stock grants their investment portfolio becomes highly concentrated in the stock of their company, essentially putting most of their eggs in one

upon exercise of outstanding put options issued by the company, or other transactions)." Column (d) of the required table must report the "Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs." This is to be accompanied by footnote disclosure of "the date each plan or program was announced," "the dollar amount (or share or unit amount) approved," "[t]he expiration date (if any) of each plan or program," "[e]ach plan or program that has expired during the period covered by the table," and "[e]ach plan or program the issuer has determined to terminate prior to expiration, or under which the issuer does not intend to make further purchases." Thus, while the requirements do not expressly mandate disclosure of a Rule 10b5-1 Plan *per se*, they do require considerable disclosure of the content of any repurchase program that is in place. In the SEC release in which these requirements were adopted, there was no express reference to Rule 10b5-1. Purchases of Certain Equity Securities by the Issuer and Others, SEC Rel. No. 33-8335, 68 Fed. Reg. 64952 (Nov. 17, 2003). The release noted, "[t]hese new disclosure requirements supplement such disclosure obligations as issuers have always had under existing antifraud and other provisions of the federal securities laws. Thus, compliance with new Item 703 of Regulations S-K [and other similar requirements adopted in the release] will not excuse an issuer from disclosure obligations arising under other provisions of the federal securities laws. See, e.g., 17 CFR 240.10b-5 and 17 CFR 240.12b-20." *Id.* at 64962 n.103.

Stock exchanges also require disclosure of issuer repurchase programs. See, e.g., COMPANY MANUAL, AMERICAN STOCK EXCHANGE § 402(a), available at http://wallstreet.cch.com/AMEXtools/PlatformViewer.asp?SelectedNode=chp_1_1_4&rmanual=/AMEX/CompanyGuide/amex-company-guide/.

114. For the sake of simplicity, the discussion in this Part of the Article focuses on a Plan that provides for a sale of company stock by a corporate executive, whether that stock was acquired at a low price in the early life of the company, through the exercise of stock options granted as part of the executive's compensation, or in some other manner. One survey concluded that Plan transactions are predominantly sales. Jagolinzer, *supra* note 65, at 2, 11.

115. See, e.g., Acxiom Company, Press Release, Acxiom Company Leader Adopts Rule 10b5-1 Trading Plan (Apr. 14, 2004), available at <http://www.acxiom.com/default.aspx?ID=2488&DisplayID=18>.

116. See, e.g., Wynn Resorts, Limited (Form 8-K) (Nov. 20, 2006), available at <http://www.sec.gov/Archives/edgar/data/1174922/000134100406003107/wynn8-k.htm>; Applied Industrial Technologies, Inc. (Form 8-K) (Nov. 13, 2006) (attaching full text of plan as exhibit to Form 8-K), available at <http://www.sec.gov/Archives/edgar/data/109563/000095015206009423/123292ae8vk.htm>. A Form 8-K may also be used to file a press release with the SEC, in the form of an exhibit to the form, thereby achieving wider dissemination of the information than might occur with a press release alone. See, e.g., Think Partnership Inc. (Form 8-K) (Nov. 9, 2006) (attaching press release), available at <http://www.sec.gov/Archives/edgar/data/829323/000110465906073327/0001104659-06-073327-index.htm>.

117. Apart from any mandatory disclosures required as described in Part II.B of this Article, there is some voluntary disclosure but it is not pervasive. One survey concluded that a substantial number of companies whose insiders had Plans did not disclose the existence of an effective trading Plan by an

basket. Notwithstanding the faith they may have in the future of the company, modern portfolio theory argues strongly for diversification.¹¹⁸ Yet sales of company stock—which must be reported promptly on Form 4¹¹⁹—might be misinterpreted by the market as an expression of lack of confidence in the company or a belief that the stock has reached a near term, or perhaps even long term, high price.¹²⁰ While one rationale for the SEC's proposal to require disclosure of Plans was that this might give investors information about "management's view of the performance and prospects of the company,"¹²¹ it is apparent that establishing a Plan does not reliably send any such (adverse) signal. More to the point, pre-transaction disclosure of a selling Plan might counter the potential negative investor impact on the market of post-sale disclosures of sales by an executive, as

insider. Jagolinzer, *supra* note 65, at 11 n.24. One study concluded that in a recent two-year period at least one executive at more than a third of the companies among the Standard & Poor's 500 sold shares using a Plan. Glenn Curtis, *Corporate Guide to Insider Transactions—Performance Matters*, 11 WALL ST. L., Feb. 2007, at 11 (citing study by Equilar, Inc.) [hereinafter "Corporate Guide"]. The full text of documents filed with the SEC on the EDGAR system (http://searchwww.sec.gov/EDGARFSCClient/jsp/EDGAR_MainAccess.jsp) can be now searched by term, such as "10b5-1."

118. The following news report is an example of disclosure of a Plan to diversify holdings:

Microsoft Chief Executive Steve Ballmer sold nearly \$1 billion in company shares this week, a move he said was intended to diversify his financial assets.

The stock sale drew attention yesterday partly because Ballmer, unlike other high-profile corporate executives, has generally held onto his shares. This week's sales were reportedly Ballmer's first in 12 years.

* * *

The news came out after the markets closed yesterday. Earlier in the day, Ballmer issued a statement confirming that he was selling shares.

"Even though this is a personal financial matter, I want to be clear about this to avoid any confusion," he said. "I remain excited about the potential for our technology to change people's lives, and I remain as committed to Microsoft as ever."

* * *

Executives can regularly sell their companies' shares under the Securities and Exchange Commission's rules governing insider trading. Some, like Ballmer, cite portfolio diversification as the reason they do so.

Kim Peterson, *Ballmer Reduces His Stake in Microsoft by \$1 Billion Executive Last Sold Any Shares in 1991*, SEATTLE TIMES, May 24, 2003, at C1.

119. See *supra* notes 84–85.

120. Investors closely watch trading by insiders, reported on Form 4, seeking to identify trends and thereby draw inferences about what management thinks about the value of the company's stock. See, e.g., Corporate Guide, *supra* note 117, at 4, 8 (presenting study of stock market price movement after reports of insider transactions, concluding that "there is a correlation between insider purchases and sales by insiders at public companies and [subsequent] stock price performance" with purchases providing "a better indicator of the future performance of the stock," while also stating that "[i]nsiders are most likely not trading on insider information" but "have insight about the fundamental direction and condition of their respective companies that the general investing public does not [and] [a]s such they are able to sufficiently take advantage of any window they may have to buy or sell their respective stocks"); Tony Cooke, *Insiders of Cable and Broadcast Unanimous in Stock Sales Lately*, WALL ST. J., Nov. 22, 2006, at C5 (reporting stock sales activity of cable and broadcasting insiders as reflecting "consensus" predicting a bearish trend in stocks in those industries). One study has concluded, however, that "there is no evidence of a negative market response to disclosure of 10b5-1 transaction filings with the SEC." Jagolinzer, *supra* note 65, at 2–3.

121. 67 Fed. Reg. at 19915. See *supra* text accompanying note 107.

well as mitigate the detrimental impact on the executive's own sales that a negative market reaction to his or her stock sales could have.¹²²

One way to dispel any misimpression is to disclose publicly—before any sales are reported on Form 4—that the executive has a Plan in place, stating that it has been adopted to effect diversification without intending to indicate any lack of confidence in the company's prospects.¹²³ This may counter any inference that investors would draw from otherwise unexplained sales of company stock, thereby avoiding the price decline that might follow or other negative impacts on the company. Pre-emptive disclosure is likely to be more effective in dampening speculation generated by transaction reports than would be a post-sale explanation that the sales were made pursuant to a Plan, such as in response to a press inquiry about the sales.¹²⁴

If an executive makes an announcement—or if the company does so to disclose the executive's impending transactions—there is no legal requirement to make detailed disclosure of the terms of the Plan, or even the amount of securities to be sold.¹²⁵ If the sales are to be made pursuant to Rule 144, however, there must be disclosure of the anticipated number of shares to be sold in the ensuing three

122. If current stockholders perceive that selling by senior management reflects a bearish judgment, those investors may sell (or others may sell the stock short), thereby causing the market price of the stock to fall (in turn, of course, reducing the value of the company stock component of the executive's portfolio and, among other things, possibly reducing the proceeds of sales pursuant to the executive's Plan or even triggering the sale of more shares pursuant to the terms of the Plan than the executive anticipated).

123. Going beyond mere disclosure that there is a Plan in place, however, poses some liability risk for the executive. If, for example, the executive makes some honest substantive comment about the company, such as expressing optimism about its earnings prospects, he or she becomes exposed to claims, and possible liability, if his or her statement turns out to have been unduly optimistic. Issues surrounding liability of an executive for statements that affect the market price of the stock, including liability for forward looking statements, are beyond the scope of this Article. Suffice it to note that in this context the less said the better—the point is merely to inform the market *in advance* that the executive is making sales for reasons not related to his or her assessment of the fair value of the stock or current prospects of the company—so long as that is a true statement. Pre-transaction disclosure will also explain why an executive sold during a period when the corporation's insider trading policy would otherwise have prohibited a sale.

124. See *supra* note 118 (reporting executive's explanation that apparently followed initial reports of his stock sales).

125. Any public statement on which investors may rely, however, must not violate Rule 10b-5 by "omit[ting] to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." 17 C.F.R. § 240.10b-5(b) (2007). For example, an insider who discloses a Plan and explains that he or she established it to diversify his or her investments, but who fails to state that an equally (or more) important reason for arranging to sell is that he or she believes the stock will soon reach a zenith and then decline may be exposed to liability to investors who purchase the stock after the Plan is disclosed, claiming that the insider's disclosure was materially incomplete, an actionable half-truth. In reality, however, this scenario may present more problems for the insider vis-a-vis his or her own transactions, as distinguished from claims by open market traders, because if the undisclosed information is, or was based on, material nonpublic information of which he or she was aware when he or she established the Plan, the Plan itself will not be valid because it would not satisfy Rule 10b5-1(c)(1)(i)(A) (providing that the Plan must be established before the person "bec[ame] aware of the [material nonpublic] information"). 17 C.F.R. § 240.10b5-1(c)(1)(i)(A) (2007).

months,¹²⁶ but that does not entail disclosure of the price or other terms that are part of the Plan.¹²⁷

Disclosure of a Plan may also provide some pre-emptive effect in the context of potential future litigation challenging the adequacy of disclosures made by the company or the executive. As noted earlier, scienter is an element of a cause of action under Rule 10b-5, including a claim alleging faulty disclosure by a public company or executive.¹²⁸ To plead such a claim, the plaintiff must “state with particularity facts giving rise to a strong inference that the defendant” acted with scienter.¹²⁹ In assessing whether a plaintiff has pleaded scienter with the requisite particularity, courts assess the sufficiency of specific allegations that an individual defendant engaged in trading based on material nonpublic information, namely trading (usually selling) when the defendant knew that material information about the company had not been publicly disclosed.¹³⁰ If, however, the prospective defendant’s trades were conducted pursuant to an *announced* Plan, the plaintiff may chose to refrain even from alleging that the defendant’s trades were indicative of wrongful conduct¹³¹—one principal purpose of a Rule 10b5-1 Plan being to counteract any claim of a violation of Rule 10b-5 in connection with the trades. If there has been no prior disclosure of the Plan, then the plaintiff will not be able to take that factor into account in deciding whether to omit any reference to the trades from the complaint or even to leave that potential defendant out of the case.

Voluntary disclosure can be made in a variety of ways, such as through a press release or filing a Form 8-K.¹³² In lieu of, or in addition to one of these means,

126. See *supra* text accompanying notes 76–81.

127. Disclosure of the price terms could be a market signal—intended or otherwise—of the executive’s assessment of the value of the stock, i.e., a price below fair market value, inasmuch as one would not expect a knowledgeable willing seller to sell below that benchmark. This assumes that there are not extenuating personal circumstances that have caused the executive to establish the Plan to dispose of some of his or her company stock, such as a divorce settlement or a balloon loan payment. As noted later, privacy concerns may motivate an executive *not* to disclose creation of a Plan (see *infra* text accompanying notes 138–140), even if securities law disclosure requirements (see *supra* text accompanying notes 76–104) mandate some disclosure before or after the sale, or both.

128. See *supra* text accompanying note 44.

129. Exchange Act, *supra* note 1, § 21D(b)(2), 48 Stat. at 899 (codified as amended at 15 U.S.C. § 78u-4(b)(2) (2000)). For a resolution of issues surrounding the particularity requirement, see *Tel-labs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

130. For a general discussion of this pleading requirement as applied to allegations of insider trading, with extensive citations to cases, see MICHAEL A. PERINO, SECURITIES LITIGATION AFTER THE REFORM ACT § 3.01.D.5.b (2007).

131. See, e.g., *Bochner & Hakala*, *supra* note 3, at 3 (arguing that prior disclosure of Plan may deter litigation, where the plaintiff would otherwise have alleged that insider trading with scienter had occurred); *Wietschner v. Monterey Pasta Co.*, 294 F. Supp. 2d 1102, 1117 (N.D. Cal. 2003) (“Plaintiffs state that both Defendants sold shares under individual SEC Rule 10b5-1 trading plans, which allows corporate insiders to set a schedule by which to sell shares over a twelve to fifteen month period. . . . This could raise an inference that the sales were pre-scheduled and not suspicious.”); but see *In re Cardinal Health Inc. Sec. Litig.*, 426 F. Supp. 2d 688, 734 (S.D. Ohio 2006) (declining to consider Rule 10b5-1 plan in the context of deciding a motion to dismiss because the existence of a plan is an affirmative defense that was not before the court).

132. See *supra* text accompanying notes 115–116.

the company may disclose the existence of executives' plans on the company website.¹³³

2. Reasons not to Make Voluntary Disclosure of a Plan

An executive may be disinclined to disclose a Plan for selling stock because he or she believes that an explanation intended to dispel any signal of a negative trend by appropriate explanation of the reason for selling may not be credited by the market. This rationale may be short-lived, however, because once the executive discloses the initial sale on Form 4 questions may arise about why the sale was made.¹³⁴ But before a sale is actually made, announcement that a significant amount of stock may be sold may depress the price of the stock,¹³⁵ harming not only other investors in the stock but also reducing the proceeds of the executive's own sales.¹³⁶ This price depression created by an overhang is comparable to the effect on the stock price of a company that recently had an initial public offering where the lock-up period of insider stock is about to expire so that substantial additional shares can now be sold in the open market, even though it may not be certain how much of the stock will actually be sold.¹³⁷

Some executives may be reluctant to disclose a Plan because of privacy concerns. They may prefer to limit disclosure of their securities transactions to the minimum required by law, such as the filing of a Form 144¹³⁸ (with the appropriate

133. See, e.g., Monsanto Company, Press Release, *Monsanto Company Chief Executive Adopts 10b5-1 Trading Plan* (Feb. 6, 2006), available at <http://www.monsanto.com/monsanto/layout/media/06/02-06-06.asp>.

134. See *supra* text accompanying notes 82–87.

135. Disclosure of a Plan for sales would not necessarily entail advance disclosure of the number of shares because the requisite Form 144 for an executive's sale can be filed as late as the day of sale (Rule 144(h), 17 C.F.R. § 230.144(h) (2007)). Once the form is filed, however, it must disclose "the amount of securities to be sold in reliance upon this rule during any period of three months." *Id.* As successive sales occur or are foreseen, timely Forms 144 must be filed to comply with the maximum three month forward looking period. See, e.g., SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Fourth Supplement, Rule 10b5-1, Item 1 (Additional Interpretations Issued December 2000), available at <http://www.sec.gov/interp/telephone/phonesupplement4.htm>.

136. To be sure, the algorithm provided in the Plan (under Rule 10b5-1(c)(1)(i)(B)(2)) can take account of price fluctuations so as to avoid sales at a price depressed by the disclosure of the Plan, or for any other reason, such as by setting a minimum sale price.

137. As expressed by one service that monitors these situations:

[F]requently, shareholders of an IPO company are subject to an agreement with the company's underwriters that restricts the right of shareholders to sell their shares for some period of time after the IPO has been priced. This time is called the "Lockup Period" and is only applicable to shareholders that acquired their shares before the IPO. When the Lockup Period expires, these shareholders are allowed to sell their shares in regular aftermarket trading. Because decisions by these shareholders to either keep or sell their shares may affect the price of the stock, monitoring the Lockup Period can be important. IPO Monitor's "Lock-up Period" report lists IPO companies whose Lockup Period agreements have not yet expired. The table lists the IPO pricing date, as well as the Lockup Period expiration date.

IPC Monitor, Description of Services (Proprietary Reports), available at <http://www.ipomonitor.com/pages/services.html>.

138. See *supra* text accompanying notes 76–81.

reference to Rule 10b5-1¹³⁹) and subsequent Form 4.¹⁴⁰ These disclosures do not occur until a sale is imminent or has been made, but at that point the privacy interest is no longer pertinent—revelation of the Plan, directly or by inference, albeit not the details of the Plan, will have occurred. Thus, a concern about privacy is seldom compelling.

One factor that will affect the decision to make voluntary disclosure is the status of the person who established the Plan. The principal rationales in favor of disclosing—to dispel a false impression created by sales and to discourage private civil damage claims in which plaintiffs allege scienter based on insider sales—apply to the more senior members of management, and perhaps to outside directors with large stockholdings in the company, the same persons who are required to file a Form 4 when they sell or buy the company's stock.¹⁴¹ Lower level management, who may find the protection afforded by Rule 10b5-1 to be useful, but who do not have a Form 4 reporting obligation, may be more inclined *not* to disclose that they have established a Plan.¹⁴² Their transactions are not nearly as likely to send any kind of signal to the market and their trading cannot be monitored by those who scrutinize trading by insiders because those persons are not required to file Form 4.

If the amount of stock to be sold is small in relation to the executive's holdings, disclosure of the Plan may give the transaction(s) more visibility than warranted, even if disclosure of the Plan serves generally to dispel misimpressions. For example, if an executive who owns a very substantial amount of stock establishes a Plan solely to provide the cash for semiannual college tuition payments shortly before the payment due date, disclosure of the Plan may receive notice out of proportion to the significance of the transactions by any measure.

Finally, voluntary disclosure does pose a limited legal risk. Disclosure may, intentionally or not, create an impression that there will be transactions in accordance

139. See *supra* text accompanying note 80.

140. See *supra* text accompanying notes 82–87.

141. See *supra* text accompanying note 83.

142. Rule 16a-1(f), 17 C.F.R. § 240.16a-1(f) (2007), imposes the reporting requirement on the “issuer’s president, principal financial officer, principal accounting officer . . . , any vice president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer” as well as officers of a parent or subsidiary if they “perform such policy-making functions for the issuer.” Someone below these ranks of management may nevertheless find it prudent to utilize Rule 144 as a safe harbor in making an open market sale, thus disclosing on Form 144 that the sales are pursuant to a Plan. See *supra* text accompanying notes 79–81. The pivotal question is whether the person is an “affiliate.” As one commentator has explained the determination:

The SEC presumes that a person who is an officer of the issuer is an affiliate of that issuer. As with persons who become presumptive affiliates because of their status as a director, a person with the title of officer might not actually have the power to influence the management policies of the issuer. Relevant factual concerns with respect to this issue include the experience of the officer, the officer’s specific title and responsibility, the officer’s business relationship and reputation with other members of management, and his or her power in fact to perform a policy making function for the issuer.

Hicks, *supra* note 53, § 10:41.5, at 10-102 to 10-103 (footnotes omitted).

with the Plan. The fewer details disclosed about the Plan, the less able the public will be to discern what is likely to transpire. In many cases, however, the first transaction under the Plan may not occur until weeks or even months after the Plan is established.¹⁴³ Depending on the price parameters in the Plan and the movement of the stock market price, it is possible that no transactions at all will occur under the Plan, or that any transactions will occur much later than was anticipated when the Plan was established. Announcing a Plan without any price parameters, as is recommended here, may cause some market activity by those anticipating eventual substantial sales by the executive in reliance on the assumed implementation of the Plan. If, for example, investors sell stock in the belief that the sales under the Plan will have some depressing effect on the stock price and then, for some reason, no sales are made under the Plan and the stock price is never moved by actual sales under the Plan, those who sold might argue that the announcement of the Plan was manipulative or deceptive, as something intended to induce investors to sell when in fact the price rose (but not high enough to trigger sales under the Plan).¹⁴⁴ There is no foolproof means of protecting the executive from such a claim, though anyone establishing a Plan where there is a significant possibility that there will be no transactions under the Plan or substantially fewer shares traded than provided for in the Plan should disclose that possibility at the outset and should internally document the reasons for establishing the Plan and the basis for the selections of the price parameters so that there will be a contemporaneous record to establish lack of a manipulative intent.¹⁴⁵

The decision whether to disclose a Plan, or how much to disclose, may be influenced by any duty that arises to update that disclosure if the terms of a Plan are changed or if the Plan is cancelled altogether. If a statement is factually accurate when made, there is no duty to correct the statement—there is nothing to correct, as the statement was a true and materially complete statement of one's present intention.¹⁴⁶ The law is murkier regarding when there is a duty to update a statement, such as a financial projection, that was true and believed when it was made.¹⁴⁷ This issue can be eliminated if the disclosure of a Plan explicitly

143. See *supra* text accompanying note 68.

144. See also Jagolinzer, *supra* note 65, at 6 & n.12 (reporting "anecdotal evidence that the market reacts negatively to a failure to comply with a preannounced trade commitment").

145. Anyone filing a Form 144 "shall have a bona fide intention to sell the securities referred to therein within a reasonable time after the filing of such notice." Rule 144(i), 17 C.F.R. § 230.144(i) (2007). There is, by contrast, no similar requirement of a bona fide intention to buy or sell with respect to Rule 10b5-1. While the Plan must be created in good faith (Rule 10b5-1(c)(1)(ii), 17 C.F.R. § 240.10b5-1(c)(1)(ii) (2007)), there is no requirement that the executive actually expect transactions to occur. For example, an executive could set up a Plan that provides for sales at a price substantially above the current market price, simply as a means to trigger sales at an unexpectedly high price should the unexpected occur when the executive might be unable to make a decision to sell without abusing material nonpublic information.

146. See, e.g., *Gallagher v. Abbott Labs.*, 269 F.3d 806, 810 (7th Cir. 2001) ("a statement may be 'corrected' only if it was incorrect when made") (emphasis in original); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1245 (3d Cir. 1989) ("a statement of intent need only be true when made"). The latter decision then addressed the duty to update under the facts of that case.

147. Compare *Stransky v. Cummins Engine Co., Inc.*, 51 F.3d 1329, 1332-33 (7th Cir. 1995) (rejecting duty under Rule 10b-5 to update projections when subsequent events showed them no

states that the party making the disclosure disclaims any obligation to update disclosures regarding the Plan, such as cancellation of the Plan.¹⁴⁸

IV. SIGNIFICANT UNRESOLVED QUESTIONS REGARDING THE VALIDITY OF RULE 10b5-1

In the absence of reported litigation applying Rule 10b5-1, some important questions that lie at the heart of the scope and validity of Rule 10b5-1 remain to be tested. This Part of the Article addresses several significant unresolved questions.

A. IS RULE 10b5-1 A VALID EXERCISE OF THE SEC'S RULEMAKING POWERS—DOES RULE 10b5-1 PRECLUDE ANY DEFENSE NOT PROVIDED BY THE RULE ITSELF?

When Rule 10b5-1 was adopted, the SEC expressly stated that the affirmative defenses provided in the rule were the *only* defenses available to a charge of a violation of Rule 10b-5 arising from trading while “aware” of material nonpublic information.¹⁴⁹ Before Rule 10b5-1 was proposed, this author argued that to violate Rule 10b-5 by trading when aware of material nonpublic information the trader had to “use” the information in making the decision to trade.¹⁵⁰ Views on the issue varied.¹⁵¹ Several courts of appeal, however, have adopted the use test for

longer to be accurate, finding that Rule 10b-5 “implicitly precludes basing liability on circumstances that arise after the speaker makes the statement”), with *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 318 (3d Cir. 1997) (recognizing duty under Rule 10b-5 to update disclosure of internal guidelines for a debt to total capitalization ratio when the guideline was changed), and *In re Time Warner Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993) (recognizing duty under Rule 10b-5 to update when expansion of range of strategic plans being considered arguably materially affected the accuracy of prior disclosures of strategic alternatives that were still “alive” in the market), *cert. denied*, 511 U.S. 1017 (1994). As summarized in one leading text:

In the federal circuits in which it is recognized, the duty to update imposes a duty, typically on a securities issuer, to modify or supplement a prior statement that, although accurate when made, has since become inaccurate or misleading in light of subsequent developments. Such past disclosures, however, need to be updated only to the extent that they remain “alive” in the minds of reasonable investors.

DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, *SECURITIES LITIGATION AND ENFORCEMENT CASES AND MATERIALS* 57 (2003). For a discussion of the principal cases addressing the duty to update, see Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose under Rule 10b-5*, 57 VAND. L. REV. 1639, 1664–70 (2004).

148. This approach, suggested by Romeo & Dye, *supra* note 71, at 915 n.70, should be effective. This is the conventional wisdom in a range of securities disclosure contexts. See, e.g., Broc Romanek, *Corporate Web Disclaimers: To Disclaim or not to Disclaim, It Should not be a Question*, 3 WALLSTREETLAWYER.COM, No. 3, at 9–13 (Aug. 1999), available at Westlaw NCEU Glass-CLE 132 (recommending including statements on corporate websites disclaiming any duty to update the website content). If nothing else, a clear, express disclaimer should make it difficult for any investor to claim he or she relied on an expectation that the information regarding the Plan would be kept current, and actual reliance is an element of a claim under Rule 10b-5. *Basic*, 485 U.S. at 243.

149. See *supra* text accompanying notes 58–59.

150. Horwich, *Possession*, *supra* note 18, at 1268–78.

151. See *supra* note 18.

claims that arose before Rule 10b5-1 was adopted.¹⁵² Rule 10b5-1 was adopted in part as an explicit effort to produce a different result in similar cases.¹⁵³ A number of commentators have argued that in adopting the rule the SEC exceeded its authority to implement Section 10(b) of the Exchange Act because the conduct prohibited by the combination of Rules 10b-5 and 10b5-1 is not prohibited by Section 10(b); they have argued such because the SEC abrogated the “use” requirement or because it purports to impose liability for conduct that does not involve scienter.¹⁵⁴

152. SEC v. Lipson, 278 F.3d 656, 661 (7th Cir. 2002) (applying Rule 10b-5 to facts that predated the effective date of Rule 10b5-1); Smith, 155 F.3d at 1066–69; Adler, 137 F.3d at 1334–39. WANG & STEINBERG, *supra* note 4, § 4:4.5, at nn.363 (Smith) and 352 (Adler) provide citations to commentary. Compare SEC v. Snyder, Civil Action No. H-03-04658, 2006 WL 1806164, at *9 (S.D. Tex. June 29, 2006) (applying “use” test to insider trading charge based on facts occurring before the effective date of Rule 10b5-1) with *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F. Supp. 2d 576, 591–93 (S.D. Tex. 2003) (rejecting use test and applying concepts of Rule 10b5-1 to transactions occurring before as well as after the effective date of Rule 10b5-1). In a criminal case involving alleged insider trading after the effective date of Rule 10b5-1, the court held that the prosecution was entitled to use the awareness test at the grand jury stage. *United States v. Nacchio*, Criminal Case No. 05-cr-00545-EWN, 2006 WL 3292818, at *1 (D. Colo. Nov. 13, 2006) (denying motion to reconsider denial of motion to dismiss indictment for prosecutorial misconduct). The instructions to the jury, however, stated:

A person trades “on the basis of” inside information if the person actually used material, non-public information in deciding to trade. It is not sufficient for the an [sic] insider to have merely possessed material, nonpublic information when he traded.

The inside information need not have been the sole cause of a trade. It is sufficient that the inside information was a significant factor in an insider’s decision to sell stock.

Qwest & Nacchio Documents - Criminal Proceedings hyperlink to 04/10/07 - Jury Instructions - Second Set, Court Instruction No. 16, available at <http://law.du.edu/jbrown/corporateGovernance/qwest/criminalProceedings/index.cfm>. The defendant was convicted on 19 of 42 counts of insider trading. Dionne Searcey, et al., *Qwest’s Nacchio is Found Guilty in Trading Case*, WALL ST. J., Apr. 20, 2007, at A1.

153. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727.

154. As noted *supra* text accompanying note 44, a rule promulgated under Section 10(b) of the Exchange Act cannot prohibit conduct that does not involve scienter. For criticism of Rule 10b5-1 as adopted, see Kevin E. Warner, *Rethinking Trades “on the Basis of” Inside Information: Some Interpretations of SEC Rule 10b5-1*, 83 B.U. L. REV. 281, 305–15 (2003) (suggesting that Rule 10b5-1 may eliminate the requirement of scienter for an insider trading violation and offering interpretations of Rule 10b5-1 that do not abrogate the scienter requirement); Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 196–99, 204 (2003) (criticizing Rule 10b5-1 as “duplicious,” questioning whether a trader who is aware of information but does not use it acts with scienter, and suggesting that Rule 10b5-1 “eliminates fraud from the liability standard” under Rule 10b-5); Stuart Sinai, *A Challenge to the Validity of Rule 10b5-1*, 30 SEC. REG. L.J. 261, 264–67, 271, 282 (2002) (arguing that Rule 10b5-1 removes the scienter requirement for insider trading, constitutes impermissible legislative action by the SEC, and effectively imposes strict liability for trading while in possession of material nonpublic information); Ryan D. Adams, Comment, “Where there is a Will, There is a Way”: The Securities and Exchange Commission’s Adoption of Rule 10b5-1, 47 LOY. L. REV. 1133, 1151 (2001) (arguing that proof of “awareness” does not meet the scienter requirement); Kimberly D. Krawiec & Richard W. Painter, *New SEC Regulations Attempt to Clarify Approach to Insider Trading*, 32 SEC. REG. & L. REP. (BNA) 1593, 1594 (Nov. 20, 2000) (“the awareness standard . . . arguably eliminates the scienter element from insider trading cases”); Deborah J. Jeffrey, *Knowing Too Much: New Rule on Insider Trading (Wrongly) Punishes for Possession of Information*, LEGAL TIMES, Nov. 20, 2000, at 34 (arguing that both use of the information and scienter are elements of an insider trading violation, and Rule 10b5-1 purports to dispense with both).

The concept of “scienter” has been interpreted in the context of Rule 10b-5 to encompass both intentional and reckless conduct. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 n.6 (9th

As discussed above, however, the import of Rule 10b5-1 taken as a whole is that trading while aware of material nonpublic information is unlawful unless the trader can show the absence of use, and the absence of “use” can be established *only* by sustaining one of the affirmative defenses provided by the rule.¹⁵⁵

This presents the question whether the SEC can effectively decree that the *only* way to establish non-use when trading while aware of material nonpublic information is to satisfy one of the affirmative defenses in Rule 10b5-1. Stated another way, if a transaction was made by or on behalf of someone who was aware of material nonpublic information, if the other elements of the violation were present and if *none* of the three specified affirmative defenses was available, could the defendant argue that the conduct did not violate Rule 10b-5 because the information was not “used” in making the decision to trade or—even if “use” is not a necessary element of an insider trading violation—because an element of one of the affirmative defenses was not satisfied to the letter?

The SEC has the “power to make such rules and regulations as may be necessary or appropriate to implement the provisions” of the Exchange Act.¹⁵⁶ Its powers are often exercised to define terms in the Exchange Act or in the SEC’s own rules.¹⁵⁷ The SEC’s authority in this respect, however, is not unlimited.¹⁵⁸ Moreover, the phrase that the SEC defined in Rule 10b5-1—“on the basis of”—is not one that appears in *haec verba* in the Exchange Act or in any statutory provision

Cir. 1990) (citing cases from or within all federal circuits), *cert. denied*, 499 U.S. 976 (1991). In this context recklessness means:

highly unreasonable [conduct] involving . . . an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir.), *cert. denied sub nom.*, Meers v. Sundstrand Corp., 434 U.S. 875 (1977). While the SEC has defined “on the basis of” to mean “aware of the material nonpublic information,” there remains a question whether the element of scienter applies to appreciation of the materiality of the information. See Allan Horwich, *The Neglected Relationship of Materiality and Recklessness in Actions under Rule 10b-5*, 55 Bus. Law. 1023 (2000) (arguing that where a defendant is charged with recklessly failing to disclose a material fact, the assessment of recklessness necessarily entails an evaluation of whether the defendant appreciated, or was reckless in not appreciating, the materiality of the omitted fact).

155. See *supra* text accompanying notes 62–64.

156. Exchange Act, *supra* note 1, § 23(a)(1), 48 Stat. at 901 (codified as amended at 15 U.S.C. § 78w(a)(1) (2000)).

157. See, e.g., Rules 0-1 (17 C.F.R. § 240.0-1 (2007) (specifying general definitions), 12b-2, 17 C.F.R. § 240.12b-2 (2007) (specifying definitions pertinent to registration of securities under the Exchange Act), and 14a-1, 17 C.F.R. § 240.14a-1 (2007) (specifying definitions pertinent to proxy solicitations).

158. Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (vacating SEC rule on the ground that the means adopted by the SEC to implement a statutory provision exceeded that contemplated by the statutory provisions on which the SEC relied in adopting the rule); *cf. also* Fin. Planning Ass’n v. SEC, 482 F.3d 481, 492–93 (D.C. Cir. 2007) (vacating SEC rule under Investment Advisers Act of 1940 as inconsistent with the statute and thus beyond the SEC’s powers); Goldstein v. SEC, 451 F.3d 873, 878–884 (D.C. Cir. 2006) (vacating on several grounds SEC rule that defined “client” as the word is used in a provision of 15 U.S.C. § 80b-3(b)(3) (2000)); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005) (remanding rule adopted by SEC under the Investment Company Act for failure to take certain factors and alternatives into consideration in adopting the rule).

pertinent to unlawful insider trading.¹⁵⁹ Rather, the rule reflects, at most, the SEC's interpretation of the requirements of Section 10(b) and Rule 10b-5.

The principal authority for guidance on assessment of the validity of an agency rule such as Rule 10b5-1 is *Chevron, U.S.A. Inc. v. Natural Resources Defense Council, Inc.*¹⁶⁰ Under *Chevron*, there is a two step process to determine whether an agency rule is valid:

When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

... If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.¹⁶¹

Under this test, if, as some have argued,¹⁶² Rule 10b5-1 as written effectively abrogates the scienter requirement imposed by Section 10(b),¹⁶³ then the rule is not valid under *Chevron* because it is "unambiguously [inconsistent with] the express intent of Congress."¹⁶⁴

The validity of Rule 10b5-1 may be called into question on other grounds. When courts have interpreted a statute in a particular way, an agency may not change that result through rulemaking under the statute.¹⁶⁵ It was, in fact, the express intent of

159. This statement is based on a Westlaw search of the Exchange Act.

160. 467 U.S. 837 (1984). The *Chevron* doctrine is still fully alive. See, e.g., *Gonzales v. Oregon*, 126 S. Ct. 904, 908 (2006) (indicating continuing vitality of *Chevron* although not applying it under the circumstances). The legal commentary on *Chevron* and related cases is vast and the decisions and its progeny remain controversial. Among recent commentary, see Note, *The Two Faces of Chevron*, 120 HARV. L. REV. 1562 (2007); Jacob E. Gersen & Adrian Vermeule, *Chevron as a Voting Rule*, 116 YALE L.J. 676 (2007); Randolph J. May, *Defining Deference Down: Independent Agencies and Chevron Deference*, 58 ADMIN. L. REV. 429 (2006).

161. 467 U.S. at 842-44 (footnotes omitted).

162. See *supra* text accompanying note 154.

163. See *supra* text accompanying note 155.

164. This conclusion is underscored by the pre-Rule 10b5-1 cases that interpreted Section 10(b) and Rule 10b-5 to impose a "use" test. See *supra* note 152. As one commentator has observed, "if *Adler* was correct in holding that Section 10(b)'s deception requirement forecloses liability in the absence of a causal connection, the SEC would lack the authority under this provision to promulgate a rule with knowing possession as the operative standard." Nagy, *supra* note 18, at 1195-96 (footnote omitted).

165. See, e.g., *Bankers Trust New York Corp. v. United States*, 225 F.3d 1368, 1376 (Fed. Cir. 2000) (reversing lower court decision applying rule of Internal Revenue Service where the rule construed the

the SEC to change the result in the cases that had construed Section 10(b) and Rule 10b-5 to require proof of “use” to establish a violation.¹⁶⁶

When an agency is interpreting its own regulation, that interpretation is entitled to substantial deference so long as the interpretation is reasonable.¹⁶⁷ Rule 10b5-1, however, is not so much an interpretation of Rule 10b-5 as a new rule that is intended to redefine the elements of unlawful insider trading under Rule 10b-5.¹⁶⁸ This presents the question whether, under the second part of the *Chevron* test—assuming that the rule is not invalid under the first part—the rule is “arbitrary, capricious, or manifestly contrary to the statute” or is simply not “reasonable.”¹⁶⁹ Cases invalidating a rule based on the second step of the *Chevron* analysis are rare.¹⁷⁰ While *Chevron*-based deference is most common where an agency rule is challenged,¹⁷¹ it seems uncontested that (i) where the statute has been interpreted directly contrary to the provisions of the rule, (ii) where the rule purports to exclude a defense, viz. lack of use, that the courts have recognized, and (iii) where the approach taken by the SEC was not the time-honored

relevant statute “in a manner different from a prior definitive court ruling”). It is important to note that the cases construing Rule 10b-5 that required proof of “use” were not ones where the courts deferred to an agency interpretation, which the agency might be free to revise. *Id.* at 1374. In the cases construing Section 10(b) and Rule 10b-5 to impose a “use” element, the courts were rejecting the arguments of government agencies that urged a different construction of the statute and rule.

The foregoing analysis presumes that the interpretations of Rule 10b-5 in cases such as *Smith* and *Adler* (*supra* note 21) were based on the unambiguous terms of Section 10(b), which is a fair reading of those cases, though perhaps not the only plausible one. Thus, the court in *Adler* found that its interpretation “best comports” with the language of Section 10(b) and Rule 10b-5 as well as the “statutory focus on fraud”, 137 F.3d at 1338–39, yet—without elaboration—noted that “the SEC has had ample opportunity to adopt a rule or amend Rule 10b-5 so as to provide that a trade with knowing possession of material nonpublic information triggers insider trading liability.” 137 F.3d at 1339. If, however, those decisions resolved an ambiguity in the statute, the prior judicial rulings would not foreclose a different agency resolution of the ambiguity by rulemaking. See *National Cable & Telecomms. Assoc. v. Brand X Internet Servs.*, 545 U.S. 967, 982–84 (2005) (“A court’s prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.”).

166. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727. The part of the one judicial decision on which the SEC relied in rejecting the “use” test was dictum, as the SEC recognized. See *supra* note 43. Moreover, the SEC itself had applied a “use” test. See *Horwich, Possession*, *supra* note 18, at 1245–46 (discussing *In re Investors Management Co.*, 44 S.E.C. 633 (1971)).

167. *Auer v. Robbins*, 519 U.S. 452, 462–63 (1997) (according deference to the agency’s interpretation when the language in the regulation is ambiguous).

168. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727–29.

169. See *supra* text accompanying notes 160–61. See also *Aid Assoc. for Lutherans v. United States Postal Serv.*, 321 F.3d 1166, 1174 (D.C. Cir. 2003):

An agency construction of a statute cannot survive judicial review if a contested regulation reflects an action that exceeds the agency’s authority. It does not matter whether the unlawful action arises because the disputed regulation defies the plain language of a statute or because the agency’s construction is utterly unreasonable and thus impermissible.

170. SECTION OF ADMINISTRATIVE LAW AND REGULATORY PRACTICE, AMERICAN BAR ASSOCIATION, A GUIDE TO JUDICIAL AND POLITICAL REVIEW OF FEDERAL AGENCIES § 3.032, at 86 (2005) (“Because *Chevron* step two invalidations are extremely rare, it is also difficult to determine the relative importance of the many factors that courts can rely on when they uphold interpretations.”).

171. *Id.* § 4.021, at 105.

non-exclusive safe harbor but instead an exclusive set of very narrowly defined defenses, the rule is not a “reasonable” application of the statute.

What is most troubling in this regard is the unprecedented approach of rejecting adoption of safe harbors that leave room for other proof of non-use. In responding to commenters who urged the safe harbor approach, the SEC stated only that it believed the approach it chose was “appropriate” and that a non-exclusive safe harbor “would effectively negate the clarity and certainty that the rule attempts to provide.”¹⁷² This rationale undermines whatever merit the approach might otherwise have, as any agency could defend almost any narrow rule as “appropriate” if all that was required to justify it was that it provides greater clarity or certainty. Fundamentally, the rule must satisfy the *Chevron* test that takes into account the terms of the relevant statute and other substantive criteria.¹⁷³

The SEC’s rulemaking to preclude any defense that does not adhere to the letter of the prescribed defenses is especially troublesome to the extent that it would apply to a criminal charge of unlawful insider trading. Because the government has the burden of proof on each element of the offense and “use” has been determined to be one of those elements,¹⁷⁴ application of Rule 10b5-1 would permit the government to discharge its burden of proof by showing only that the defendant was “aware” of the material nonpublic information at the time of the transaction, and the defendant could not rebut that element without satisfying a prescribed defense. The rule of lenity generally applicable in criminal cases provides that if a statute is ambiguous, then the more lenient construction, that is, one favoring the defendant, is applied.¹⁷⁵

A statute is not “‘ambiguous’ for purposes of lenity merely because” there is “a division of judicial authority” over its proper construction. [Citation omitted.] The rule of lenity applies only if, “after seizing everything from which aid can be derived,” [citation omitted], we can make “no more than a guess as to what Congress intended.”¹⁷⁶

In the context of the use/possession debate in applying Rule 10b-5, careful analysis suggests that *either* proof of use is an element of the wrong *or* the resolution is ambiguous; in the latter event, the more lenient rule—requiring that the government prove use—applies.

When the same statute has application to civil as well as criminal proceedings, the rule of lenity operates in both spheres:

[The statutory provision at issue] is a criminal statute, and it has both criminal and noncriminal applications. Because we must interpret the statute consistently, whether we encounter its application in a criminal or noncriminal context, the rule of lenity applies.¹⁷⁷

172. Rule 10b5-1 Adopting Release, 65 Fed. Reg. at 51727.

173. See *supra* text accompanying notes 160–71.

174. *Smith*, 155 F.3d at 1066–69.

175. See, e.g., *Ladner v. United States*, 358 U.S. 169, 214 (1958).

176. *Reno v. Koray*, 515 U.S. 50, 64–65 (1995).

177. *Leocal v. Ashcroft*, 543 U.S. 1, 11–12 n.8 (2004).

If Rule 10b-5 is properly interpreted to require proof of use in the criminal context, then the same principle must apply in civil actions, including an enforcement action brought by the SEC.

While no parallel situation has been found, where an agency has adopted a rule construing a statute and in turn has specified that certain conduct will constitute a defense to a charge of violating that statute and no other conduct can rebut the charge, the foregoing analysis strongly suggests that the SEC's effort to specify exclusive defenses or an exhaustive list of defenses is not valid. As a result, a defendant or respondent in either a criminal case or civil action charging unlawful insider trading should be allowed to rebut any showing of use (or proof of trading while "aware") without being limited to the three affirmative defenses set forth in Rule 10b5-1.

B. IS IT A VIOLATION OF RULE 10B-5 TO TIME CORPORATE DISCLOSURE TO MAXIMIZE PROFIT OR MINIMIZE LOSS RESULTING FROM TRADES MADE PURSUANT TO A VALID RULE 10B5-1 PLAN?

Some commentators have expressed concern that executives who establish Plans and who are in a position to influence the timing of corporate disclosures have manipulated that timing to maximize profits resulting from transactions carried out pursuant to the terms of their Plans.¹⁷⁸ If an executive knows that his or her Plan will result in a sale of company stock on a particular date, he or she may be able to cause a delay in the disclosure of unfavorable news so that the expected stock price

178. See, e.g., Jagolinzer, *supra* note 65. The abstract of that paper states:

The SEC enacted Rule 10b5-1 to deter insiders from trading with private information, yet also protect insiders' preplanned, non-information-based trades from litigation. Despite its requirement that insiders plan trades when not privately informed, the Rule appears to enable strategic trade. Participating insiders' sales systematically follow positive and precede negative firm performance, generating abnormal forward-looking returns larger than those earned by non-participating colleagues. Neither market transaction disclosures responses nor "predictable" reversion following positive performance appears to explain the association between 10b5-1 sales and negative future performance. There is evidence, however, that a substantive proportion of randomly drawn plan initiations are associated with pending adverse news disclosures. There is also some evidence that early sales plan terminations are associated with pending positive performance shifts, reducing the likelihood that insiders' sales execute at low prices. Collectively, this suggests that, on average, trading within the Rule does not solely reflect uninformed diversification.

The author posits several explanations for abnormal trade returns by those using Plans, one of which is that the rule "allows insiders to manipulate the timing or content of information disclosures subsequent to plan initiation." *Id.* at 7. See also *id.* at 9 ("participants may modify the timing or content of news announcements to increase returns on previously planned trades"). On the point at issue in this discussion, however, the author states that "[i]t is not possible to directly examine, through publicly available data, whether [this] strategy is specifically utilized" (*id.* at 9), and concludes that it is "difficult to detect empirically" whether Plan participants "manipulate information flows to the market to maximize returns to 10b5-1 plan trades" (*id.* at 28) and that the "study leaves open the question of how participants are able to generate abnormal trade returns within their plans [although] . . . abnormal returns could . . . result . . . if participants alter the timing or content of disclosures once trades have already been planned" (*id.* at 27). In other words, while the data produced by his study is consistent with a conclusion that executives may alter the timing or content of corporate disclosures (see, e.g., *id.* at 13 ("only sales executed within 10b5-1 appear to systematically anticipate pending firm performance declines")), the analysis is not conclusive or definitive. See also, e.g., Jane Sasseen, *Insiders with a Curious Edge*, BUSINESS WEEK, Dec. 18, 2006, at 38 (summarizing principal conclusions of the

decline is deferred until after the sale, thereby producing larger proceeds. Similarly, though perhaps more benign, an executive can accelerate the disclosure of favorable news so that it is released before a sale under a Plan.¹⁷⁹ This presents the question whether exercising this influence over the timing of corporate disclosure in connection with the executive's Plan is a violation of the securities laws.¹⁸⁰ The Staff of

Jagolinzer study and describing transactions of several executives with Plans where substantial sales were made at historical highs, prior to downturns).

Similar studies have questioned the propriety of trading activity without coming to a definitive conclusion. See, e.g., Alan J. Ziobrowski, et al., *Abnormal Returns from the Common Stock Investments of the U.S. Senate*, 39 J. FIN. & QUANT. ANAL. 661 (2004) (documenting that a "portfolio that mimics the purchases of U. S. Senators [during the period 1993–1998] beats the market by 85 basis points per month"), available at weber.ucsd.edu/~jlbroz/PElunch/ziobrowski_etal_2004.pdf.

179. These practices are much like the "spring loading" or "bullet dodging" practices that have come to light regarding questionable corporate stock option granting practices. In spring loading the date of the actual option grant or the effective date for the grant of the option is set as or changed to a date shortly before the public announcement of favorable information concerning the company. The option holder thus receives the benefit of an immediate upswing in the market price of the stock and is assured that the options are almost immediately in the money, although there is no certainty that the option will be in the money when it becomes exercisable, often not until years into the future. In bullet dodging the grant is set as or deferred until public announcement of unfavorable information concerning the company. The option grantee is assured of having an exercise price set at a market price that is depressed by the bad news that has just been announced by the company, as distinguished from an exercise price that is immediately out of the money. See, e.g., M. P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597 (2007). In his study, Jagolinzer notes the similarity of his analysis of trading pursuant to Plans to the analyses of suspect option grant activity. Jagolinzer, *supra* note 65, at 13.

180. For purposes of this analysis, it is assumed that the timing of either the positive or negative news is discretionary, i.e., there is no failure to comply with a mandatory disclosure requirement such as the requirement that information required to be disclosed on Form 8-K be disclosed within four business days of the triggering event. General Instruction B to Form 8-K, available at <http://www.sec.gov/about/forms/secforms.htm#1934forms> (hyperlink to 8-K). Of course, the corporation that must file the Form 8-K has the discretion to file any time within the four day window, so that disclosure could be delayed, or accelerated, within that time frame in an attempt to affect the economic outcome of a sale under a Plan. The failure to file a timely Form 8-K can result in sanctions. See, e.g., Exchange Act, *supra* note 1, § 15(c)(4), 48 Stat. at 895 (codified as amended at 15 U.S.C. § 78o(c)(4) (2000)) (granting SEC authority to require a person to comply with the public company reporting provisions of the Exchange Act where the person was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure); In the Matter of Sparteck, Inc., et al., Sec. Proceedings File No. 15,567, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,961, at 81402 (Feb. 14, 1979) (reporting settlement of administrative proceeding initiated because of failure to timely file Form 8-K).

This entire discussion about the discretionary timing of corporate disclosures takes into account that, as a general principle, absent a specific disclosure requirement, such as one of the events required by Form 8-K to be disclosed, a public company does not have a general obligation to disclose an event simply because it is material, whether favorable or unfavorable. See J. ROBERT BROWN, JR., *THE REGULATION OF CORPORATE DISCLOSURE* § 3.01 (3d ed. 2007). At the same time, public companies that have listed their securities on registered exchanges must agree to make prompt disclosure of material developments. See, e.g., NEW YORK STOCK EXCHANGE LISTED COMPANY MANUAL § 202.05 (Aug. 21, 2006) ("A listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities. This is one of the most important and fundamental purposes of the listing agreement which the company enters into with the Exchange.").

If an executive delayed disclosure when there was a duty on his or her part to update (see *supra* text accompanying note 147), the executive could be liable for violating Rule 10b-5 if the other elements of the violation were established, such as scienter (see *supra* text accompanying notes 44, 129, and 154).

the SEC recently announced it was going to look “hard” at whether Plans “are being abused in various ways to facilitate trading based on inside information.”¹⁸¹

One principle is clear. It is not a violation of Rule 10b-5 for someone who has established a Plan to terminate the Plan to abort a sale that would have taken place pursuant to the Plan at a disadvantageous price, when the person who created the Plan has come to know that there are undisclosed material positive developments at the company that would likely cause the price of the stock to increase after the Plan sale.¹⁸²

Another issue seems unremarkable—if the timing of the disclosure to enhance the profitability of an impending transaction otherwise contravenes one of the prohibitions imposed by Rule 10b-5, then the sale will satisfy the element that the behavior must be “in connection with the purchase or sale of any security,” the final clause of the rule.¹⁸³

The analysis of whether other essential elements of a violation of Rule 10b-5 are satisfied by timing the release of corporate disclosure to maximize profits under a Plan must start from first principles under Rule 10b-5. First, Rule 10b-5 can be no broader than the statutory provision under which it was promulgated, Section 10(b) of the Exchange Act.¹⁸⁴ Second, Section 10(b) reaches only conduct that is “manipulative” or “deceptive,” the words used in the statute.¹⁸⁵ The term “manipulation” is “virtually a term of art when used in connection with the securities markets,”¹⁸⁶ generally referring to “practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead by artificially affecting market activity,”¹⁸⁷ and “connot[ing] intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.”¹⁸⁸

181. Linda Chatman Thomson, Director, SEC Division of Enforcement, Remarks at the 2007 Corporate Counsel Institute, at 10 (Mar. 8, 2007), available at <http://www.sec.gov/news/speech/2007/spch030807lct2.htm> (citing the Jagolinzer study, *supra* note 65). While stating that “if executives are in fact trading on inside information and using a plan for cover, they should expect the ‘safe harbor’ to provide no defense” (*id.*), she did not explain how such conduct violated the law or under what circumstances an affirmative defense under Rule 10b5-1 would not be available. Her use of the term “safe harbor” was also anomalous. See *supra* text accompanying notes 58–59.

182. See *supra* text accompanying note 73.

183. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1513 (2006) (“it is enough that the fraud alleged ‘coincide’ with a securities transaction—whether by the plaintiff or by someone else”; “[t]he requisite showing, in other words, is ‘deception ‘in connection with the purchase or sale of any security,’ not deception of an identifiable purchaser or seller,” (quoting *O’Hagan*, 521 U.S. at 651, 658)); *SEC v. Zandford*, 535 U.S. 813, 822 (2002) (“It is enough that the scheme to defraud and the sale of securities coincide.”).

184. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472–73 (1977) (“The scope of the Rule cannot exceed the power granted to the Commission by Congress under § 10(b).”); *Ernst & Ernst*, 425 U.S. at 214 (Rule cannot exceed scope of Exchange Act Section 10(b)).

185. *Santa Fe*, 430 U.S. at 472–473 (stating that “the language of the statute must control the interpretation of the Rule” and the “language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception”; holding that Rule 10b-5 does not reach a breach of fiduciary duty that does not entail manipulation or deception).

186. *Ernst & Ernst*, 425 U.S. at 199.

187. *Santa Fe*, 430 U.S. at 476.

188. *Ernst & Ernst*, 425 U.S. at 199. See also *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979) (defining “manipulation” as “practices in the marketplace which have

Manipulation in this sense does not, for example, encompass corporate mismanagement in the nature of a breach of fiduciary duty.¹⁸⁹ The exercise of control over the timing of corporate disclosure, even if in breach of a duty to the corporate entity (since by hypothesis done for the personal benefit of the officer and not for the benefit of the corporation), is thus not the type of “manipulation” encompassed by Rule 10b-5.

This leaves the question whether the deliberate timing of disclosure to maximize profits under a Plan is a “deceptive” act within the meaning of Rule 10b-5, recognizing that deception can take the form of a misrepresentation or omission.¹⁹⁰ The essence of deception is “to create a false appearance of fact,” thus focusing on the *effect* of the deception.¹⁹¹ Accepting as a given that the actual timing of the disclosure is independently lawful,¹⁹² no one is “deceived” by a delayed or accelerated corporate disclosure in violation of Rule 10b-5. To be sure, if the delay in disclosure is designed to allow a planned sale to take place *before* the release of bad news that will cause the stock price to decline, someone who bought the stock before the disclosure will have paid more than he or she would have if the

the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself”) (cited with approval in *Regents of Univ. of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 390–91 (5th Cir. 2007), *pet. for cert. filed sub nom.*, *Regents of Univ. of Cal. v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 75 U.S.L.W. 3557 (Mar. 5, 2007) (No. 06-1341), and *In re Charter Commc'ns Sec. Litig.*, 443 F.3d 987, 992 n.2 (8th Cir. 2006), *cert. granted sub nom.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007)).

189. *Santa Fe*, 430 U.S. at 477.

190. *Santa Fe*, 430 U.S. at 476 & n.15. A complete failure to speak—a pure omission—is a violation of Rule 10b-5 only if there was a duty to speak. *See, e.g., Basic*, 485 U.S. at 239 n.17 (1988); *Chiarella*, 445 U.S. at 228. While the discussion in *Santa Fe* focused on whether there was a private cause of action for the conduct alleged, so that some of the considerations weighed by the Court related to whether the implied private cause of action for damages for a violation of Rule 10b-5 extended to a breach of fiduciary duty, 430 U.S. at 480, the overall tenor of the opinion applies to the scope of Rule 10b-5, and to Section 10(b) generally.

191. *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048, 1050 (9th Cir. 2006), *pet. for cert. filed sub nom.*, *Avis Budget Group v. Cal. State Teachers' Ret. Sys.*, 75 U.S.L.W. 3236 (Oct. 19, 2006) (No. 06-560). The court in *Simpson* upheld the concept of “scheme” liability in the context of a private civil action. *Id.* at 1050. The issue of the viability of this theory is now before the U.S. Supreme Court in *Charter*, *supra* note 188. On the subject of scheme liability, see also *Credit Suisse First Boston*, *supra* note 188, 482 F.3d at 382–94 (rejecting scheme liability on the facts pleaded).

Many of the cases cited in this Article on the issue of the scope of Section 10(b) and Rule 10b-5 arose in the context of a claim of private civil liability. As addressed in *Simpson* and *Charter*, the scope of private liability remains constrained by the ruling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), in which the Court held that Section 10(b) and Rule 10b-5 do not encompass a claim for aiding and abetting. *See Simpson*, 452 F.3d at 1047–51, and *Charter*, 443 F.3d at 990–93. Although the Exchange Act was amended to grant courts the authority to impose remedies upon the application of the SEC where the defendant “knowingly provide[d] assistance to another person” in violation of, for example, Rule 10b-5 (Exchange Act, *supra* note 1, § 20(e), 48 Stat. at 899 (codified as amended at 15 U.S.C. § 78t(e) (2000))), in the situation addressed here an executive who arguably knowingly assisted the corporation in delaying or accelerating a disclosure would not be exposed to a civil proceeding brought by the SEC because, for the reasons discussed in the text, the corporation itself would not have violated Rule 10b-5 because there was no “deception” by *anyone* in delaying or accelerating the disclosure.

192. *See supra* note 180.

executive had not caused the disclosure to be deferred. By hypothesis, however, there was no independent duty to make earlier disclosure.

Similarly, if good news is accelerated so that it affects the market price before a planned sale, a buyer might end up paying more for the stock than if the disclosure had not been accelerated, but, that, too, does not entail breach of any duty of disclosure to the prospective buyer. There is no discernible deception in issuing a truthful disclosure earlier than might otherwise have been required.¹⁹³

There is one very important caveat to this conclusion. Rule 10b5-1(c)(1)(ii) provides that the affirmative defenses afforded by a Plan are available only if the Plan was “entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section,” undoubtedly meaning Rule 10b-5.¹⁹⁴ If the Plan was entered into with the intent to time corporate news releases to maximize profits or minimize losses under the Plan, that would be a manipulative act *ab initio*, virtually indistinguishable in substance from classic insider trading—albeit by affecting the timing of disclosure rather than timing of the transactions. Thus, someone who *did* influence the timing of disclosure to his or her advantage is likely to face a challenge to the *bona fides* of the creation of the Plan at its inception. It may be difficult to fend off that challenge, based on the benefit of hindsight, even if when the Plan was created there was no intent to influence subsequent disclosures.

V. CONCLUSION

Rule 10b5-1 has undoubtedly proved to be a panacea for corporate executives and others whose flexibility to trade in the stock of their companies was severely

193. The foregoing analysis assumes that there is no affirmative representation, such as in connection with any disclosure of the Plan itself, regarding how the corporation will time corporate disclosures surrounding dates of transactions that will be carried out pursuant to the Plan. A misrepresentation regarding the executive's intention regarding the timing of future disclosures, such as vis-à-vis transactions under a Plan, could violate Rule 10b-5. Cf. *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.*, 532 U.S. 588 (2001) (holding that false promise, in connection with sale of securities option, to later honor an exercise notice of the option violated Rule 10b-5).

The focus of this discussion is on whether there has been a violation of Rule 10b-5. Conduct that does not violate the federal securities laws may, nevertheless, be wrongful, such as in breach of a fiduciary duty to the corporation. For example, many of the private damage actions based on alleged misconduct in pricing stock options (*see supra* note 179) are derivative actions brought against the alleged misbehaving directors and officers for breaching a duty to the corporation that issued the options, seeking a return of the options or the profits obtained on exercise of the options, and not for a violation of the federal securities laws. *See, e.g., Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007) (denying a motion to dismiss derivative claims against directors in connection with allegations of backdating of options); Amanda Bronstad, *Backdate Suits are in Pipeline, Next Step in Stock-Option Probes*, NAT'L L.J., June 5, 2006, at 1, available at <http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1149757524394>. In the instant context, however, it is difficult to envision a breach of fiduciary duty if what the executive has done is choose from among otherwise lawful dates a permissible date that provides a greater benefit to him or her than some other permissible date. The executive has, to be sure, used his or her influence or control over the corporate disclosure process to gain an advantage, but he or she has not done so in a way that harmed, or imposed an additional cost on, the corporation.

194. 17 C.F.R. § 240.10b5-1(c)(1)(ii) (2007).

hampered by cautious attention to the prohibitions imposed by Rule 10b-5. Those with Plans are able to use them with little or any prior disclosure of the Plans, but there is no less disclosure than there was before Rule 10b5-1, when an executive or director had no obligation to disclose any impending purchase or sale of stock except to the extent required by Rule 144, which can be as late as the same day as the initial sale. Moreover, actual insider transactions are now disclosed on Form 4 more quickly than they were when the rule was adopted.

The SEC adopted Rule 10b5-1 with the express purpose of resolving an uncertainty in applying Rule 10b-5—the “possession” versus “use” issue. This Article questions whether the rule has done that in practical effect—the SEC itself seems to acknowledge that any litigated case is going to turn on the issue of “use”—and there is a serious question whether the rule is valid, insofar as it may seek to dispense with the requisite element of scienter in a proceeding under Rule 10b-5. Of equal concern, it is highly doubtful that the SEC’s attempt to prescribe *exclusive* defenses is a valid exercise of its powers. A defendant or respondent should be able to meet a charge of unlawful insider trading with a showing of non-use of material nonpublic information that does not satisfy one of the express affirmative defenses. This is not meant to suggest that anyone contemplating a Plan need not scrupulously establish and adhere to the Plan. The point is that neither a defect in the Plan, nor a failure to have a Plan at all, should preclude assertion of non-use, irrespective of whether possession of material nonpublic information creates a presumption or inference of use in a civil proceeding.

Finally, while there is some evidence that insiders with Plans may be influencing the timing of corporate disclosures to maximize profits or minimize losses, the exercise of this influence—so long as it was not intended when the Plan was established—does not appear to run afoul of any prohibition in the Exchange Act.