



# Reexamining the Rule 10b5-1 Trading Plan Defense to Insider Trading

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Earlier this week, the House of Representatives passed the Promoting Transparent Standards for Corporate Insiders Act ([H.R. 624](#)) by a vote of 413-3. Previously included as part of the JOBS and Investor Confidence Act of 2018 ([S. 488](#)), which passed the House of Representatives of the 115th Congress but was not enacted, the bill would direct the Securities and Exchange Commission (SEC) to carry out a study regarding the potential need to reform SEC [Rule 10b5-1](#) and to conduct further rulemaking. The SEC enacted Rule 10b5-1 in 2000, providing a way for insiders to transact in their company's securities without running afoul of federal insider trading laws by setting up prearranged trading plans. For example, corporate executives, whose compensation may be significantly made up of company stock, could engage in legitimate prearranged trading in company securities under the rule, even though they are often privy to inside information. Rule 10b5-1 has since come under periodic scrutiny for its potential susceptibility to abuses that could facilitate insider trading by corporate insiders.

This Sidebar reviews the purpose of Rule 10b5-1 trading plans, the debate regarding whether amendments to the rule are necessary to prevent insider trading by corporate executives, and the Promoting Transparent Standards for Corporate Insiders Act as passed by the House that is now pending in the Senate.

## *10b5-1 Trading Plans as a Defense to Insider Trading*

Insider trading is a violation of [Section 10\(b\)](#) of the Securities Exchange Act and SEC [Rule 10b-5](#), which prohibit, respectively, the “use [of] . . . any manipulative or deceptive device or contrivance” and “any act, practice, or course of business which . . . operates as a fraud or deceit” in connection with the purchase or sale of a security. The scope of insider trading liability has developed over the years through the courts, and the law generally [prohibits](#) “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 or confidence . . .” In 2000, the SEC [adopted](#) Rule 10b5-1 largely to clarify that the language “on the basis of” contained in the standard means that a person was “aware of” material nonpublic information at the time of the trade. In so doing, the SEC rejected a more stringent standard some courts had embraced that required a showing that the person *actually used* their knowledge of material nonpublic information as a basis for their decision to trade. The SEC [explained](#) that it would be “highly doubtful” that a person with inside

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information could completely disregard that knowledge in making the decision to purchase or sell a security.

In adopting the broader knowledge standard, however, the SEC also included affirmative defenses (or safe harbors) in the rule that could under certain circumstances shield those with knowledge of material nonpublic information from liability for conducting certain trades. Under the [rule](#), “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 [b]efore becoming aware of the information, the person had . . . adopted a written plan for trading securities.” In other words, the rule establishes a defense to insider trading for transactions executed pursuant to a prearranged plan adopted in good faith and, importantly, at a time when the person was not aware of material nonpublic information. Specifically, to avail themselves of the defense, a person must specify the date, volume and prices of trades in advance; designate a pre-set formula for trading; or hand control of the trades over to another person who is not aware of material nonpublic information (so long as the insider does not have any subsequent influence over the trading).

The 10b5-1 plan defense addresses the trading needs of corporate insiders, like executives and directors, who may from time to time have a legitimate need or desire to transact in their company’s stock, but are also frequently privy to inside information. Corporate insiders now [commonly](#) adopt 10b5-1 plans, which may be particularly useful because a significant component of executive [compensation](#) often comes in the form of company stock.

### *The Debate over 10b5-1 Plans*

The SEC and others have questioned the plans’ potential for abuse and possible weaknesses over at least the past [decade](#), citing certain well-publicized [reports](#) and [studies](#) indicating that many executives achieve above-average returns when trading in their company’s stock, even when trading pursuant to Rule 10b5-1 trading plans. In response, some, including the [Council of Institutional Investors](#) (CII), have pointed to various characteristics of the plans that might make them susceptible to exploitation. These include an insider’s ability to adopt a plan shortly before the trading is to begin (e.g., within days), the ability to cancel or amend the plan at any time, and the lack of disclosure rules surrounding plan adoption and alterations. These potential weaknesses have raised suspicions among critics that insiders may in fact be strategically entering into or modifying the plans based on material nonpublic information (e.g., entering into a plan days before the announcement of a major corporate event), but still utilizing the plan as a [mask](#) for inappropriate trading activity. CII has therefore called for reforms such as requiring a delay period between adoption of a plan and trading (e.g., 90 days), allowing insiders to enter into plans only during certain specified trading windows (e.g., after earnings releases, when insiders are unlikely to possess further inside information), and discouraging plan alterations and cancellations through mandatory disclosure requirements. In 2002, the SEC itself also [proposed](#), but did not ultimately promulgate, disclosure rules for 10b5-1 plan adoptions, modifications, and terminations.

Supporters of the current rule, though, have [challenged](#) whether executives’ beating the market is truly indicative of insider trading. They point out that such performance data should be unsurprising because company executives are often industry experts. Further, they note that because Rule 10b5-1 allows insiders to specify that sales should occur on a certain date only if a certain price is met, their trades could simply reflect a pre-determined instruction to “sell high” (this aspect of the rule, too, has been [criticized](#) by some commentators). Moreover, legal advisors have noted that, particularly in light of the scrutiny 10b5-1 plans have received from time to time, many companies have already voluntarily adopted [best practices](#) incorporating many of the same reforms that have been proposed. Further restrictions, they argue, could render the plans so inflexible as to prohibit legitimate activity and to chill their use overall.

It should be noted that the current rule does not *permit* the abuses highlighted by CII and others, given the rule’s good faith requirement and its condition that the person not be in possession of material nonpublic

information when entering into a plan. The SEC has further clarified that plan terminations and alterations may preclude the availability of the defense depending upon the circumstances (see the SEC guidance linked [here](#), particularly Questions 120.18-120.20). Courts have at times rejected attempts by defendants to rely on the existence of their 10b5-1 plans to dispute securities fraud claims brought against them. For instance, in 2008 a federal district court in Los Angeles, in [refusing](#) to dismiss securities fraud claims against a Countrywide Financial executive, remarked that his frequent adoption and amendments to 10b5-1 plans “appear[ed] to defeat the very purpose of 10b5-1 plans, which were created to allow corporate insiders to ‘passively’ sell their stock . . . without direct involvement.” In other cases, however, the existence of a defendant’s Rule 10b5-1 plan can pose a significant hurdle for plaintiffs attempting to establish the [strong inference](#) of scienter required to survive a motion to dismiss in private securities fraud cases. A New York federal district court in 2014, for example, dismissed securities fraud claims against a Lululemon executive and director trading pursuant to Rule 10b5-1 plans. Even though plaintiffs alleged, for example, that the company’s founder and director had made significant stock sales of over \$100 million shortly after certain product quality issues (which led to a product recall) had emerged at the company, the complaint was dismissed as it did not contain facts indicating that he knew of the quality issues when entering into his Rule 10b5-1 trading plan.

### *Promoting Transparent Standards for Corporate Insiders Act*

In light of the concerns raised above, the Promoting Transparent Standards for Corporate Insiders Act would direct the SEC to undertake a study analyzing whether Rule 10b5-1 needs to be amended. The Act would then require the SEC to commence further rulemaking addressing the study’s results. Specific potential amendments set forth in the bill for the SEC to examine include:

1. allowing insiders to adopt 10b5-1 plans only during specified trading windows;
2. imposing mandatory trading delays after adoption of a 10b5-1 plan;
3. limiting the ability of insiders to adopt multiple 10b5-1 plans;
4. limiting the frequency of plan modifications;
5. requiring disclosure of plan adoptions and modifications; and
6. requiring corporate boards to police and monitor certain 10b5-1 plans.

The intended study by the SEC may serve to further inform the longstanding debate regarding Rule 10b5-1, potentially through, for example, gathering updated trading data and examining whether voluntary corporate best practices appear to sufficiently mitigate potential problems.

## **Author Information**

Nicole Vanatko  
Legislative Attorney

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