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Solving the Paradox of Insider Trading Compliance

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SOLVING THE PARADOX OF INSIDER TRADING COMPLIANCE

*John P. Anderson**

Regulators demand the impossible when they require issuers to design and implement effective insider trading compliance programs because insider trading is a crime that neither Congress nor the Securities Exchange Commission has defined with any specificity. This problem of uncertainty is then compounded by the threat of heavy civil and criminal sanctions for violations. Placed between this rock and hard place, issuers tend to adopt overbroad insider trading compliance programs, which comes at a heavy price in terms of corporate culture, cost of compensation, share liquidity, and cost of capital. The irony is that, since all of these costs are ultimately passed along to the shareholders, insider trading enforcement under the current regime has precisely the opposite of its intended effect. This is the paradox of insider trading compliance for issuers, just one more symptom of a dysfunctional insider trading enforcement regime that is in need of a dramatic overhaul.

There are a number of conceivable paths to resolving this paradox. The most obvious solution would be for the Securities Exchange Commission to issue a rule or for Congress to promulgate a statute defining insider trading with greater specificity. But while simply fixing definitions to the elements of insider trading under the current regime would improve matters, this Article calls for a more radical solution. It suggests that the current enforcement regime be liberalized to permit insider trading where an issuer approves a trade in advance and has disclosed that it permits such trading pursuant to regulatory guidelines. It argues that such reform would lead to a more rational, efficient, and just insider trading enforcement regime. Moreover, by aligning the interests of issuers, shareholders, and regulators, this reform would also offer the most effective solution to the paradox of insider trading compliance.

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INTRODUCTION

Regulators demand the impossible when they require issuers to design and implement effective insider trading compliance programs because insider trading is a crime that neither Congress nor the Securities Exchange Commission (SEC) has defined with any specificity.¹ This problem of uncertainty is then compounded by the threat of heavy civil and criminal sanctions for violations.² Placed between this rock and hard place, issuers tend to adopt overbroad insider trading compliance programs, which comes at a heavy price in terms of corporate

1. See STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 26–27 (2d ed. 2007) [hereinafter BAINBRIDGE, *SECURITIES LAW*].

2. See Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C. § 78 (2012)). As explained in Section I *infra*, the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) imposes the civil penalty of treble damages to all “controlling persons” of those who trade on material nonpublic information, if they “knew or recklessly disregarded the fact that [a] controlled person was likely to engage in” insider trading and failed to prevent it. 15 U.S.C. § 78u-1(b)(1)(A). The failure to implement and enforce an effective insider trading compliance program sometimes counts as “reckless disregard” by an issuer. See WILLIAM K. S. WANG & MARC I. STEINBERG, *INSIDER TRADING* 884–85 (3d ed. 2010). In addition to the risk of stiff civil penalties under ITSFEA, the Federal Sentencing Guidelines offer issuers an added incentive to adopt insider trading compliance policies and procedures. See U.S. SENTENCING GUIDELINES MANUAL § 8B2.1 (U.S. SENTENCING COMM’N 2014). The potential for criminal liability for the failure to implement adequate compliance programs is also addressed in Section I *infra*.

culture, cost of compensation, share liquidity, and cost of capital.³ The irony is that, since all of these costs are passed along to the shareholders, insider trading enforcement under the current regime has precisely the opposite of its intended effect.⁴ This is the paradox of insider trading compliance for issuers, just one more symptom of a dysfunctional insider trading enforcement regime that is in need of a dramatic overhaul.⁵

There are a number of conceivable paths to resolving this paradox. The most obvious and ready-to-hand solution would be for the SEC to issue a rule or for Congress to promulgate a statute expressly defining insider trading.⁶ But while simply fixing definitions to the elements of insider trading under the current regime would improve matters, this Article calls for a more radical solution. It suggests that the current enforcement regime be liberalized to permit insider trading where, *inter alia*, an issuer approves the trade in advance and has disclosed that it permits such trading pursuant to express regulatory guidelines. Issuer-proscribed insider trading and trading based on misappropriated information would remain illegal. Such reform would lead to a more rational, efficient, and just enforcement regime. Moreover, by aligning the interests of issuers, shareholders, and regulators, it would also offer the most effective solution to the paradox of insider trading compliance.

This Article proceeds as follows: Section I summarizes the current civil, criminal, and reputational consequences to issuers for failing to implement a rigorous insider trading compliance program. Section II points out the hopeless uncertainty surrounding the SEC's current working definition of insider trading as trading "on the basis of" material nonpublic information."⁷ Section III identifies the significant challenges and costs to issuers in articulating and implementing an insider trading compliance program in the midst of such legal uncertainty. Section IV then articulates the resulting paradox of insider trading compliance for issuers, namely that accommodating the current enforcement regime tends to undermine the very policy goals that justify its existence.

The SEC is aware of this paradox and tried to address it in 2000 with the adoption of an affirmative defense for insiders who trade through qualified trading plans under Rule 10b5-1(c).⁸ Section V argues that, far from resolving the paradox of insider trading compliance for issuers, Rule 10b5-1(c) has just

3. See *infra* Section III.

4. See *infra* Sections III and IV.

5. See *infra* Section IV; see also Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1515–20 (1999) (discussing other symptoms of a dysfunctional insider trading regime, including candid insider trading and deceptive trading).

6. Joan MacLeod Heminway has argued convincingly for just such an approach concerning the element of materiality in the context of insider trading. See Joan MacLeod Heminway, *Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading*, 72 LA. L. REV. 999, 1013–14 (2012) [hereinafter Heminway, *Just Do It!*]; Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1190–91 (2003) [hereinafter Heminway, *A Call for Action*].

7. 17 C.F.R. § 240.10b5-1(b) (2016).

8. *Id.* § 240.10b5-1(c).

complicated matters further. For these and other reasons, Section VI suggests that the current insider trading enforcement regime results in a net harm (both moral and economic) to society and is therefore in urgent need of reform.

Finally, Section VII proposes a path forward. It recommends that the existing 10b5-1(c) trading plan regime be modified to permit issuers to license their insiders to trade based on material nonpublic information so long as certain disclosure and reporting requirements are satisfied. Issuer-proscribed insider trading and trading based on misappropriated information would remain prohibited. It argues that this proposed reform would result in a more rational and just enforcement regime because issuer-licensed insider trading is both economically beneficial to society and morally permissible, while issuer-proscribed and misappropriation trading are economically harmful and morally impermissible. Moreover, by aligning the interests of issuers, shareholders, and regulators, this reform would dissolve the paradox of insider trading compliance for issuers.

I. STRONG COMPLIANCE OR ELSE!

Firms with weak compliance programs stand to incur derivative civil and criminal liability for the insider trading of their employees, and the penalties (both reputational and monetary) are stiff. To begin, the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA)⁹ extended the civil penalty of treble damages¹⁰—once limited to actual traders under the Insider Trading Sanctions Act of 1984 (ITSA)¹¹—to all “controlling persons.”¹² Under ITSFEA, issuers may incur derivative liability if they “knew or recklessly disregarded the fact that [a] controlled person was likely to engage in the act or acts constituting

9. See Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C. § 78 (2012)).

10. Firms are subject to penalties not exceeding “the greater of [\$1,525,000], or three times the amount of the profit gained or loss avoided as a result of such controlled person’s violation.” 15 U.S.C. § 78u-1(a)(3). The penalty was last adjusted for inflation in 2013. Adjustments to Civil Monetary Penalty Amounts, Securities Act Release No. 9387, Exchange Act Release No. 3557, Investment Company Act Release No. 30,408, 105 SEC Docket 2898 (Feb. 27, 2013).

11. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered sections of 15 U.S.C. § 78 (2012)). Congress “did not extend the treble penalties of ITSA to controlling persons or to employers under principles of respondeat superior.” WANG & STEINBERG, *supra* note 2, at 812.

12. Although ITSFEA does not expressly define “controlling person,” the legislative history makes clear that its meaning is adopted from section 20(a) of the Exchange Act. The Committee Report summarized its meaning as follows:

“Controlling person” may include not only employers, but any person with power to influence or control the direction or the management, policies, or activities of another person. “Control” is inferred from possession of such power, whether or not it is exercised. The Committee expects the Commission and courts to continue to interpret the term “controlling person” on a case-by-case basis according to the factual circumstances.

H.R. REP. NO. 100-910, at 17 (1988), *as reprinted in* 1988 U.S.C.A.N. 6043, 6054 (citations omitted). See generally Howard M. Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C. L. REV. 465 (1990) (discussing the history and implications of ITSFEA).

the violation and failed to take appropriate steps to prevent such act or acts before they occurred.”¹³ The failure to adopt and implement effective insider trading compliance programs and procedures can sometimes stand as evidence of “reckless disregard” under section 21A(b)(1)(A).¹⁴ The legislative history reflects that the intent behind ITSFEA was to “increase the economic incentives” for controlling persons to “supervise vigorously their employees.”¹⁵ Measured by this goal, ITSFEA appears to have had its desired effect. Most issuers have adopted strict insider trading compliance policies and procedures¹⁶ despite the fact that they are not expressly required to do so under the ITSFEA.¹⁷ As one sample insider trading compliance policy explains: “Onerous penalties may be assessed against the Company for the insider trading violations of its employees. Accordingly, if the Company does not take active steps to adopt preventive policies and procedures covering securities transactions by Company personnel, the consequences could be severe.”¹⁸ In addition to the risk of stiff civil penalties under ITSFEA, the Federal Sentencing Guidelines offer issuers an added incentive to adopt insider trading compliance policies and procedures.¹⁹ Under the Federal Sentencing Guidelines, an issuer can significantly reduce its “culpability score” for insider trading and other offenses by having an effective compliance and ethics program in place.²⁰ Moreover, the

13. 15 U.S.C. § 78u-1(b)(1)(A). Issuers were subject to derivative liability for their employees’ insider trading violations under section 20(a) of the Exchange Act, but they were not subject to treble damages.

14. See WANG & STEINBERG, *supra* note 2, at 884–85; Robert A. Prentice, *The Future of Corporate Disclosure: The Internet, Securities Fraud, and Rule 10b-5*, 47 EMORY L.J. 1, 83 (1998); Alan M. Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180, 184–85 (1990).

15. WANG & STEINBERG, *supra* note 2, at 814–15 (quoting H.R. REP. NO. 100-910, at 17).

16. A 1996 survey found that over ninety-two percent of sample firms had adopted a written policy regulating insider trading. *Id.* at 807 n.3 (citing J.C. Bettis, J.L. Coles & M.L. Lemmon, *Corporate Policies Restricting Trading by Insiders*, 57 J. FIN. ECON. 191, 192 (2000)).

17. Only broker-dealers or investment advisor firms are required to implement a written compliance policy. See 15 U.S.C. §§ 78o(g), 80b-4a. Section 406 of the Sarbanes-Oxley Act of 2002 does, however, require that issuers disclose whether they have adopted a code of ethics for high-level financial officers. Pub. L. No. 107-204, § 406, 16 Stat. 745, 789 (codified at 15 U.S.C. § 7264). Such codes of ethics typically include provisions concerning the improper use of insider information. See WANG & STEINBERG, *supra* note 2, at 884.

18. Steven Chasin, Comment, *Insider v. Issuer: Resolving and Preventing Insider Trading Compliance Policy Disputes*, 50 UCLA L. REV. 859, 862 n.9 (2003) (quoting Dale E. Short & Yvonne E. Chester, *Form: Sample Insider Trading Policy*, in *ADVISING AND DEFENDING* 437, 437 (Joseph F. Troy & William D. Gould eds, 1998)).

19. See U.S. SENTENCING GUIDELINES MANUAL, *supra* note 2, § 8B2.1 (providing standards for organizational compliance programs).

20. See *id.* § 8C2.5(f); see also Ellen S. Podgor, *Educating Compliance*, 46 AM. CRIM. L. REV. 1523, 1528 n.37 (2009) (“Companies can reduce their culpability score by three points when they have in place an effective compliance and ethics program.”). Note, however, that a 2004 amendment to the Federal Sentencing Guidelines created a

rebuttable presumption, for purposes of subsection (f)(1), that the organization did not have an effective compliance and ethics program if an individual—(i) within high-level personnel of a small organization; or (ii) within substantial authority personnel, but not within high-

Justice Department has made it clear that the adoption and implementation of effective compliance programs will impact the decision to prosecute firms for the actions of their employees.²¹

II. BUT WHAT IS INSIDER TRADING?

Despite the threat of stiff civil and criminal sanctions, the crime of insider trading has never been defined by statute or rule.²² Congress and the SEC have instead chosen to allow the definition to develop through the common law and by administrative action.²³ The main statutory authority for insider trading is section 10(b) of the Exchange Act of 1934, which proscribes the employment of “any manipulative or deceptive device or contrivance” in “connection with the purchase or sale of any security.”²⁴ The courts have interpreted the language of section 10(b) to require a showing of common law fraud.²⁵ But since most insider traders gain their trading advantage by silence rather than by affirmative misrepresentation, satisfying the elements of fraud requires showing a duty to disclose.²⁶ The Supreme Court has identified two theories under which a section 10(b) duty to disclose prior to trading exists: (1) the “classical theory,” which covers true insider trading (trading by the issuer’s employees or those affiliated with the issuer); and (2) the “misappropriation theory,” which addresses outsider trading (or trading by persons who are not employees or otherwise affiliated with the issuer).²⁷ Since this Article addresses issuer compliance policies, its

level personnel, of any organization, participated in, condoned, or was willfully ignorant of, the offense.

U.S. SENTENCING GUIDELINES MANUAL, *supra* note 2, § 8C2.5(f)(3)(B)(i)–(ii).

21. See Memorandum from Larry D. Thompson, Deputy Att’y Gen., U.S. Dep’t of Justice, to Heads of Dep’t Components, U.S. Att’ys 8 (Jan. 20, 2003), http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20_privwaiv_dojthomp_authcheckdam.pdf [hereinafter, Thompson Memorandum] (“Compliance programs are established by corporate management to prevent and to detect misconduct and to ensure that corporate activities are conducted in accordance with all applicable criminal and civil laws, regulations, and rules. The Department encourages such corporate self-policing, including voluntary disclosures to the government of any problems that a corporation discovers on its own.”). The 2006 memorandum from Deputy Attorney General Paul McNulty replaced the Thompson Memorandum, but it preserved its policy toward compliance programs. See Press Release, U.S. Dep’t of Justice, U.S. Deputy Attorney General Paul J. McNulty Revises Charging Guidelines for Prosecuting Corporate Fraud (Dec. 12, 2006), http://www.justice.gov/archive/opa/pr/2006/December/06_odag_828.html.

22. See BAINBRIDGE, SECURITIES LAW, *supra* note 1, at 26–28.

23. See *id.* at 28–29.

24. 15 U.S.C. § 78j(a)–(b) (2012). Section 10(b) is implemented by the SEC in Exchange Act Rule 10b-5, which proscribes “any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.” 17 C.F.R. § 240.10b-5(c) (2016).

25. For example, the Supreme Court has explained that section 10(b) was designed by Congress as a “catchall” provision, and that “what it catches must be fraud.” *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980).

26. See *id.* at 228 (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (AM. LAW INST. 1977)).

27. See *United States v. O’Hagan*, 521 U.S. 642, 651–53 (1997).

focus will be limited to the classical theory.

Under the classical theory, a corporate insider who seeks to benefit from trading her company's shares on the basis of material nonpublic information violates a "fiduciary or other similar relation of trust and confidence" to the current or prospective shareholder on the other side of the transaction.²⁸ This creates a duty to disclose prior to any such trading.²⁹ But this definition of insider trading is not enlightening without accompanying definitions of its key elements. For example, what information counts as "material"? When is information "nonpublic"? Under what circumstances does one trade "on the basis of" information? Answering any of these questions forces insiders and issuers' compliance officers³⁰ to take sides in a number of ongoing scholarly debates, splits among circuits, and conflicting direction from the SEC and the courts.

A. *When Is Information Material?*

In *Basic Inc. v. Levinson*,³¹ the Supreme Court held that information is material for purposes of insider trading liability if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making a trading decision.³² In addition, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."³³ But, as Professor Joan MacLeod Heminway explains, "[t]he facial simplicity" of this definition "masks the complexities encountered by transaction planners" and others in applying it.³⁴

The qualitative materiality standard articulated in *Basic* is subject to multiple interpretations.³⁵ Who is the "reasonable shareholder" or "reasonable investor"?³⁶ Is she small or institutional, a short-term speculator or long-term investor?³⁷ What constitutes the "total mix" of information?³⁸ And, under any

28. *Chiarella*, 445 U.S. at 228 (quoting RESTATEMENT (SECOND) OF TORTS, *supra* note 26, § 551(2)(a)).

29. *Id.* at 230.

30. An issuer's compliance officer is typically the issuer's general counsel or some other individual with access to material nonpublic information. See Susan Lorde Martin, *Compliance Officers: More Jobs, More Responsibility, More Liability*, 29 NOTRE DAME J.L. ETHICS & PUB. POL'Y 169, 184 (2015) ("Traditionally, the [chief compliance officer] was part of the Chief Legal Officer's [General Counsel's] . . . office, and sometimes one person held both titles." (footnote omitted)).

31. 485 U.S. 224 (1988).

32. *Basic*, 485 U.S. at 231–32 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (articulating this definition of materiality in the context of proxy solicitations)).

33. *Id.* at 231–32 (quoting *TSC Indus.*, 426 U.S. at 449).

34. Heminway, *A Call for Action*, *supra* note 6, at 1138–39.

35. *Id.* at 1139.

36. *Id.* at 1152.

37. See Donald C. Langevoort, *Commentary: Stakeholder Values, Disclosure, and Materiality*, 48 CATH. U. L. REV. 93, 98 (1998) ("[I]nvestors are not homogeneous . . .").

38. Heminway, *A Call for Action*, *supra* note 6, at 1152–53.

reading, the *Basic* standard demands a fact-intensive analysis that will expose even the most thoughtful and diligent advance planning to second-guessing by regulators and the courts *ex post*.³⁹ For example, information concerning a potential problem or opportunity for an issuer may be judged so speculative at the time of a proposed trade that advance disclosure would be misleading to the public.⁴⁰ But if the trade is executed without disclosure, and the problem or opportunity later comes to pass, it will often appear material in retrospect.⁴¹ This example illustrates the problem raised by the awareness of contingent or “soft” information in advance of a trade.

Soft information is information that “inherently involves some subjective analysis or extrapolation, such as projections, estimates, opinions, motives, or intentions.”⁴² As Professors William Wang and Marc Steinberg explain, such information “does not necessarily relate to expectations regarding the future, but may include any statement that cannot be factually supported, whether due to a lack of substantiating data or because the information consists primarily of subjective evaluations or opinions.”⁴³ In *Basic*, the Supreme Court addressed the problem of soft information by suggesting that its materiality should be determined “upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”⁴⁴ But, rather than improve clarity, the *Basic* “probability-magnitude” test has itself been criticized as vague and unhelpful.⁴⁵

The *Basic* probability-magnitude test appears at first blush to be modeled after the famous Hand formula from tort law.⁴⁶ Under that formula, liability is determined by weighing the product of the probability of injury and its “gravity” against the “burden of adequate precautions.”⁴⁷ If the former is greater than the latter, then liability is imposed for failure to take adequate precautions.⁴⁸ But the *Basic* test adopts only half of the equation. It offers nothing corresponding to the “burden of adequate precautions” value in the Hand formula.⁴⁹ In other words,

39. *See id.* at 1140 (“[T]his failure of [regulatory] guidance may . . . lead to allegations that there has been a failure of adequate disclosure, even with thoughtful advance planning.”).

40. *See* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 936–37 (1999).

41. *See id.*

42. *See* WANG & STEINBERG, *supra* note 2, at 125 (quoting Bruce A. Hiler, *The SEC and the Courts’ Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1116 (1987)).

43. *Id.*

44. *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)); *see also* *United States v. Smith*, 155 F.3d 1051, 1065–66 (9th Cir. 1998) (concluding that the soft information at issue was material).

45. *See, e.g.*, Chasin, *supra* note 18, at 868–69.

46. STEPHEN M. BAINBRIDGE, *INSIDER TRADING LAW AND POLICY* 67 (2014) [hereinafter BAINBRIDGE, *INSIDER TRADING LAW*].

47. *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947).

48. *Id.* (“[I]f the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether B [is] less than PL.”).

49. BAINBRIDGE, *INSIDER TRADING LAW*, *supra* note 46, at 67.

the *Basic* formula offers no objective threshold for materiality.⁵⁰ As Professor Stephen Bainbridge puts it, the Court “never tells us how high a probability or how large a magnitude is necessary for information to be deemed material.”⁵¹ Consequently, insiders who trade based on speculative information must do so “knowing that a jury, acting with the benefit of hindsight, may reach a different conclusion about how probability and magnitude should be balanced” than they do at the time of the trade.⁵²

Finally, there is the disturbing problem of “bootstrapping” by courts when making materiality determinations.⁵³ In *SEC v. Texas Gulf Sulphur Co.*,⁵⁴ the Second Circuit explained that “a major factor in determining whether” information is material “is the importance attached to the [information] by those who knew about it.”⁵⁵ And, according to the court, an insider’s choice to trade alone can serve as an indication of such importance.⁵⁶ In *Basic*, the Supreme Court confirmed that “trading (and profit making) by insiders can serve as an indication of materiality.”⁵⁷ But if trading alone can serve as an indication of materiality, then, as Professor Bainbridge points out, “the materiality requirement becomes meaningless because all information in the defendant’s possession when he or she traded would be material.”⁵⁸ Taken to the extreme (and nothing in the definition of materiality offered by the courts precludes this), *any* information that an insider actually trades on can therefore be deemed material.

In sum, the lack of a clear and objective standard permits almost any information to be deemed material for purposes of insider trading liability, at least with the benefit of hindsight. Such flexibility can be quite useful to the SEC and prosecutors. Consequently, it should come as no surprise that the SEC has openly resisted efforts to bring greater clarity to the definition of materiality.⁵⁹

50. *Id.*

51. *Id.*

52. *Id.*

53. *See id.* at 68.

54. 401 F.2d 833 (2d Cir. 1968).

55. *Texas Gulf Sulphur*, 401 F.2d at 851. The defendants in *Texas Gulf Sulphur* were charged with violating insider trading laws after they made representations to the investing public stating there was a lack of information on drilling results from a project in Ontario, Canada. *Id.* at 839–42. The insiders were aware that these results preliminarily showed the possibility of a profitable strike, and traded while in possession of such information. *Id.* The issue before the court was whether this information was “material.” *Id.* at 842.

56. *Id.* (“[T]he timing by those who knew of it of their stock purchases and their purchases of *short-term* calls—purchases in some cases by individuals who had never before purchased calls or even TGS stock—virtually compels the inference that the [information was material] . . .” (emphasis added)).

57. *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988).

58. BAINBRIDGE, INSIDER TRADING LAW, *supra* note 6, at 68.

59. *See Heminway, A Call for Action*, *supra* note 6, at 1140 (noting the SEC “purposefully has left ambiguous the effect of applying the existing materiality standard to any specific factual situation”); *see also* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716,

This might lead one to conclude that ambiguity in the test for materiality leaves corporate employees charged with insider trading little alternative but to defend by claiming that the information they traded upon was *public* at the time of trading. But the test for whether information is public is no clearer than the standard for materiality.

B. When Is Information Nonpublic?

In his dissenting opinion in *Dirks v. SEC*,⁶⁰ Justice Blackmun expressed frustration that

the SEC seemingly has been less than helpful in its view of the nature of disclosure necessary to satisfy the disclose-or-refrain duty. The [SEC] tells persons with inside information that they cannot trade on that information unless they disclose; it refuses, however, to tell them how to disclose.⁶¹

Blackmun added, “This seems to be a less than sensible policy, which it is incumbent on the [SEC] to correct.”⁶² Despite this admonition, the SEC has yet to issue a rule on proper disclosure (i.e., on when information will be deemed public for purposes of insider trading liability).⁶³ And this is a problem, for, as one commentator puts it, “While on its face the concept might seem simplistic, the dividing line between public and nonpublic information is porous.”⁶⁴

In the absence of a statute or rule defining when information becomes public, the SEC and the courts have applied two tests: the “dissemination and absorption” test and the “efficient market” test.

Under the dissemination and absorption test, to become public, information must first be “disseminated in a manner calculated to reach the securities marketplace in general through recognized channels of distribution.”⁶⁵ Courts

51,721 (Aug. 24, 2000) [hereinafter August 24, 2000 Selective Disclosure and Insider Trading Release] (acknowledging that “materiality judgments can be difficult,” but that the SEC does not “believe an appropriate answer to this difficulty is to set forth a bright-line test”); John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41, 42 (1998) (pointing out that the SEC has “stubbornly refused to promulgate rules designed to fill in the details of a broadly stated qualitative standard of materiality”).

60. 463 U.S. 646 (1983).

61. *Dirks*, 463 U.S. at 678 (Blackmun, J., dissenting).

62. *Id.*

63. WANG & STEINBERG, *supra* note 2, at 145 (noting that the SEC has not issued a rule on proper disclosure and has preferred to adopt a case-by-case, fact-based approach). Even Regulation Fair Disclosure (Regulation FD) (adopted in 2000) does not define “nonpublic.” 17 C.F.R. §§ 243.100–243.103 (2016). The SEC does, however, offer some guidance: “In order to effect a meaningful public disclosure of corporate information, it must be disseminated in a manner calculated to reach the securities marketplace in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information.” Faberge, Inc., Exchange Act Release No. 10,174, 1973 WL 149283, at *6 (May 25, 1973).

64. Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J.L. & BUS. 151, 170 (2011).

65. WANG & STEINBERG, *supra* note 2, at 147 (quoting Faberge, Inc., Exchange Act Release No. 10,174, 1973 WL 149283, at *6 (May 25, 1973)).

have understood the requirement that the disclosure be “general” to mean that it must not favor “any special person or group.”⁶⁶ So, for example, courts have found appearances on the Dow Jones broad tape⁶⁷ or on the Reuters Financial Report wire service⁶⁸ to be sufficient dissemination. But dissemination over less recognized wire systems (e.g., AutEx) has been found insufficient because it reached only a limited number of subscribers.⁶⁹ Dissemination is, however, only half the test. The information must also be “*absorbed* by the investing public,” and absorption is not necessarily simultaneous with dissemination.⁷⁰ As the court explained in *Texas Gulf Sulphur*, “Where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination.”⁷¹ Just when information is translatable into investment action is unclear, and opinions vary widely on this point.⁷² Some have suggested that absorption occurs as little as fifteen minutes after information hits the wire.⁷³ In *SEC v. Ingoldsby*,⁷⁴ however, the court held that information of a change in leadership remained nonpublic nine days after a press release and eight days after it was highlighted in a *Wall Street Journal* article because the issuer was small and the information had not been fully digested by the *relevant* investing public.⁷⁵

The omnipresence of the Internet has made the question of dissemination and absorption of information still more unpredictable and inscrutable.⁷⁶ Companies can now “functionally” disseminate information without filing it with the SEC or releasing it to a public news source (e.g., by posting it on Twitter,

66. *Dirks*, 463 U.S. at 653 n.12 (quoting *Faberge, Inc.*, 1973 WL 149283, at *6).

67. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 854 (2d Cir. 1968) (noting that information remains nonpublic “until [it] could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape”).

68. *See, e.g., duPont Glove Forgan, Inc. v. Arnold Bernhard & Co.*, 73 Civ. 3071, 1978 WL 1062, at *7 (S.D.N.Y. Feb. 27, 1978).

69. *See, e.g., Faberge, Inc.*, 1973 WL 149283, at *6.

70. *WANG & STEINBERG, supra* note 2, at 145.

71. *Texas Gulf Sulphur*, 401 F.2d at 854 n.18.

72. *E.g., Robert A. Prentice, The Internet and Its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J.L. & TECH. 263, 275–76 (1999) (noting that “there is no clear rule regarding what period of time constitutes a reasonable period for absorption. . . . [and] [r]esults . . . have varied widely” based on the issuer and the nature and complexity of the information).

73. *See Billard v. Rockwell Int’l Corp.*, 526 F. Supp. 218, 220 (S.D.N.Y. 1981) (quoting 2 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 7.4(7)(B) (1967)).

74. CIV. A. No. 88–1001–MA, 1990 WL 120731 (D. Mass. May 15, 1990).

75. *Ingoldsby*, 1990 WL 120731, at *5.

76. *See Bondi & Lofchie, supra* note 64, at 170 (“Due to the prevalence of online message boards, social networking, and blogs, information and rumors about companies can spread quickly to millions of interconnected investors. In some cases those rumors are leaked by company insiders. The growth of so-called watchdog groups, such as Wikileaks, have generated a new level of uncertainty as to what information is considered ‘nonpublic.’”); *see also WANG & STEINBERG, supra* note 2, at 146 (“The development of the Internet has made it more difficult to determine when information is public.”).

Facebook, mass email, posting on the company website, etc.).⁷⁷ But there is no guarantee that such functional dissemination will be recognized as legally sufficient by the SEC.⁷⁸ At the end of the day, issuers are left guessing as they navigate these “murky waters.”⁷⁹

Vagueness in the SEC’s preferred dissemination and absorption test⁸⁰ has led some courts to adopt an alternative method, based on the “efficient capital market hypothesis” (ECMH), for determining when information is public for the purposes of section 10(b) insider trading liability.⁸¹ The ECMH comes in “weak,” “semi-strong,” and “strong formulations.”⁸² The semi-strong formulation is the most widely accepted; it “posits that at any given time, share prices in an efficient market will incorporate all publicly available information relating to publicly traded companies (in addition to general information about the economy as a whole).”⁸³ Under the efficient market approach, information is considered public when it is “impounded in [the] price” of the stock by traders in the active investment community, regardless of whether the issuer has disclosed the information by public announcement or SEC filing.⁸⁴ After all, once impounded in the price the information cannot be misused by the trader.⁸⁵ So, under the ECMH approach, information may be “public” for purposes of insider trading liability even though the general investing public may have no access to it.⁸⁶

The ECMH approach, however, generates problems of its own. It may be possible for an expert witness and jury to look at a stock’s price charts months or

77. Prentice, *supra* note 72, at 279.

78. See, e.g., August 24, 2000 Selective Disclosure and Insider Trading Release, *supra* note 59, at 51,724. (noting that posting on a corporate website is not sufficient for “public disclosure” under Regulation FD); WANG & STEINBERG, *supra* note 2, at 146–47 (suggesting that certain methods of disseminating information on the Internet may not satisfy the dissemination and absorption approach); Prentice, *supra* note 72, at 279–93 (discussing available technology for the release of information that the SEC has not yet provided guidance on).

79. Prentice, *supra* note 72, at 279.

80. Bondi & Lofchie, *supra* note 64, at 171–72 (the SEC has “clung” to the dissemination and absorption theory).

81. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555–65 (1984) (providing an excellent summary of the ECMH).

82. See generally Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (providing the first modern articulation of the efficient capital market hypothesis and its division into weak, semi-strong, and strong forms). See also Gilson & Kraakman, *supra* note 81, at 555 (recognizing Fama’s article as the first to divide efficient market theory into weak, semi-strong, and strong forms).

83. Prentice, *supra* note 72, at 277.

84. See, e.g., *United States v. Libera*, 989 F.2d 596, 601 (2d Cir. 1993) (“We agree that information may be considered public for Section 10(b) purposes even though there has been no public announcement and only a small number of people know of it. The issue is not the number of people who possess it but whether their trading has caused the information to be fully impounded into the price of the particular stock. Once the information is fully impounded in price, such information can no longer be misused by trading because no further profit can be made.”).

85. *Id.*

86. *Id.*

years later and determine whether information was impounded,⁸⁷ but it is far more difficult for traders to make this determination at the moment of trading. After all, how can one know in advance of one's trade whether a sufficient number of traders in the active investment community are aware of the relevant information? One cannot simply monitor price movement. No movement in stock price could reflect prior impoundment, a lack of dissemination, or the introduction of offsetting collateral information. Some price movement may reflect only partial impoundment,⁸⁸ or it may reflect the impact of collateral information. There is simply no way to be certain *ex ante*.

In sum, the SEC and the courts have set a demanding threshold for publicity (dissemination and absorption, or impoundment). Absent explicit conditions of satisfaction it is often impossible for traders to know whether the threshold has been crossed at the time of trading.⁸⁹ But, at the end of the day, just how worrisome should ambiguity in the elements of materiality and publicity be, given that section 10(b) insider trading liability is a form of common law fraud requiring scienter?⁹⁰ Shouldn't an insider at least be able to trade with confidence so long as she is not trading firm shares strategically (i.e., on the basis of material nonpublic information), but rather to diversify or to gain access to cash? The SEC and the courts give different answers to this question.

C. When Does One Trade "On the Basis of" Information?

Section 10(b) imposes liability only on insiders who trade in their own company's shares "on the basis of material nonpublic information."⁹¹ But there are almost always a myriad of nonstrategic reasons that could explain any given insider trade. Such explanations are easy to manufacture but difficult to disprove. Historically, the SEC addressed this challenge of proof by taking the position that the element of scienter in Rule 10b-5 could be satisfied by proving the insider's *knowing possession* of material nonpublic information, even if it could not be demonstrated that the possession of this information *caused* the trading.⁹² This strategy, however, met resistance in the courts. In 1998, the Second Circuit rejected the SEC's proposed knowing possession standard for civil insider trading liability in *SEC v. Adler*.⁹³ The *Adler* court held that the element of scienter for insider trading liability under section 10(b) and Rule 10b-5 requires proof that the insider "used" or "[took] advantage of" material nonpublic information.⁹⁴ Then, later that same year, the Ninth Circuit expressly

87. *E.g., id.*

88. *E.g., id.* (noting that though the stock price began to move at the time of trading, it was not yet fully impounded).

89. See Prentice, *supra* note 72, at 270 (contending that the publicity test is "demanding, yet vague").

90. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976).

91. *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1996).

92. See BAINBRIDGE, *SECURITIES LAW*, *supra* note 1, at 92-93.

93. 137 F.3d 1325 (11th Cir. 1998).

94. *Adler*, 137 F.3d at 1333-37.

rejected the knowing possession standard for criminal insider trading liability in *United States v. Smith*.⁹⁵ Sensing that the circuits were trending against its favored possession test,⁹⁶ the SEC adopted Rule 10b5-1 in October 2000.⁹⁷

Under 10b5-1(b), the SEC defines trading “on the basis of” inside information as trading while “aware” of material nonpublic information.⁹⁸ Though the SEC did not expressly define the scienter element of 10b-5 liability in terms of “knowing possession,” the release suggests that awareness means the same thing, explaining that “the goals of insider trading prohibitions . . . are best accomplished by a standard closer to the ‘knowing possession’ standard.”⁹⁹ The SEC claims its adoption of 10b5-1(b) has not diminished the element of scienter required for insider trading liability under section 10(b) and Rule 10b-5.¹⁰⁰ But a number of commentators have suggested that the rule change draws insider trading closer to being a strict liability offense¹⁰¹ and question the SEC’s authority for the change, particularly in the criminal context.¹⁰² Thus, with the SEC and federal courts potentially at odds over the proper definition of “on the basis of” as it relates to the mental element of insider trading liability, traders are forced to take sides. And when the mere awareness test under Rule 10b5-1(b) is combined with vagueness in the definitions of materiality and publicity, a conservative insider may decline to trade altogether.¹⁰³ For, as demonstrated above, corporate insiders will almost never enjoy complete confidence that they are not “aware” of *some* information that could be deemed material and nonpublic in hindsight. Though the federal courts may be ready to vindicate an insider who did not *use* inside information *strategically*, few are ready to trade

95. 155 F.3d 1051, 1066–69 (9th Cir. 1998).

96. See August 24, 2000 Selective Disclosure and Insider Trading Release, *supra* note 59, at 51,727; John P. Anderson, *Anticipating a Sea Change for Insider Trading Law: From Trading Plan Crisis to Rational Reform*, 2015 UTAH L. REV. 339, 349 [hereinafter Anderson, *A Sea Change*] (describing the SEC’s proposal of 10b5-1 as a way to avoid “further erosion” of section 10(b) and Rule 10b-5 by the courts).

97. 17 C.F.R. § 240.10b5-1 (2016).

98. *Id.* § 240.10b5-1(b).

99. August 24, 2000 Selective Disclosure and Insider Trading Release, *supra* note 59, at 51,727.

100. Selective Disclosure and Insider Trading, Exchange Act Release No. 7881, 73 SEC Docket 3, 2000 WL 1201556, at *22 (Aug. 15, 2000) (“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.”).

101. *E.g.*, Anderson, *A Sea Change*, *supra* note 96, at 375; Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913, 921–22 (2007); Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 196–99 (2003); Kevin E. Warner, Note, *Rethinking Trades “on the Basis of” Inside Information: Some Interpretations of SEC Rule 10b5-1*, 83 B.U. L. REV. 281, 306 (2003).

102. *E.g.*, BAINBRIDGE, SECURITIES LAW, *supra* note 1, at 93 (“The bulk of the evidence . . . raises serious doubts as to the validity of Rule 10b5-1.”); Horwich, *supra* note 101, at 944–49.

103. This is not entirely true. Rule 10b5-1(c) provides an affirmative defense for insiders who trade within a plan that is qualified under the rule. It is argued below, however, that recent SEC staff interpretations of 10b5-1(c) should undermine traders’ confidence in the effectiveness of these trading plans as a safe harbor from civil and criminal liability. See *infra* Section V for an explanation of this argument.

and then litigate the statutory authority for 10b5-1(b) to test the theory.

III. CHALLENGES AND COSTS OF INSIDER TRADING COMPLIANCE

This Article has demonstrated that to avoid treble damages under ITSFEA and criminal liability under section 10(b) and Rule 10b-5, firms must implement strong compliance policies designed to prevent insider trading. But it has also shown that in the absence of any clear legal definition of insider trading, vagueness, uncertainty, and controversy surround the question of precisely what conduct is proscribed by the law. This state of affairs places issuers in an awkward position. If they do not implement effective compliance programs, they risk serious civil, criminal, and reputational sanctions should one or more of their employees be found guilty of insider trading. But how can issuers implement policies to reliably prevent conduct that is not defined with any specificity?

There are a number of insider trading control mechanisms employed by issuers; they include (1) a published ban on any trading in an issuer's shares based on material nonpublic information (i.e., self-policing),¹⁰⁴ (2) requiring preclearance for trading,¹⁰⁵ and (3) the imposition of "blackout periods."¹⁰⁶ Predictably, ambiguities in the law of insider trading create significant challenges to designing and implementing each of these control mechanisms, and answering these challenges translates directly into significant costs to firms.

A. *Cannot Rely on Self-Policing*

Ambiguity in the law of insider trading presents serious challenges for issuers in articulating and implementing effective self-policing plans. At a minimum, self-policing requires educating employees by offering an everyday language definition of the proscribed conduct.¹⁰⁷ Once employees are educated, the policy must then set out the nature of the controls that will be in place to identify noncompliance and incentivize compliance.¹⁰⁸ The obstacles to designing and implementing such a policy for insider trading should by now be obvious.

Again, it is generally understood that issuers' employees violate the law against insider trading when they seek to benefit by trading (or tipping) on the basis of material nonpublic information in violation of some "fiduciary or other similar relation of trust and confidence."¹⁰⁹ But simply parroting these words in a written compliance policy is unhelpful without also offering definitions of its key elements. But, as has been explained, crucial elements of this definition (e.g.,

104. See Chasin, *supra* note 18, at 861–62.

105. See BAINBRIDGE, *INSIDER TRADING LAW*, *supra* note 46, at 157; Chasin, *supra* note 18, at 863.

106. See BAINBRIDGE, *INSIDER TRADING LAW*, *supra* note 46, at 154–56; Chasin, *supra* note 18, at 862.

107. WANG & STEINBERG, *supra* note 2, at 827.

108. *Id.* at 825.

109. *Chiarella v. United States*, 445 U.S. 222, 228 (1979) (quoting RESTATEMENT (SECOND) OF TORTS, *supra* note 26, § 551(2)(a)).

materiality, publicity, and mental state) remain uncertain.¹¹⁰ Thus, giving expression to these terms with sufficient specificity to guide conduct pursuant to a written self-policing policy forces issuers to take sides in ongoing scholarly debates, splits among circuits, and conflicting direction from the SEC and the courts. In doing so, issuers are forced to guess, and risk guessing wrong.

Consequently, issuers who rely exclusively on self-policing policies have three options, and none of them are good. First, an issuer can adopt a written policy that bans employees from trading in its shares based on material nonpublic information without defining the key terms. But this defeats the goals of effective compliance (i.e., preventing violations while insulating the firm from liability when violations occur) by leaving employees without a clear sense of what conduct is proscribed. Second, an issuer can adopt a written ban on insider trading that actually defines key terms such as “material,” “nonpublic,” and “based on” in everyday language that can educate and guide the conduct of its employees. But this strategy risks contradiction by the ex post interpretations of regulators or the courts. Third, an issuer can adopt a “play-it-safe” approach by banning all (or nearly all) trading in firm shares by employees. But this tactic is highly inefficient (precluding vast numbers of perfectly legal trades) and would virtually eliminate equity as a form of employee compensation.¹¹¹ Thus, an insider trading compliance policy that relies exclusively on self-policing would either be vague and therefore unhelpful, well defined and therefore risky, or blanket and therefore highly inefficient. The result is that, in practice, issuers tend to adopt written policies that proscribe insider trading without defining it with specificity,¹¹² but they then supplement this written ban with other control mechanisms, such as preclearance for trading and blackout periods.¹¹³ Supplementing self-policing with these control mechanisms does not resolve the problem of insider trading compliance in the face of legal ambiguity.

B. Challenges and Costs of Uncertainty for Preclearance

Given the uncertainties and risks associated with reliance on self-policing, many commentators recommend that issuers adopt preclearance procedures for employee trades.¹¹⁴ But preclearance is not without its own challenges. The same

110. What counts as a fiduciary duty or duty of trust and confidence is also ambiguous, but this is less of a concern for issuers because (right or wrong) the Supreme Court has made it clear that it recognizes the issuer and its employees as owing a fiduciary duty to shareholders.

111. Firms that adopt such play-it-safe insider trading compliance policies could still use stock and stock options as a form of compensation, but the value of the compensation would be diminished significantly by the fact that employees could not liquidate their shares or exercise their options until after leaving the firm. This would also create a perverse incentive for employees to leave the firm to diversify their portfolio—or to leave whenever the stock is performing well.

112. See Alan J. Berkeley, *Form of Summary Memorandum and Sample Corporate Policy on Insider Trading*, 29 A.L.I.-A.B.A. BUS. L. COURSE MATERIALS J. 49, 58–60 (2005) (offering a general definition of insider trading along with the suggestion that, when in doubt about whether information is “material” or “nonpublic,” employees should “assume that the information is”).

113. See BAINBRIDGE, *INSIDER TRADING LAW*, *supra* note 46, at 154–57.

114. *E.g., id.* at 157; Berkeley, *supra* note 112, at 461–62.

ambiguities in the law that preclude effective self-policing will hinder compliance officers in making appropriate preclearance decisions. The problem of ambiguity in the law is then compounded by compliance officers' limited access to facts regarding employees' knowledge and motives for trading. Compliance officers are therefore required to exercise a great deal of discretion in preclearing insider trades and, given the incentives, this often leads to inefficient results. Consider the following scenario.

Imagine the chief financial officer (CFO) of ABC Corp. requests preclearance for the sale of 10,000 shares of ABC stock pursuant to the company's compliance plan. The CFO explains that he wants to sell because he needs cash to cover the down payment and closing costs for the purchase of a new home. Six months prior, ABC Corp. publicly announced that its president would be retiring and that a successor would be named soon. Two days prior to the CFO's preclearance request, ABC Corp. posted a press release on its website announcing that ABC's senior vice president of marketing would be the new president. The news was picked up and noted by the *Wall Street Journal* that same day. For years, it had been assumed by analysts that this senior vice president would be the president's successor. Indeed, a number of analysts had already issued reports operating under the assumption that this senior vice president would get the nod. These analyst reports agreed that, given the senior vice president's similar background and management style, the change would not affect ABC's operations. The stock price has remained steady since the press release was posted.

Before clearing the CFO's trade, the compliance officer must determine whether it is based on material nonpublic information. Is news of the new president's identity "public"? As explained above, the compliance officer gets little or no help from the statutes and rules in answering this question. Applying the dissemination and absorption test, the compliance officer must consider whether news of the leadership change has been disseminated through recognized sources in a manner calculated to reach the general market.¹¹⁵ Indications from the SEC suggest that ABC posting the release on the company's website alone would not be sufficient.¹¹⁶ Still, publication in the *Wall Street Journal* is likely to be regarded as a recognized source of distribution with general reach.¹¹⁷ But dissemination is only half the test; the compliance officer must also determine whether the information has been absorbed (i.e., whether it is "readily translatable into investment action") by the investing public.¹¹⁸ The answer is not obvious here. As noted above, the *Ingoldsby* court held that information concerning a change in leadership had not been sufficiently absorbed a full nine days after it was highlighted in the *Wall Street Journal*

115. See WANG & STEINBERG, *supra* note 2, at 145.

116. See *id.* at 148.

117. This conclusion is not certain. As noted above, regulators have found publication through some subscriber-based news or wire services to be insufficient. See, e.g., Faberge, Inc., Exchange Act Release No. 10174, 1973 WL 149283, at *6 (May 25, 1973).

118. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 n.18 (2d Cir. 1968).

because it had not been fully digested by the relevant investing public.¹¹⁹ Applying the efficient market approach (i.e., trying to determine whether the information has been impounded in the price of the stock)¹²⁰ will not help the compliance officer here either. In this case it is impossible for the compliance officer to know *ex ante* whether the information has reached a sufficient number of traders in the active investment community for ABC shares. It is no help for the compliance officer to look to the share price to determine whether the information has been impounded because it has remained static. This could reflect either that (1) the information has reached the active investment community and was not deemed material (as prior analyst reports would suggest), (2) it has not yet reached the active investment community (as in *Ingoldsby*), or (3) its effect has been offset by other information. In the midst of such uncertainty, and in light of the significant risks of guessing wrong, a prudent compliance officer would likely act under the assumption that the information is nonpublic.¹²¹ But there remains the question of materiality.

Is news of the new president's identity material? On the one hand, in light of the surrounding circumstances and related analyst buzz, the compliance officer might conclude that the new president's identity would not be considered important by the reasonable investor, or as altering the "total mix" of information available, because the market had long assumed this was ABC's succession plan. On the other hand, the compliance officer might worry that any change in leadership is *per se* important to investors. Indeed, Regulation Fair Disclosure (Regulation FD) explicitly identifies "changes in control or in management" as information that may be material.¹²² In making the materiality determination, courts will sometimes look to the market's reaction upon disclosure.¹²³ Here, the compliance officer might look at the static price and conclude that information regarding the change in leadership is not material. But while price movement is a factor, courts have held it is not dispositive,¹²⁴ and, as noted above, here there may be the concern that two days has not provided enough time for the market to absorb the information.

Moreover, the preclearance decision cannot focus exclusively on facts of which the compliance office is aware. Given the CFO's position, he may know of future earnings or other financial information not available to the compliance

119. SEC v. *Ingoldsby*, CIV. A. No. 88-1001-MA, 1990 WL 120731, at *5 (D. Mass. May 15, 1990).

120. See, e.g., *United States v. Libera*, 989 F.2d 596, 601 (2d Cir. 1993). See *supra* notes 81-86 and accompanying text for a discussion of the efficient market approach.

121. See *Berkeley*, *supra* note 112, at 60 ("[W]hen in doubt about whether information is non-public . . . assume that the information is 'non-public' . . .").

122. See August 24, 2000 Selective Disclosure and Insider Trading Release, *supra* note 59, at 51,721.

123. See, e.g., *SEC v. Tome*, 638 F. Supp. 596, 623 (S.D.N.Y. 1986) (finding that a jump in price from thirty dollars per share to forty-five dollars per share immediately upon public announcement of a tender offer was an indication of materiality).

124. See, e.g., *United States v. Bilzerian*, 926 F.2d 1285, 1298 (2d Cir. 1991) (stating that a price change—or lack thereof—is not dispositive of materiality).

officer but that may nevertheless be material. The compliance officer will ask the CFO if he is aware of any such information, but he can never be certain that the CFO has provided an honest answer.

To complicate matters further, the CFO *may not know* whether he is aware of material nonpublic information. He is no doubt privy to a great deal of soft information about which he has formed opinions concerning the future performance of the company, but he may not know whether such information is sufficiently crystallized or important to count as material. As explained above, even if the CFO is completely forthright with the compliance officer by sharing all of the soft information that he possesses, the *Basic* probability-magnitude test will likely be useless to the compliance officer in making a decision *ex ante*. For example, the CFO may have learned that there is a five percent chance that one of ABC's leading products may have to be recalled. The magnitude is great, but the probability is low. The *Basic* test provides no threshold for determining when the product of probability and magnitude equals materiality, so the compliance officer must guess. And, in guessing, the compliance officer recognizes that, should the recall actually occur, a future jury will judge his decision with the benefit of hindsight.¹²⁵ Even more concerning, the compliance officer must consider the fact that, under *Texas Gulf Sulphur* and *Basic*, jurors may take the mere fact that the CFO traded while in possession of this soft information as itself "an indication of materiality."¹²⁶

Thus, as one commentator puts it, given the subtlety of the question, and the limited information available to the compliance officer, "it may be almost impossible for [a compliance] officer to make [a materiality] determination empirically."¹²⁷ When in doubt, a prudent compliance officer will err on the side of finding the information material.¹²⁸

But trading by an insider is illegal only if it is done "on the basis of" material nonpublic information, and our CFO has represented that he is trading only because he needs cash to close on his new house. If our compliance officer applies Rule 10b5-1(b), however, she must ignore the CFO's stated purpose for the sale of ABC shares and focus strictly on the question of whether he is currently "aware" of any material nonpublic information. But, again, this places the compliance officer in a difficult position. As noted above, it will be very difficult for the compliance officer to determine whether the CFO is "aware" of any material nonpublic information—either because the CFO may be untruthful or because, without clear regulatory guidance, neither he nor the compliance officer may be able to answer this question with any certainty. Thus, the prudent default is to assume awareness of material nonpublic information and deny clearance for the trade. As noted above, there are good reasons for concluding

125. See BAINBRIDGE, *INSIDER TRADING LAW*, *supra* note 46, at 67.

126. *Basic, Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988) (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851 (1968)).

127. Chasin, *supra* note 18, at 868.

128. See Berkeley, *supra* note 112, at 60 ("When in doubt about whether particular non-public information is material, exercise caution.").

that the SEC exceeded its authority in adopting the mere awareness standard under Rule 10b5-1, but, of course, the compliance officer would not put the firm or her employment at risk to challenge the rule.

Thus, with potential firm liability and the compliance officer's own employment on the line, she will have every incentive to play it safe and refuse preclearance for trades in the face of such uncertainty. This conservative approach, however, leads to a number of adverse consequences for the firm and its shareholders.

First, the CFO may bear ill will toward the compliance officer. Since the CFO told the compliance officer that he is not aware of any material nonpublic information and wishes to trade only to close on his house, then, when the trade is not approved, the CFO may assume the compliance officer determined that he was untruthful. Such ill will can undermine the spirit of cooperation and mutual respect that is so important to a strong compliance culture and a strong firm. To avoid this potential for in-house conflict, the firm may choose to shift preclearance decisions to outside counsel, but this comes at a significant cost to the firm and therefore the shareholders.¹²⁹ At a minimum, such difficult compliance decisions are likely to be a distraction for management, which also affects share value.¹³⁰

Second, corporate insiders typically receive a large portion of their compensation in firm shares.¹³¹ Equity compensation holds value for insiders only if it can be liquidated without much difficulty.¹³² Thus, any restrictions the company places on its employees' ability to monetize firm shares will devalue them as compensation, requiring the company to offer more shares to achieve the same remunerative effect in the future.¹³³ In the example above, the compliance officer's denial of preclearance devalued ABC shares to the CFO. This costs ABC (and therefore its shareholders) because the CFO is now more likely to demand a comparative increase in ABC shares (or cash) in his next negotiation of compensation.¹³⁴

129. Heminway, *A Call for Action*, *supra* note 6, at 1180–82 (noting that the costs to a firm and its shareholders in turning to outside counsel to make compliance decisions are increased by ambiguity in the law).

130. *Id.* at 1177–80 (noting that vagueness in insider trading law distracts management from focusing on business and operations, which negatively impacts stockholder value).

131. M. Todd Henderson, *Insider Trading and CEO Pay*, 64 VAND. L. REV. 505, 508 (2011) (reporting that between 1999 and 2008, “the average public company executive earned more than half her total pay in the form of stock options or restricted stock”).

132. *See id.* at 509 (noting that restrictions on the ability to liquidate shares “reduce the value of the shares granted”); *see also* Karl T. Muth, *With Avarice Aforethought: Insider Trading and 10b5-1 Plans*, 10 U.C. DAVIS BUS. L.J. 65, 67 (2009) (“To enjoy the proceeds of selling stock issued as compensation, the executive must be able to liquidate stock while in possession of inside information.”).

133. *See* Anderson, *A Sea Change*, *supra* note 96, at 375; Henderson, *supra* note 131, at 509–10 (noting that when the insiders cannot trade without restrictions, the value of the shares is reduced, which causes an “increase [in] the amount of shares necessary to achieve the same incentive effects”).

134. *See* Heminway, *A Call for Action*, *supra* note 6, at 1174–77 (contending that vagueness in the law leads to delayed or foregone transactions).

Third, in part because equity has become a leading component of corporate compensation packages,¹³⁵ insider ownership typically accounts for a large proportion of a given issuer's outstanding shares. As Professor Jesse Fried points out, "Although U.S. firms are commonly thought to have relatively diffuse ownership, average insider ownership in publicly-traded firms is . . . surprisingly high."¹³⁶ Professor Fried cites to one study suggesting that directors and officers own an average of twenty-four to thirty-two percent of a given firm's equity.¹³⁷ This figure excludes insiders' stock options, "which would further increase their effective equity ownership."¹³⁸ With so many shares in the hands of insiders, it stands to reason that significant restrictions on their trading would decrease liquidity in a firm's shares. This, in turn, increases a firm's cost of capital.¹³⁹

Finally, in addition to risking ill will and increasing the costs of compensation and capital, too conservative a position on preclearance may expose a company to liability for breach of good faith and fair dealing in its negotiation of employment agreements. No federal law expressly empowers issuers to restrict trading activity by insiders.¹⁴⁰ Consequently, issuers typically bargain for these restraints in employment contracts, which include trading policies.¹⁴¹ But, unless an issuer details the precise parameters of insider trading restrictions in advance (say, in the compliance policy), an insider-employee can challenge a compliance officer's conservative preclearance strategy as devaluing his shares in a way not contemplated by the parties *ex ante*.¹⁴²

Of course, a compliance officer could avoid these costs by adopting a liberal approach to preclearance, but, in light of the ambiguities in the law outlined above, she would thereby risk exposing the company to civil and criminal insider trading liability. There appear to be no good options for an effective preclearance strategy under the current insider trading regime.

C. Challenges and Costs of Uncertainty for Blackout Periods

Another insider trading compliance strategy for issuers is the implementation of "blackout periods" in lieu of (or in addition to) a preclearance program.¹⁴³ A blackout period is a date range within which issuers preclude their officers and directors from trading in a corporation's shares.¹⁴⁴ A

135. Henderson, *supra* note 131, at 508.

136. Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PA. L. REV. 801, 804 (2014).

137. *Id.*; see also Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1382–83 (2009) (summarizing findings from multiple studies on director and officer corporate ownership).

138. Fried, *supra* note 136, at 804 n.11.

139. See Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 J. FIN. ECON. 223, 249 (1986) (explaining that the greater the liquidity of a security, the lower the expected return required by investors, which decreases the firm's cost of capital).

140. Chasin, *supra* note 18, at 861.

141. *Id.* at 861–62 (describing the insider-employee bargaining process).

142. See *id.* at 865.

143. WANG & STEINBERG, *supra* note 2, at 897.

144. *Id.*

“trading window” is a period during which relevant employees are permitted to trade (i.e., it is the flipside of the coin to a blackout period).¹⁴⁵ The duration of blackout periods will vary from issuer to issuer, and they are not always fixed. For example, many issuers impose regular blackout periods around the quarterly disclosure process (e.g., beginning three or four weeks prior to scheduled disclosure and ending forty-eight hours after filing).¹⁴⁶ It is assumed that such blackout periods will cover the time period during which officers and directors are most likely to have access to material nonpublic information. As one commentator puts it, “[B]ecause of the substantial and wide-ranging disclosures required in these reports . . . there is a relatively low probability that an insider who trades during the time immediately following their dissemination will be deemed to have traded on material nonpublic information.”¹⁴⁷ But firms do not always limit blackout periods to disclosure seasons; they will often close an otherwise open trading window if new material information arises (e.g., of a proposed merger or acquisition) that is not yet ripe for disclosure.¹⁴⁸

The SEC has not prescribed set blackout periods or trading windows,¹⁴⁹ so they are typically set by issuers on the advice of counsel or at the discretion of compliance officers.¹⁵⁰ In the midst of the legal ambiguity in the law of insider trading detailed above, however, the exercise of discretion in setting trading windows and blackout periods creates many of the same problems and runs many of the same risks as preclearance.

Again, in addition to regular blackout periods around quarterly filings, compliance officers will close otherwise open trading windows when employees become aware of material nonpublic information concerning a company.¹⁵¹ But, as one commentator notes, “[a]n issuer always has undisclosed information about numerous different aspects of its business,” and “[b]y the time all of that information has been disseminated publicly . . . new undisclosed information doubtless will have been developed.”¹⁵² So, just as with the preclearance decision, there will never be a time when compliance officers can be certain insiders do not possess material nonpublic information. This is particularly true in light of ambiguity in the law and the reality that their ex ante materiality and publicity determinations will be judged by regulators, prosecutors, and jurors ex post, and with the benefit of hindsight.

This leaves compliance officers or corporate counsel making blackout period decisions with the same bad choices they faced under the preclearance program. They can adopt a conservative strategy and extend blackout periods to

145. Robert A. Barron, *Some Comments on the Pre-Clearance Procedure*, 37 SEC. REG. L.J. 383, 387–88 (2009) (using the coin analogy).

146. *E.g., id.* at 383.

147. BAINBRIDGE, *INSIDER TRADING LAW*, *supra* note 46, at 155.

148. *Id.*

149. Barron, *supra* note 145, at 387.

150. *See id.*

151. *See, e.g.,* Chasin, *supra* note 18, at 863.

152. BAINBRIDGE, *INSIDER TRADING LAW*, *supra* note 46, at 154.

all but a few small trading windows immediately following quarterly filings. But such a restrictive blackout policy will decrease the value of shares issued by a firm as compensation to employees by limiting their liquidity.¹⁵³ Again, this means firms will have to issue more shares to achieve the same remunerative effect, at great cost to their existing shareholders.¹⁵⁴ In addition, as with preclearance, implementing so conservative a policy might affect a firm's cost of capital (by decreasing liquidity),¹⁵⁵ and it may expose the company to liability for breaching its contractual duties of good faith and fair dealing owed to its employees.¹⁵⁶ Finally, implementing extended blackout windows will force insiders to make large trades in short, periodic spurts, which will have an unnatural impact on the price and trading volume of those shares.¹⁵⁷ Such concentrated trading may attract unwarranted (and therefore misleading) market attention.¹⁵⁸

The alternative for firms, however, is no better. By adopting a more liberal approach and limiting the imposition of blackout periods to only rare circumstances in which there is widespread knowledge of market-moving, material nonpublic information (say, in the midst of merger or tender offer negotiations), a compliance officer risks exposing a company to significant liability.¹⁵⁹

Ultimately, as with self-policing and preclearance, ambiguity in the law of insider trading leaves a conscientious compliance officer with few good options in designing and implementing an effective trading window policy.

IV. THE PARADOX

To take stock, vagueness in the law translates into uncertainty for issuers in the design and implementation of their insider trading compliance programs. This uncertainty, when combined with the threat of significant reputational and economic sanctions for "ineffective" compliance programs, typically leads firms to adopt a "play-it-safe" approach. Issuers design and implement compliance regimes that are marked by highly restrictive preclearance decision making and extended blackout periods.

But stingy preclearance and lengthy blackout periods come at a heavy price

153. Anderson, *A Sea Change*, *supra* note 96, at 355 (stating restrictions on shares diminish their value); Henderson, *supra* note 131, at 509–10 (noting that insiders value the opportunity to trade without limitation).

154. Anderson, *A Sea Change*, *supra* note 96, at 375; Henderson, *supra* note 131, at 509.

155. See *supra* notes 131–34 and accompanying text for a discussion of the devaluing effect of restrictive policies.

156. See, e.g., Chasin, *supra* note 18, at 863.

157. See Peter J. Romeo & Alan L. Dye, *Insider Trading Under Rules 10b5-1 and 10b5-2*, in POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW, SH013 A.L.I.-A.B.A. 893, 901 (2002) ("Open market sales by [insiders] . . . often attract unwanted attention, due to the perception of many investors that such sales may reflect a lack of confidence in the company.").

158. *Id.*

159. See *supra* Section I for a discussion of the potential criminal and civil penalties for firms with weak or ineffective compliance programs.

to firms in terms of corporate culture, cost of compensation, share liquidity, cost of capital, and risk of contractual liability to employees. If an issuer is rational, the magnitude of such inefficiencies will be a direct function of the ambiguity in the law (which is great) and the severity of the sanctions for violation (which are stiff). This is the paradox of insider trading compliance for issuers: ambiguity in the law combined with the threat of stiff reputational and legal sanctions creates a perverse incentive to adopt compliance programs that are highly inefficient and ultimately costly to shareholders.¹⁶⁰ Thus, ironically, the very insider trading regulations that were implemented to increase value for shareholders appear to be having the opposite effect.

The SEC has not been blind to this paradox, and in 2000 it adopted Rule 10b5-1(c) in an attempt (albeit unsuccessfully) to address it.

V. 10b5-1(C) TRADING PLANS: JUST MORE UNCERTAINTY

Rule 10b5-1(c) provides, *inter alia*, that an affirmative defense to insider trading is available to those who trade company shares through a qualified trading plan (“Trading Plan” or “Plan”).¹⁶¹ To qualify, a Plan must be written¹⁶² and it must specify the amount, price, and date of the securities to be purchased or sold,¹⁶³ or it must include “a written formula or algorithm” that determines the Plan transactions.¹⁶⁴ A qualifying Plan must have been entered into while the insider was unaware of material nonpublic information, and the insider is not permitted to have any subsequent influence “over how, when, or whether to effect [Plan] purchases or sales.”¹⁶⁵ Finally, a Trading Plan provides an affirmative defense to insider trading liability only when it was “entered into in good faith.”¹⁶⁶

According to Linda Chatman Thomsen, former Director of the SEC Division of Enforcement, part of the rationale for adopting 10b5-1(c) Trading Plans was “to give executives opportunities to diversify or become more liquid through the use of plans with prearranged trades without facing the prospect of an insider trading investigation.”¹⁶⁷ In other words, the SEC implicitly admitted

160. See Heminway, *A Call for Action*, *supra* note 6, at 1174 (noting that lack of clarity creates additional transactional costs without a resulting benefit); Heminway, *Just Do It!*, *supra* note 6, at 1012 (arguing that “[v]agueness” in insider trading law may raise “economic efficiency concerns”).

161. 17 C.F.R. § 240.10b5-1(c)(1)(i)(A)(3) (2016).

162. *Id.*; see also Anderson, *A Sea Change*, *supra* note 96, at 351 n.9 (explaining how the written requirement differentiates this affirmative defense from others in the rule).

163. 17 C.F.R. § 240.10b5-1(c)(1)(i)(B)(1).

164. *Id.* § 240.10b5-1(c)(1)(i)(B)(2).

165. *Id.* § 240.10b5-1(c)(1)(i)(B)(3).

166. *Id.* § 240.10b5-1(c)(1)(ii).

167. Linda Chatman Thomsen, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Opening Remarks Before the 15th Annual NASPP Conference (Oct. 10, 2007), <https://www.sec.gov/news/speech/2007/spch101007lct.htm> [hereinafter Thomsen, NASPP Conference Remarks]; see also Henderson, *supra* note 131, at 516–17 (noting that regulators expect the Plans to increase opportunities for optimization trading and potentially decrease the value of informed trading).

what was argued above, that its preferred knowing possession test (now reflected in the strict awareness test under 10b5-1(b)) made it virtually impossible for insiders to trade without the risk of liability outside of these Plans.¹⁶⁸ As one commentator put it, “[p]rior to the adoption of [Trading Plans], the insider trading laws provided no means of assuring that a transaction in the company’s securities by an insider would escape liability under these laws,” which placed compliance officers in a serious “predicament.”¹⁶⁹ Once Trading Plans became available, firms immediately began availing themselves of them. Indeed, since the adoption of Rule 10b5-1(c) in 2000, the use of Trading Plans by corporate insiders has become pervasive, accounting for billions of dollars of trading each year.¹⁷⁰ Yet despite the SEC’s intentions, Trading Plans have not resolved the paradox of insider trading compliance for issuers.

To begin, 10b5-1(c)’s requirement that Trading Plans be entered into at a time when insiders are not aware of material nonpublic information leaves compliance officers in much the same position they were in prior to the adoption of the rule. Without the aid of clear statutory or regulatory guidance, they still must determine whether an insider is aware of material nonpublic information at the time the Plan is adopted. In other words, compliance officers’ “predicament” of authorizing insider trades in the face of legal and factual uncertainty¹⁷¹ is simply pushed back to the date of a Trading Plan’s adoption, rather than the date of a trade. To make matters worse, the regulatory scrutiny of this decision has increased exponentially in light of recent studies reflecting that insiders are using Trading Plans to beat the market.¹⁷²

In August 2005, the *Wall Street Journal* reported the initial results of a study by Professor Alan Jagolinzer reflecting that insiders using Trading Plans were beating the market on average by 5.6 percentage points.¹⁷³ Professor Jagolinzer’s subsequently published article explains that Trading Plan participants’ stock sales “tend to follow price increases and precede price declines.”¹⁷⁴ Moreover, the study shows that Trading Plan initiations (which usually include sell orders) “are associated with subsequent adverse news disclosure and that early [Trading

168. As one commentator put it, “[I]f executives [did] not have access to the 10b5-1 plans, they [would] never be able to sell their stock.” Sougata Mukherjee, *The Dangerous Game Corporate Executives Are Playing*, TRIANGLE BUS. J. (Dec. 11, 2012, 2:29 PM), <http://www.bizjournals.com/triangle/blog/2012/12/the-dangerous-game-corporate.html>.

169. Donald H. Meiers, *Rule 10b5-1 Trading Plans: A Win-Win Situation*, 9 METROPOLITAN CORP. COUNS., no. 5, May 10, 2001, 2001 WLNR 12908239.

170. See, e.g., Susan Pulliam & Rob Barry, *Executives’ Good Luck in Trading Own Stock*, WALL ST. J. (Nov. 27, 2012, 11:17 PM), <http://www.wsj.com/articles/SB10000872396390444100404577641463717344178> (quoting Professor Alan Jagolinzer, University of Colorado Boulder).

171. See *supra* Sections III and IV for a discussion of the challenges of corporate compliance and the resulting costs to shareholders.

172. See, e.g., Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders’ Strategic Trade*, 55 MGMT. SCI. 224, 226–27 (2009) (providing an analysis of insiders’ abnormal returns while using Trading Plans).

173. Tony Cooke & Serena Ng, *Moving the Market—Tracking the Numbers/Street Sleuth: Insiders Prosper Despite SEC Rule; Even with Planned Trades, Executives Still Can Beat Overall Market Performance*, WALL ST. J., Aug. 5, 2005, at C3.

174. Jagolinzer, *supra* note 172, at 224.

Plan] termination is associated with positive firm performance.”¹⁷⁵ From these results, Professor Jagolinzer concludes that insiders are using Trading Plans to trade “strategically.”¹⁷⁶ In November 2012, the *Wall Street Journal* followed up with its own study suggesting the strategic use of Trading Plans by insiders.¹⁷⁷ It found that while 1,418 of executives who traded in their own company’s shares during the period of the study recorded average gains (or avoided average losses) of ten percent, only half that number recorded losses of ten percent or more.¹⁷⁸

These studies have led to increased media scrutiny of Trading Plans and calls for the SEC to address the issue.¹⁷⁹ It is likely the SEC will respond to this pressure with a rule change imposing greater restrictions on Plan use.¹⁸⁰ Indeed the *Wall Street Journal* quoted a fund manager stating that he would be “shocked” if the SEC does not reform 10b5-1 to prevent the strategic use of Trading Plans by insiders.¹⁸¹ And as firms wait for the SEC’s next move to address this controversy over Trading Plans, SEC staff comments and guidance on this issue have only clouded Trading Plan use in increased uncertainty.

For example, the chief counsel of the SEC’s Division of Corporate Finance has stated that he would “love to catch” an insider abusing Trading Plans “and use him as an example.”¹⁸² He added that the SEC is “looking for [a] big [Trading Plan] case[] to send a message.”¹⁸³ But while the SEC has made it clear that it is after insiders who are using Trading Plans “for cover”¹⁸⁴ while they trade on material nonpublic information, as one commentator notes, the SEC has not explained “how such conduct violate[s] the law or under what circumstances an affirmative defense under Rule 10b5-1 would not be available.”¹⁸⁵

Many suggest that one of the principal means of manipulating Trading Plans to beat the market is early termination.¹⁸⁶ The SEC has affirmed that, *ceteris*

175. *Id.*

176. *Id.* at 225–26.

177. Pulliam & Barry, *supra* note 170.

178. *Id.*

179. Anderson, *A Sea Change*, *supra* note 96, at 340 n.6 (citing a number of Wall Street Journal articles questioning the legitimacy of Trading Plan use).

180. *See id.* at 388–89.

181. Jean Eaglesham & Rob Barry, *Trading Plans Under Fire: Despite 2007 Warning, Experts Say Loopholes Remain for Corporate Insiders*, WALL ST. J. (Dec. 13, 2012, 9:00 PM), <http://www.wsj.com/articles/SB10001424127887324296604578177734024394950>.

182. Yin Wilczek, *No Conclusion on 10b5-1 Plans, but SEC Monitoring Situation, Official Says*, SEC. L. DAILY (BNA) (Apr. 18 2013, 9:15 PM), www.bloomberglaw.com/s/news/2d7316f12bf2b30c45edb8a7e04297b1/document/MLHA5C3H65TU?headlineOnly=false&highlight=Yin+Wilczek (quoting Thomas Kim).

183. *Id.*

184. Linda Chatman Thomsen, Dir., Div. of Enf’t, U.S. Sec. & Exch. Comm’n, Remarks at the 2007 Corporate Counsel Institute (Mar. 8, 2007), <https://www.sec.gov/news/speech/2007/spch030807lct2.htm>.

185. Horwich, *supra* note 102, at 951 n.181.

186. *E.g.*, Anderson, *A Sea Change*, *supra* note 96, at 365 (“If the information does not pan out

paribus, the act of terminating an existing Trading Plan while aware of material nonpublic information does not violate securities laws because it does not involve the sale or purchase of a security.¹⁸⁷ The power to terminate a Plan based on material nonpublic information effectively “allows insiders to create a cost-free option to buy or sell” a company’s shares.¹⁸⁸ And studies indicate that insiders are indeed using early plan terminations strategically. For example, one study reflects that forty-six percent of sampled Plan terminations “preced[ed] positive news events” for the company, while only eleven percent “preced[ed] negative (ambiguous) news events.”¹⁸⁹ Technically, strategic early Plan terminations exploit a “loophole” in Rule 10b5-1(c) and therefore remain within the letter of the law.¹⁹⁰ Nevertheless, the SEC has issued vague threats¹⁹¹ and ambiguous guidance insisting its enforcement arm can reach this conduct.¹⁹² For example, the SEC qualified its approval of early Plan terminations by warning that (1) such terminations may deprive an insider of the affirmative defense for prior transactions under the Plan,¹⁹³ and (2) frequent early terminations may raise concerns over whether an insider established a new Plan in good faith.¹⁹⁴ This guidance is subject to multiple interpretations, but the gist seems to be that if an insider engages in frequent or otherwise suspicious Plan terminations, the SEC may conclude either that the Plan was never qualified because the insider had material nonpublic information at adoption, or that the insider was using

as expected, the insider may just terminate the plan. In effect, the ability to terminate Trading Plans based on material nonpublic information allows insiders to create a cost-free option to buy or sell.”); Cooke & Ng, *supra* note 173, at C3 (“I just think [selective termination is] such a major loophole in terms of that particular rule . . . [It allows insiders to] get rid of the bad trades and keep what look like the good trades.” (quoting Associate Professor Constance Bagley, Harvard Business School)); *see also* Horwich, *supra* note 101, at 951 (“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.”); Jagolinzer, *supra* note 172, at 227 (“Finally, the SEC allows participants to terminate plans before events or changes in firm performance that might negatively affect their trade returns.”); Stanley Veliotis, *Rule 10b5-1 Trading Plans and Insiders’ Incentive to Misrepresent*, 47 AM. BUS. L.J. 313, 329–30 (2010) (asserting that there is a loophole by which an individual may terminate the plan at any time).

187. *See* U.S. Sec. & Exch. Comm’n, Compliance and Disclosure Interpretations: Exchange Act Rules, Question 120.27 (Feb. 13, 2012), <http://www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm> [hereinafter Compliance and Disclosure Interpretations].

188. Anderson, *A Sea Change*, *supra* note 96, at 365; *see also* Veliotis, *supra* note 186, at 329 (noting that selective termination gives insiders an option to use insider information to trade).

189. Jagolinzer, *supra* note 172, at 235.

190. This author has argued elsewhere that the strategic termination loophole was unavoidable for the SEC in effecting a compromise in the “use versus possession” debate. *See* Anderson, *A Sea Change*, *supra* note 96, at 365.

191. *See, e.g.*, Thomsen, NASPP Conference Remarks, *supra* note 167; Wilczek, *supra* note 182 (stating that the SEC is taking a hard look at the possibility that plans are being abused).

192. *See, e.g.*, Compliance and Disclosure Interpretations, *supra* note 187, at 120.18, 120.19 (discussing the various ways termination could affect the availability of the Rule 10b5-1(c) defense).

193. *Id.* at 120.18.

194. *Id.* at 120.19.

early Plan termination “as part of a plan or scheme” to evade the *spirit* (if not the letter) of 10b-5.¹⁹⁵

But, from the standpoint of insider trading compliance, the problem is that the SEC and the courts often seem to have very different ideas of what the “spirit” of section 10(b) and Rule 10b-5 is.¹⁹⁶ This fact was most recently illustrated by the Second Circuit’s rejection of the SEC’s favored theory of insider trading tippee liability in *United States v. Newman*.¹⁹⁷ With the SEC and the courts often far apart concerning the purpose and scope of section 10(b) insider trading liability, it is no help to suggest that compliance officers approve only those Trading Plans that are consistent with the spirit of the law. Instead, conscientious compliance officers will be forced to adopt a conservative approach to Trading Plan adoptions,¹⁹⁸ just as they are with preclearance and blackout periods.¹⁹⁹ But, for the same reasons outlined above,²⁰⁰ taking a conservative approach to Trading Plans threatens to undermine their usefulness to firms in improving the liquidity of company shares offered to employees as compensation.²⁰¹ In other words, the SEC’s qualifications to 10b5-1(c) may well undermine its very purpose, which was to provide some relief to firms in implementing workable insider trading compliance regimes. In sum, the adoption of Trading Plans as an affirmative defense to insider trading liability has done little if anything to address the paradox of insider trading compliance.

VI. IT’S NOT WORTH IT

This Article has established that vagueness in the law of insider trading leads to uncertainty concerning its scope. Compliance officers can rarely be certain that a trade is permitted in advance. When such uncertainty is considered alongside the market stigma and costs of any SEC investigation (regardless of its ultimate findings) and the extreme penalties an issuer may incur if found civilly or criminally liable, firms typically adopt a hyperconservative approach to insider trading compliance. This Article has argued, however, that adopting such a play-it-safe approach to insider trading compliance results in significant inefficiencies. These inefficiencies directly affect the bottom line for firms and their shareholders. This, again, is the paradox of insider trading compliance for

195. 17 C.F.R. § 240.10b5-1(c)(1)(ii) (2016).

196. See Anderson, *A Sea Change*, *supra* note 96, at 368–71.

197. 773 F.3d 438, 442–43 (2d Cir. 2014).

198. For example, one commentator suggests that firms follow a “keep it simple, stupid” approach. Boris Feldman, *The Best-Laid Plans of 10b5-1*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Feb. 6, 2013), <http://blogs.law.harvard.edu/corpgov/2013/02/06/the-best-laid-plans-of-10b5-1/>. Firms should initiate Trading Plans “48 or 72 hours after the earnings release” and should skip a quarter until they are given effect. *Id.* Under this conservative approach, “modification” and “termination” are “two four-letter words in the world of 10b5-1 plans. Neither is prohibited, but both should be avoided.” *Id.*

199. Berkeley, *supra* note 112, at 55–56.

200. See *supra* Part III.C and Section IV for a discussion of the liquidity problems associated with conservative approaches.

201. See Anderson, *A Sea Change*, *supra* note 96, at 358 n.150.

issuers.

The following question must therefore be addressed: Does the current insider trading enforcement regime, which forces these difficult and costly compliance decisions on firms, do more harm than good to their shareholders? After all, insider trading laws are presumably designed to protect a firm's shareholders and market participants in general. If the costs of insider trading compliance to issuers (combined with the costs of enforcement and criminalization to society writ large) outweigh the benefits, then reform is needed. The literature is replete with research weighing the costs of insider trading,²⁰² but the costs of compliance are rarely factored into the equation.

In what follows, this Article argues that when the paradox of insider trading compliance for issuers is weighed alongside other moral and economic considerations, it becomes clear that reform is needed. In reaching this conclusion, however, a solution also emerges. This Article argues that the paradox of insider trading compliance can be resolved by reforming the current insider trading enforcement regime to expressly permit "issuer-licensed" insider trading.²⁰³ Such reform will also result in a more rational, efficient, and just insider trading enforcement regime.

A. *Distinguishing Issuer-Licensed Insider Trading*

When weighing the appropriateness of insider trading enforcement through the lens of the paradox of insider trading compliance, it is helpful to posit a counterfactual regime that does not regulate insider trading of any form. The idea is to ask ourselves: If we did not have an insider trading enforcement regime in place, would we find the necessity of implementing one? If we did not first posit the absence of regulation, then this exercise would be inherently question-begging because the risk of sanctions under the regulatory regime and the trading expectations of others would always give participants an economic and moral incentive for compliance, even if all agree that they would be better off had the scheme never been adopted.²⁰⁴ The mere existence of a regulatory regime cannot serve as its principal justification.

In addition to positing a laissez-faire insider trading regime, the following analysis focuses on a specific subclass of insider trading, issuer-licensed insider trading.²⁰⁵ Issuer-licensed insider trading occurs where the insider "trades on material nonpublic information [with the firm's approval]"²⁰⁶ and where "the

202. E.g., John P. Anderson, *Greed, Envy, and the Criminalization of Insider Trading*, 2014 UTAH L. REV. 1, 7–17 [hereinafter Anderson, *Greed, Envy*].

203. See *infra* Part VI.A for a definition of the term "issuer-licensed." See also John P. Anderson, *What's the Harm in Issuer-Licensed Insider Trading?*, 69 U. MIAMI L. REV. 795, 797–802 (2015) [hereinafter Anderson, *What's the Harm*] (explaining why issuer-licensed insider trading should not be criminalized).

204. E.g., Anderson, *Greed, Envy, supra* note 202, at 37.

205. For other scholarship discussing issuer-licensed insider trading, see Anderson, *A Sea Change, supra* note 96, at 379–82; Anderson, *Greed, Envy, supra* note 202, at 28; and Anderson, *What's the Harm, supra* note 203, at 787–802.

206. Anderson, *A Sea Change, supra* note 96, at 379 (alteration in original).

issuer's policy allowing insider trading is disclosed to the investing public."²⁰⁷

Issuer-licensed insider trading must be distinguished from two other forms of trading, "issuer-proscribed" insider trading and trading based on misappropriated information.²⁰⁸ Issuer-proscribed insider trading occurs where an insider trades (or tips others who trade) based "on material nonpublic information [despite the fact that] the insider has promised—or otherwise undertaken pursuant to company policy [express or implied]—not to trade on such information."²⁰⁹ Misappropriation trading occurs where a corporate *outsider* improperly obtains material nonpublic information in violation of some duty of trust or confidence and, unbeknownst to the source, seeks to benefit by trading (or tipping others who trade) on the information.²¹⁰

One reason issuer-licensed insider trading supplies the focus here is that neither misappropriation nor issuer-proscribed insider trading contributes to the paradox of compliance outlined above. Misappropriation trading, by definition, does not address firm insiders. As for issuer-proscribed insider trading, the paradox dissolves with the understanding that the interests of firms and regulators will always be in concert. In other words, since the issuer has, for its own reasons, independently sought a promise from its employee(s) not to trade, external enforcement of that promise by the state would, all things being equal, always promote the firm's recognized interests. There would be no quandary for the compliance officer because the firm, not some regulatory rule or principle, determines the impermissibility of the trading.

Moreover, the moral and other social costs of both issuer-proscribed insider trading and misappropriation trading clearly outweigh any potential benefits. This is because both misappropriation trading and issuer-proscribed insider trading violate a promise to a firm (or a source) not to trade on the firm's (or source's) material nonpublic information. In both cases, the deception not only risks significant harm to the promisee (otherwise it would not have sought the promise not to trade),²¹¹ but it also involves an injustice that may warrant civil or criminal sanction independent of any direct economic harm to the promisee.²¹²

In sum, return to the question posed above: If we did not have an insider

207. Anderson, *What's the Harm*, *supra* note 203, at 798.

208. The current insider trading jurisprudence has divided insider trading liability under section 10(b) of the Securities and Exchange Act of 1934 (15 U.S.C. § 78j(b) (2012)) into two broad theories: the classical theory and the misappropriation theory. *United States v. O'Hagan*, 521 U.S. 642, 651–53 (1997). Under the classical theory, a corporate insider incurs liability by seeking to benefit from trading (or tipping off others who trade) in shares of her own company based on material nonpublic information. *Chiarella v. United States*, 445 U.S. 222, 228 (1980). Both issuer-licensed and issuer-proscribed insider trading as defined here would fall under the classical theory of insider trading. See Anderson, *What's the Harm*, *supra* note 203, at 796–97.

209. Anderson, *A Sea Change*, *supra* note 96, at 379 (second alteration in original).

210. See *O'Hagan*, 521 U.S. at 652 (explaining the premise of liability under the misappropriation theory).

211. See Anderson, *What's the Harm*, *supra* note 203, at 800–01; see also Anderson, *Greed, Envy*, *supra* note 202, at 27–36 (discussing the moral implications of insider trading).

212. See Anderson, *Greed, Envy*, *supra* note 202, at 27–36.

trading enforcement regime in place, would we find the necessity of implementing one? Concerning issuer-proscribed and misappropriation trading, the answer is yes. The balance of reasons dictates that if issuer-proscribed and misappropriation trading were not regulated, then firms, shareholders, and indeed justice would demand that regulation be imposed. And this conclusion would be unaffected by the paradox of insider trading compliance for issuers.

The opposite is true when the focus shifts to issuer-licensed insider trading.

B. No Economic Harm or Moral Wrong in Issuer-Licensed Insider Trading

To begin, as explained above, where insider trading is proscribed by issuers, the regulators' and issuers' interests are clearly aligned, and the costs of compliance to the issuers are costs they would presumably incur in any event. There is the risk of divergence only where an issuer would license an insider's trading but for the regulation. The paradox of insider trading compliance outlined above illustrates the potential costs of this divergence, which are only amplified by vague and ambiguous enforcement rules and principles. Such divergence could nevertheless be justified if there were reasons for concluding that even issuer-licensed insider trading results in net economic harm or is otherwise morally wrong. But this is not the case.

Unlike issuer-proscribed or misappropriation trading, issuer-licensed insider trading does not involve the violation of a commitment not to trade. Quite the opposite is true. Presumably insider trading would be licensed by an issuer only in those circumstances where it is determined that such trading would result in a net benefit to the firm; otherwise, why would the firm permit it?²¹³ Moreover, where an issuer expressly permits an insider to trade, such trading does not violate a moral duty to the firm because no promise is broken.²¹⁴ Finally, many have claimed that, independent of any economic arguments, insider trading is deceptive and unfair to other traders because insider trades are based on an information advantage counterparties cannot overcome.²¹⁵ But issuer-licensed insider trading is not susceptible to this charge. For, where a firm approves an insider's use of material nonpublic information and publicly announces that it is

213. Anderson, *What's the Harm*, *supra* note 203, at 799. See generally Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313 (2002) (explaining the advantages of allowing firms to control informed trading decisions). It is, of course, possible that the interests of individual members of management (e.g., those approving or rejecting the trade requests) and the firm may sometimes diverge. But such divergence, if it persists, will always be corrected by other self-interested members of management whose advancement is tied to the success of the firm. Moreover, under the model proposed below, not only must each trade be formally reviewed and approved, the profits from that trade must also be publicly disclosed by the firm.

214. Anderson, *Greed, Envy*, *supra* note 202, at 36–37.

215. E.g., STUART P. GREEN, LYING, CHEATING, AND STEALING: A MORAL THEORY OF WHITE-COLLAR CRIME 235–40 (Oxford Univ. Press 2006) (arguing that insider trading amounts to cheating); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 412 (1999) (arguing that any time someone trades on illegitimately acquired material nonpublic information, she cheats her counterparty who does not have access to that information); Patricia H. Werhane, *The Ethics of Insider Trading*, 8 J. BUS. ETHICS 841, 843–44 (1989) (identifying lack of “equal access to information” as a basis for categorizing insider trading as immoral).

doing so, there is no deception and no unfairness.²¹⁶ The investing public is fully aware that there may be insiders with an information advantage on the other side of any transaction in the company's shares. The public is therefore free to either refuse to trade in that firm's stock, or to demand a lower price for it.²¹⁷

Another harm commonly attributed to insider trading is that it shakes confidence in the markets.²¹⁸ But there is something question-begging about this claim when applied to issuer-licensed insider trading. Issuer-licensed insider trading should shake confidence in the markets only if it can be shown on balance to impose some independent harm or wrong on firms, shareholders, or traders. If, as has been suggested here, there is no such harm or wrong, then there are no grounds for thinking that even widespread issuer-licensed insider trading would shake confidence in the markets.²¹⁹

In sum, the principal economic and moral justifications for regulating issuer-proscribed and misappropriation trading do not apply to issuer-licensed insider trading. As a result, if issuer-licensed insider trading were regulated, then any costs of compliance with such regulation would result in a net loss to the firm and its shareholders. On top of this, the costs to society of civil and criminal enforcement of these regulations must be considered.

C. *Costs of Enforcement*

A common justification for resisting further statutory or regulatory certainty in the law of insider trading is that such clarity comes at the expense of flexibility in enforcement.²²⁰ The concern is that bright-line rules would tie the hands of regulators in confronting new and creative forms of insider trading.²²¹ It

216. See Anderson, *Greed, Envy*, *supra* note 202, at 36–40.

217. See Prakash, *supra* note 5, at 1515–20 (stating that disclosure of general intent to allow trading on the firm's material, nonpublic information is sufficient to avoid deception); see also Anderson, *Greed, Envy*, *supra* note 202, at 36–40 (discussing immorality in the context of insider trading); Anderson, *What's the Harm*, *supra* note 203, at 795 (asserting that the "Law of Conservation of Securities [and other moral criticisms are] not helpful to answering the moral question of whether insider trading is a victimless crime because it either proves too much or too little").

218. *E.g.*, *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) ("Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."); see also Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356 (1979) ("If the market is thought to be systematically populated with such transactors some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages. None of those responses is socially useful."); Homer Kripke, *Manne's Insider Trading Thesis and Other Failures of Conservative Economics*, 4 CATO J. 945, 954 (1985) ("Such trading runs the risk of destroying an important public interest, namely, confidence in the national securities markets.").

219. See Anderson, *Greed, Envy*, *supra* note 202, at 41–42 (characterizing concerns that public attitudes regarding the unfairness of nonpromissory insider trading would undermine markets as unfounded).

220. See, *e.g.*, Heminway, *Just Do It!*, *supra* note 6, at 1001–02.

221. *Id.* at 1011–12 (stating that SEC flexibility around key regulatory terms allows enforcement agents to mold strategies to new, unforeseen situations).

is true that increased clarity in the law would limit the discretion of regulators and prosecutors, but such flexibility is not without its own costs. First, as a matter of justice, that discretion may sometimes be exercised to prosecute innocent conduct or conduct not contemplated by the authorizing statute.²²² The time-honored principle of legality, “[n]ullum crimen sine lege, [demands] that there must be no crime or punishment except in accordance with fixed, reasonably specific, and fairly ascertainable preestablished law.”²²³ As Judge Barrington Parker explained in his pointed statement addressing the government’s “amorphous theory” of insider trading liability in *Newman*, “Your theory leaves all these institutions at the mercy of the government.”²²⁴ Second, as demonstrated above, flexibility in enforcement imposes costs of uncertainty on those who are regulated. But setting aside the moral and economic implications of enforcement amidst legal uncertainty, there are more straightforward costs that are associated with the regulation of issuer-licensed insider trading.²²⁵

In addition to the costs of compliance and government-imposed sanctions incurred on a finding of liability,²²⁶ there are the significant costs of legal defense against civil or criminal investigations. These costs are incurred even if the trading is ultimately proved innocent.²²⁷ Moreover, the targets of even baseless insider trading investigations will suffer from social and market stigma.²²⁸ More still, devoting government resources to monitoring issuer-licensed insider trading imposes costs on society in terms of tax dollars spent investigating and prosecuting that conduct,²²⁹ and in terms of law enforcement resources diverted

222. *E.g.*, *Kolender v. Lawson*, 461 U.S. 352, 357 (1983) (“Where the legislature fails to provide such minimal guidelines, a criminal statute may permit ‘a standardless sweep [that] allows policemen, prosecutors, and juries to pursue their personal predilections.’” (alteration in original) (quoting *Smith v. Goguen*, 415 U.S. 566, 575 (1974))); *see also*, Anderson, *A Sea Change*, *supra* note 96, at 371–78 (asserting that the current law is insufficient to address the problem of insider trading).

223. DAVID A. J. RICHARDS, *THE MORAL CRITICISM OF LAW* 195 (1977).

224. *See* Nate Raymond, *U.S. Prosecutor Grilled over Insider Trading Definition in Key Appeal*, REUTERS (Apr. 22, 2014, 3:31 PM), <http://www.reuters.com/article/2014/04/22/insidertrading-appeal-idUSL2N0NE0OR20140422> (quoting U.S. Circuit Judge Barrington Parker).

225. *See supra* Section III.

226. *See supra* Sections I and III.

227. *See* Nelson Obus, *Refusing to Buckle to SEC Intimidation*, WALL ST. J. (June 24, 2014, 7:37 PM), <http://www.wsj.com/articles/nelson-obus-refusing-to-buckle-to-sec-intimidation-1403651178> (“We chose to fight. It took 12 years and \$12 million, but we won.”).

228. *See id.* (“Our names were finally cleared. But the victory was not without cost, beyond the millions of dollars in legal fees. The price also was inordinate amounts of time and distraction, and untold opportunity cost to our business.”).

229. *See* Diane Del Guercio, Elizabeth R. Odders-White & Mark J. Ready, *The Deterrence Effect of SEC Enforcement Intensity on Illegal Insider Trading: Evidence from Run-up Before News Events 1 n.1* (Oct. 5, 2015) (unpublished manuscript), <http://ssrn.com/abstract=1784528> (“In 2014, the SEC dedicated \$456 million and 1373 staff to the Enforcement Division. This does not count resources devoted to other divisions within the SEC or to enforcement by the U.S. Attorney’s Offices of the Department of Justice.”); *see also* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 230, 258–61 (2007) (offering comparative figures on enforcement inputs).

from the enforcement of laws that actually protect the public from harm.²³⁰

Finally, scholars have suggested that there are a number of benefits that flow to the firm and markets from issuer-licensed insider trading that are denied to the investing public by its regulation.²³¹ For example, most agree that insider trading moves a stock price to better reflect the true value of a company in light of nonpublic information.²³² It has also been suggested that insider trading has a “market smoothing effect.”²³³ Insider trading typically results in a gentle price slope leading up to the disclosure of material nonpublic information.²³⁴ Such trading therefore acts as “a stabilizing force” on the market by mitigating radical price shifts that would otherwise occur upon release of material information.²³⁵ In addition, Professor Henry Manne famously argues that insider trading serves as an effective form of corporate compensation that encourages entrepreneurship at little or no cost to shareholders.²³⁶

D. *The Problem of Adverse Selection*

Are there any benefits to criminalizing issuer-licensed insider trading not considered thus far? Many scholars have suggested that all strategic insider trading harms firms because it increases their cost of capital by forcing market makers²³⁷ to increase their bid-ask spread²³⁸ to account for the problem of

230. Henry G. Manne, *Busting Insider Trading: As Pointless as Prohibition*, WALL ST. J. (Apr. 28, 2014, 7:20 PM), <http://www.wsj.com/articles/SB10001424052702304279904579516170211639290>.

231. See, e.g., BAINBRIDGE, INSIDER TRADING LAW, *supra* note 46, at 176–89; Anderson, *Greed, Envy*, *supra* note 202, at 14–17.

232. E.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 868 (1983) (asserting that insider trading will move the share price of a stock “closer to what it would have been had the information been disclosed”); Henry G. Manne, *Insider Trading and Property Rights in New Information*, 4 CATO J. 933, 935 (1985) (“[N]o economist has ever denied . . . that insider trading will always push stock prices in the ‘correct’ direction.”).

233. See Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 574 (1970) [hereinafter Manne, *Law Professors*].

234. Anderson, *Greed, Envy*, *supra* note 202, at 15.

235. *Id.*

236. Henry G. Manne, *Entrepreneurship, Compensation, and the Corporation*, 14 Q.J. AUSTRIAN ECON. 3, 16–18 (2011). According to Professor Manne,

If any service presently being purchased by the corporation is compensated more highly, more of that service will be offered. Valuable information is an economic good that can be substituted for other media in which the higher compensation can be paid. If the service performed is or can be one which gives access to valuable information, less of other forms of compensation must be paid in order to secure the same amount of the service.

Manne, *Law Professors*, *supra* note 233, at 579; see also Carlton & Fischel, *supra* note 232, at 861–66 (arguing that insider trading is an efficient form of compensation based on the Coase theorem).

237. Market makers are securities dealers who provide market liquidity for a company’s shares by standing ready to step in and transact where buy and sell orders for a security fail to achieve equilibrium. Stanislav Dolgoplov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 88 (2004).

238. The market maker’s bid-ask spread is the difference in the prices at which she will buy and sell a given security. *Id.* It represents the “price of immediacy” and the cost of illiquidity in the market for a company’s shares. *Id.* at 89.

“adverse selection.”²³⁹ A market maker’s role is to maintain liquidity for a company’s shares by trading from its own inventory to adjust for order imbalances.²⁴⁰ Where insider trading is prevalent, market makers “bear[] the risk of consistently buying ‘high’ from and selling ‘low’ to insiders” when correcting for these imbalances.²⁴¹ To adjust for this risk, market makers must increase the bid-ask spread.²⁴² But this increase in the spread operates as a “tax” on all investors, not just insiders.²⁴³

The significance of the impact of insider trading on the bid-ask spread has been disputed.²⁴⁴ For example, some have suggested that even if insider trading were entirely eliminated, the problem of adverse selection would persist because there will always be some traders (such as brokers and analysts) who are better informed than the market makers.²⁴⁵ But, in any event, recall that only *issuer-licensed* insider trading is being considered here. It is hard to imagine a firm would authorize its employees to trade on the firm’s material nonpublic information unless such trading would benefit the firm. If licensing insider trading would result in a net harm to a firm and its shareholders by decreasing liquidity, increasing the bid-ask spread, and therefore raising the cost of capital, the firm would be free to withhold authorization.²⁴⁶

Moreover, the problem of adverse selection as a justification for criminalizing issuer-licensed insider trading is less telling when considered in light of the paradox of compliance for issuers. As explained above, legal uncertainty combined with the threat of stiff penalties has forced firms to adopt overly conservative preclearance requirements and extended blackout periods for insider trading.²⁴⁷ These conservative policies choke the liquidity of shares held by insiders (typically twenty-four to thirty-two percent of a firm’s outstanding shares).²⁴⁸ Permitting issuer-licensed insider trading would remove the need for such conservative trading policies and therefore increase the liquidity of these shares. This increase in liquidity would mitigate (perhaps entirely offset) any tightening that might result from adverse selection.

Thus, on balance, these considerations suggest that (unlike issuer-

239. *Id.* at 89.

240. *Id.* at 98.

241. *Id.* (citing Merton H. Miller & Charles W. Upton, *Strategies for Capital Market Structure and Regulation*, in MERTON H. MILLER, FINANCIAL INNOVATIONS AND MARKET VOLATILITY 127, 142 (1991)).

242. *See id.* at 93, 96.

243. Henry G. Manne, *The Case for Insider Trading*, WALL ST. J. (Mar. 17, 2003, 12:01 AM), <http://www.wsj.com/articles/SB104786934891514900>.

244. *E.g.*, Dolgoplov, *supra* note 237, at 109 (noting that market makers have not been among those who complain of adverse selection from insider trading).

245. *E.g.*, Carlton & Fischel, *supra* note 232, at 880.

246. *See supra* Part VI.B; *see also* Anderson, *What’s the Harm*, *supra* note 203, at 799. *See generally* Ayres & Choi, *supra* note 213 (explaining the advantages of allowing firms to control informed trading decisions).

247. *See supra* Sections III and IV.

248. Fried, *supra* note 136, at 804. *See supra* Part III.B for a discussion of the challenges to enacting effective preclearance enforcement programs.

proscribed and misappropriation trading) there are no moral or economic grounds for regulating issuer-licensed insider trading. Consequently, an insider trading enforcement regime that regulates issuer-proscribed insider trading and misappropriation trading, but not issuer-licensed insider trading, would be preferable to the current U.S. enforcement regime in terms of efficiency and justice.²⁴⁹ Such a regime would also resolve the paradox of insider trading compliance by synchronizing the interests of firms, shareholders, and regulators. But what would such an enforcement regime look like?

VII. A PATH FORWARD

Though the introduction of Rule 10b5-1 Trading Plans has proven unsuccessful in resolving the paradox of insider trading compliance, such Plans may nevertheless provide the roadmap for reform. As explained above, insiders' strategic use of Trading Plans has been the subject of recent scrutiny by the media and the SEC.²⁵⁰ But strategic use of Trading Plans should give cause for concern only if it results in harm or unfairness to investors or other market participants.

Research suggests that the firms whose employees are using Plans to trade strategically typically negotiate a proportionately lower salary.²⁵¹ If true, this means that firms are actually aware of and are licensing the strategic trading of their employees.²⁵² Moreover, studies reflect that firms whose employees use Trading Plans to beat the market are more likely to disclose Plan use in their regulatory filings.²⁵³ Where there is firm approval and public disclosure, strategic Trading Plan use begins to resemble issuer-licensed insider trading as defined above.²⁵⁴ Indeed, this author has argued elsewhere that, with a number of modifications, 10b5-1(c) Trading Plans could provide the model for an enforcement regime that permits harmless issuer-licensed insider trading while continuing to proscribe issuer-proscribed and misappropriation trading.²⁵⁵

Under the proposed reform, a firm, at its discretion, would be permitted to

249. This author has suggested elsewhere that issuer-licensed insider trading is actually consistent with the current insider trading regime as interpreted by the Supreme Court under *O'Hagan*. Anderson, *A Sea Change*, *supra* note 96, pt. VI.D, at 385–87. For similar arguments, see Henderson, *supra* note 131, at 542–43; and Prakash, *supra* note 5, at 1516. But since the SEC has not expressly recognized issuer-licensed insider trading as legal, it is doubtful any firm would risk an enforcement proceeding to put this interpretation to the test.

250. See *supra* Section V.

251. Henderson, *supra* note 131, at 515 (noting that “firms restricting insiders’ ability to trade pay about 13% more in total compensation than firms permitting insiders to trade freely”).

252. *Id.* at 537 (“[T]here is evidence that firms and executives bargain about insider-trading profits, both from optimization trades and informed trades, and that these profits are considered in meeting an executive’s reservation wage.”).

253. E.g., M. Todd Henderson, Alan Jagolinzer & Karl Muller, *Hiding in Plain Sight: Can Disclosure Enhance Insiders’ Trade Returns* 20 (Univ. of Chi. Law Sch., Coase-Sandor Working Paper Series in Law & Econ., Paper No. 411, 2012), http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=1646&context=law_and_economics.

254. See Anderson, *A Sea Change*, *supra* note 96, pt. VI.A, at 380–82.

255. *Id.*

allow its employees to trade on the company's material nonpublic information so long as (1) the insider submits a plan to the firm that details the proposed trade, (2) the firm authorizes that plan, (3) the firm has previously disclosed to the investing public that it will permit its employees to trade on the firm's material nonpublic information when it is in the interest of the firm to grant such permission,²⁵⁶ and (4) the firm discloses ex post all trading profits resulting from the execution of these plans.²⁵⁷ In short, this modified trading plan regime ("Modified Trading Plans" or "Modified Plans") would offer an express safe harbor for issuer-licensed insider trading while leaving the remainder of the current insider trading enforcement regime in place to capture issuer-proscribed and misappropriation insider trading.

The result would be a more rational and just insider trading enforcement regime.²⁵⁸ It would be more *rational* because it would proscribe only conduct that is harmful (issuer-proscribed and misappropriation trading) and permit conduct that firms themselves have determined would benefit their shareholders (issuer-licensed trading).²⁵⁹ Precious law enforcement dollars would no longer be wasted on enforcing rules that do not benefit society.²⁶⁰ And firms and employees would no longer be forced to expend resources to defend against the enforcement of such rules.²⁶¹ The proposed regime would be more *just* because, by permitting issuer-licensed insider trading, it would no longer impose stiff criminal penalties on conduct that is, all things being equal, morally innocent.²⁶² But most importantly, at least for purposes of this Article, the introduction of Modified Trading Plans would dissolve the paradox of insider trading compliance.

The Modified Trading Plan regime proposed here would no longer require compliance officers to choose between the bad options. Under the current insider trading enforcement regime, firms are forced to adopt overly conservative, and therefore highly inefficient, compliance policies for fear of regulatory scrutiny pursuant to a vague and ambiguous framework.²⁶³ By

256. *See id.* It should be noted that the disclosure requirement contemplated here would be limited to notice of the firm's discretionary use of Modified Trading Plans. It would not require the ex ante disclosure of any Plan-specific information, or even of the creation, modification, or termination of specific Modified Plans. The reason is that complete disclosure in advance of Modified Plan trades would result in front-running that would deprive the insider of its advantage. Even partial ex ante disclosure would likely generate more confusion than clarity because investors would likely build expectations around Plans that might later be modified or terminated. Moreover, there is the risk that the market might overreact to partial disclosure, risking harm to both insiders and other market participants. *See id.* pt. VI.A, at 380–82.

257. *See id.* at 379–88; *see also* Henderson, *supra* note 131, at 550–51.

258. *See* Anderson, *A Sea Change*, *supra* note 96, pt. VI.A, at 380–82.

259. *See supra* Part VI.B for a discussion of why there is nothing morally wrong with issuer-licensed insider trading. *See also* Anderson, *What's the Harm*, *supra* note 203, at 789–99 (analyzing harmful and beneficial conduct).

260. *See supra* Part VI.C.

261. *See supra* Part VI.C.

262. *See supra* Part VI.B.

263. *See supra* Sections III and IV.

availing themselves of Modified Trading Plans, however, firms would be permitted to reject only those trade requests there are firm-specific reasons for rejecting. In other words, a firm's best interests—rather than fear of regulatory scrutiny—would dictate whether a Modified Plan is approved. This would be an internal business decision that requires no subtle (and therefore risky) interpretations of the law. Should a firm reject a Modified Trading Plan request, and should an insider trade anyway, then, assuming such trading is based on material nonpublic information, the insider would be subject to enforcement action. But, under such circumstances, the firm's interests would be aligned with the regulators; the firm would have every reason to encourage enforcement.

The proposed enforcement regime would effectively eliminate the costs of insider trading compliance for issuers.²⁶⁴ Insiders would be less likely to bear ill will over the rejection of proposed Modified Trading Plans because such decisions would be based on business reasons, not suspicion of illegal conduct.²⁶⁵ Firms would also be free to determine the liquidity of their employees' equity compensation through their own management of Modified Plans. Such decisions would be based on business reasons; they would no longer be determined by an ever-present fear of SEC investigation under a vague and inscrutable enforcement regime.²⁶⁶ Finally, firms would no longer be forced to adopt overly conservative insider trading compliance regimes that could expose them to liability for breaching contractual duties of good faith and fair dealing owed to their employees.²⁶⁷

CONCLUSION

Vagueness in the law translates into uncertainty for issuers in designing and implementing insider trading compliance programs. Faced with the threat of stiff sanctions for "ineffective" insider trading compliance programs, issuers are forced to adopt compliance regimes that are marked by highly restrictive preclearance decision making and extended blackout periods. But these play-it-safe compliance policies are purchased by issuers at a heavy price in terms of corporate culture, cost of compensation, share liquidity, and cost of capital. Ultimately these costs are passed along to shareholders in terms of decreased share value. The result is that insider trading regulations adopted to increase value for shareholders are having the opposite effect.

The paradox of insider trading compliance for issuers throws the failings of the current U.S. insider trading enforcement regime into stark relief. Whatever advantages there are to uncertainty in the law of insider trading, this Article has suggested that they are outweighed by its costs. To the extent that vagueness in

264. See *supra* Sections III and IV.

265. This is more favorable for businesses than the current expensive and ineffective alternatives explored in Section III *supra*.

266. See *supra* Section IV for a discussion of how ambiguities in the law lead to challenges with enforcement mechanisms.

267. See *supra* text accompanying notes 140–42 for a discussion of the liability firms face with conservative compliance programs.

the law is protected by the SEC and Congress to facilitate flexibility in enforcement, we must ask ourselves what is more important. Is it racking up convictions? Or is it promoting the values insider trading law was adopted to promote (justice, fairness, liquidity, efficiency, and ultimately increased value for shareholders)? Choose the cliché: Haven't we put the cart before the horse? Haven't we lost the forest for the trees? In any event, the paradox of insider trading compliance offers just one more reason why change is needed, and soon. The reform proposed here is a vital option.