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Taming Rule 10b-5-1: The Unfinished Business of *Texas Gulf Sulphur*

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TAMING RULE 10b-5-1: THE UNFINISHED BUSINESS OF *TEXAS GULF SULPHUR*

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ABSTRACT

Insider trading has shaped both the evolution of the Securities Exchange Commission (SEC) and the current state of securities law. The injustice of insider trading, especially as felt by everyday shareholders and investors, mandated action by government regulators. Consequently, the SEC enacted Rule 10b-5—a prohibition and prosecution on any corporate officials' use of material, non-public information for private profit. In SEC v. Texas Gulf Sulphur Co.*, Rule 10b-5 grew into the sanction on insider trading that it is known as today. As case law whet Rule 10b-5's reach on insider trading, corporate executives became increasingly concerned that necessary business transactions would be considered fraud. Thus, the SEC promulgated Rule 10b-5-1. Through this safe harbor, corporate officials could again purchase or sell shares in the companies they ran. Although the safe harbor is subject to certain limitations, abuse of Rule 10b-5-1 has become increasingly apparent. This article seeks to critically analyze the shortcomings of Rule 10b-5-1 and investigate potential courses of action that could remediate its insufficiencies.*

TABLE OF CONTENTS

I. WHEN EXECUTIVES CONCEAL MATERIAL INFORMATION IN THEIR PURCHASES AND SALES 884
II. THE FEDERAL RESPONSE 884
III. RULE 10B5-1 885
IV. FLAWS IN THE SAFEGUARD 887
V. CRITICAL STUDIES AND REPORTS 888
VI. POTENTIAL AMENDMENTS TO RULE 10B5-1 889
VII. PESSIMISM ABOUT REFORMS 891
VIII. SHAREHOLDERS DO HAVE WAYS TO REDRESS THIS WRONGDOING 893
IX. CONCLUSION 894

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I. WHEN EXECUTIVES CONCEAL MATERIAL INFORMATION IN THEIR PURCHASES AND SALES

INSIDER trading is one of the perennially fascinating topics in securities law.[1] Corporate officials who profit from privileged information do something inherently wrong—much like someone who cheats at poker by finding out the cards held by the other players. In addition, it is not as if these illicit gains can be justified as some form of occult compensation for underpaid officers and directors. In recent years, their remuneration has been lush.[2]

Such fraud naturally arouses the indignation of ordinary shareholders who sense the injustice of their executives benefitting from non-public facts that are likely to determine the movement of their shares. Information drives stock prices, and while there is nothing wrong with predicting future valuations by insightfully assessing publicly available data, all investors must be on a level playing field. As the Securities and Exchange Commission ("SEC" or "Commission")[3] put it: "[T]he fundamental unfairness of insider trading harms not only individual investors, but also the very foundations of our markets, by undermining investor confidence in [their] integrity."[4]

The law once seemed to condone that wrongdoing—apparently in a belief that such clandestine gains were just another form of compensation for corporate management. As ethical awareness grew, however, some courts began granting relief against those who abused their knowledge of "special facts."[5] The federal securities laws passed in the 1930s were specifically designed to protect investors from such fraud.

II. THE FEDERAL RESPONSE

One of them, the Securities Exchange Act of 1934 (Exchange Act),[6] contains several provisions targeting insider trading. It requires that certain corporate officials and large shareholders disclose the shares they hold in their companies,[7] and gives stockholders the right to recover any "short swing" profits made trading them.[8] Another section of the statute

1. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 504 (7th ed. 2017).
2. *See* Daniel J. Morrissey, *Executive Compensation and Income Inequality*, 4 WM. & MARY BUS. L. REV. 1, 3 (2013).
3. The SEC is the independent federal regulatory agency charged with administering and enforcing the federal securities laws. For a full description of the Commission and its mission, see *Office of the Investor Advocate*, SEC, https://www.sec.gov/page/investor-advocate-landing-page [https://perma.cc/2WPY-FV4K] (last modified Feb. 8, 2017).
4. *See* Selective Disclosure and Insider Trading, Exchange Act Release No. 33-7881 (Aug. 15, 2000), 2000 WL 1201556, at *20.
5. *See, e.g.*, Strong v. Repide, 213 U.S. 419, 431 (1909); Goodwin v. Agassiz, 186 N.E. 659, 660 (Mass. 1933).
6. 15 U.S.C. §§ 78a-78mm (2012).
7. *See* Exchange Act § 16(a), 15 U.S.C. § 78p(a) (2012).
8. *See* § 78p(b).

grants broad power to the SEC to make rules prohibiting fraudulent practices in connection with the purchase or sale of any security.[9]

Acting on that mandate, in the early 1940s the Commission promulgated the most far-reaching of those provisions, Rule 10b-5.[10] By the early 1960s, it was using Rule 10b-5 to sanction corporate officials who purchased stock from their investors without telling them important information.[11] Just a few years later, that legal approach became well established in the foundational case celebrated in this symposium, *SEC v. Texas Gulf Sulphur Co*.[12] In that case, an influential appellate court upheld injunctions against a company, a number of its officers, and directors who had downplayed mineral findings on their firm's properties while at the same time buying more stock themselves and tipping off others to do the same.

In the ensuing decades, while the Commission was vigorously prosecuting such wrongdoing,[13] rulings from the U.S. Supreme Court refined the reach of Rule 10b-5's prohibition on insider trading. To be liable, purchasers or sellers of securities had to have a fiduciary duty to the individuals with whom they traded.[14]

Those who were told non-public information by an insider could be liable as well, but only if their tipper received an improper benefit in exchange for the information.[15] Just recently the Supreme Court reaffirmed this approach when it sustained the conviction of a tippee who bought shares using confidential news he received from a family member.[16] In addition, the Supreme Court held in *United States v. O'Hagan* that individuals could violate Rule 10b-5 if they used information they misappropriated, even if they had no relationship with their trading counterparties.[17]

III. RULE 10B5-1

Yet even as the law on insider trading became clearer, executives who wanted to purchase or sell shares in their companies remained concerned. Often, they know significant matters about their firms that are not available to the public. The Commission addressed those apprehensions by promulgating a new rule, Rule 10b5-1, which was designed to give corpo-

9. *See* Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2012).

10. Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2017).

11. *See In re* Cady, Roberts & Co., Exchange Act Release No. 34-6668 (Nov. 8, 1961), 1961 WL 60638, at *1–3.

12. *See generally* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d. Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

13. One SEC chair in the early 1980s famously said the Commission would "come down on insider trading with 'hobnail boots.'" David A. Vise, *Former SEC Chief John Shad Dies*, WASH. POST (July 9, 1994), https://www.washingtonpost.com/archive/local/1994/07/09/former-sec-chief-john-shad-dies/9170b707-f685-4282-822e-35329acbdecf/?utm_term=.64ce6db9363c [https://perma.cc/AHW3-XMVB].

14. *See* Chiarella v. United States, 445 U.S. 222, 230 (1980).

15. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983).

16. *See* Salman v. United States, 137 S. Ct. 420, 423 (2016).

17. *See* United States v. O'Hagan, 521 U.S. 642, 649–50 (1997).

rate officials a more detailed procedure for liquidating holdings in their own companies without their sales being fraudulent. As a prelude to the new rule, however, the SEC first clarified its own position on what would constitute trading "on the basis"[18] of material, non-public information.

Because of language in the *O'Hagan* opinion, many questioned whether just buying or selling shares while in possession of material non-public information could be tantamount to its illegal usage.[19] The Commission's response was in essence "yes." If executives were "aware" of material, non-public information and trading, the SEC said the common sense understanding would be that they were inevitably making use of it.[20] As one court succinctly put it, "material information can not lay idle in the human brain."[21]

After stating that, however, the Commission went on to promulgate Rule 10b5-1 as an affirmative defense to charges of such illegal action. Using it, large shareholders and corporate officials could set up plans in advance for purchases or sales of their shares if they established them when they were not in possession of material, non-public information.[22] These programs would then be available as a safe harbor to charges of insider trading, even if executives made purchases or sales of their shares when they knew of privileged information that might otherwise subject them to liability.[23]

Under the rule, such a plan for trading would have to provide written instructions to a broker that would have three aspects. First, it must specify the amount, price (which may include a limit price),[24] and particular dates for the purchases or sales.[25] While the rule does not mandate that an executive wait any length of time before beginning to trade after initiating a plan, many companies require a time length (typically a month)[26] as a matter of risk management.[27]

Second, the program would include a formula or similar method for determining the amount, price, and date of those trades.[28] Under those

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18. *Id.* at 653, 656.

19. *See* Richard W. Painter, Kimberly D. Krawiec & Cynthia A. Williams, *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153, 154–60 (1998).

20. *See* Selective Disclosure and Insider Trading, *supra* note 4, at *21.

21. United States v. Teicher, 987 F.2d 112, 120–21 (2d. Cir. 1993).

22. Selective Disclosure and Insider Trading, *supra* note 4, at *19–20.

23. *See* Stuart Gelfond & Arielle L. Katzman, *Insider Trading, Proactive Planning: A Guide to Rule 10b-5-1 Plans*, 29 INSIGHTS: CORP. & SEC. L. ADVISOR NO. 11, November 2015, at 1, 4.

24. This is "an order to buy or sell stock at a specific price or better." *Limit Orders*, SEC, https://www.sec.gov/fast-answers/answerslimithtm.html [https://perma.cc/F4J5-GUJ3] (last modified Mar. 10, 2011).

25. *See* Exchange Act Rule 10b5-1, 17 C.F.R. § 240.10b5-1(c)(1)(i)(B)(1) (2017).

26. Gelfond, *supra* note 23, at 5.

27. *See* Michael Kaplan, *Rule 10b5-1 Plans: What You Need to Know*, DAVIS POLK (Jan. 18, 2013), https://www.davispolk.com/files/files/Publication/c0b412f9-d08e-4abf-a327-3f215728160e/Preview/PublicationAttachment/5dbd1bac-15b1-4b37-ae75-4388773478c4/011813_10b-5_1.pdf [https://perma.cc/BX9M-4DLS].

28. *See* 17 C.F.R. § 240.10b5-1(c)(1)(i)(B)(2) (2017).

conditions, the executive's broker would have no discretion in making purchases or sales. Under the third feature, however, brokers could have such discretion so long as they also have the exclusive right to determine how and when to make the trades and are unaware of any material non-public information when doing so.[29]

At first examination, then, the rule seemed to have the virtue of preventing self-dealing conflicts in much the same way as a traditional blind trust. In such situations, those holding public office give over the management of their investments to an independent party and know nothing of how that individual will administer them.[30] Similarly, a Rule 10b5-1 pre-ordained plan offers a safe harbor from insider trading liability even if transactions made under it occur when corporate officials are aware of non-public material information.[31] Given the legitimate reasons that corporate officials may have to raise funds by selling their stock, such a program can be of great benefit to them. As one commentator put it, "a well-thought-out and implemented 10b5-1 plan may help a company and its executives avoid or ultimately refute accusations of impropriety."[32]

IV. FLAWS IN THE SAFEGUARD

However, the rule hardly provides an airtight guarantee that company officials will not be able to profit unfairly from insider transactions. For example, 10b5-1 plans do not have to be publicly disclosed, and as a result, regulators or other shareholders cannot verify that those who set them up are adhering to them.[33] Thus, there is no outside check on whether corporate officials are establishing their plans, as they are supposed to, without information about future stock movements in mind.

In addition, there is nothing to stop executives from modifying or cancelling existing plans and not disclosing such changes. They can therefore move in and out of these programs—ending one or setting up another—while in possession of private information. For that matter, corporate managers may even have multiple plans in effect at the same time. In that case, any one of them can provide an affirmative defense to illegal trading.[34]

Even assuming these plans are set up when corporate officials are unaware of significant inside information, they can still game the rule by publicly disclosing such facts or holding them back in ways that will maximize their trading profits.[35] For instance, CEOs who know of negative news

29. *See* 17 C.F.R. § 240.10b5-1(c)(1)(i)(B)(3) (2017).

30. For a good critical piece on those, however, see Megan J. Ballard, *The Shortsightedness of Blind Trusts*, 56 KAN. L. REV. 43 (2007).

31. *See* Gelfond, *supra* note 23, at 4.

32. Kaplan, *supra* note 27, at 1.

33. *See* Taylan Mavruk & H. Nejat Seyhun, *Do SEC's 10b5-1 Safe Harbor Rules Need to be Rewritten?*, 2016 COLUM. BUS. L. REV. 133, 135–36 (2016).

34. *See* Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, 55 MGMT. SCI. 224, 226–27 (2009).

35. *See id.* at 226.

can delay its release until after sales under their plans occur. Conversely, they might speed up disclosure of news likely to favorably impact the price of their stock so that it would hit the market before one of their planned sales happens. In addition, since corporations themselves can adopt 10b5-1 programs, a company might delay the release of good news so it could repurchase its own shares more cheaply.[36]

V. CRITICAL STUDIES AND REPORTS

Even though the reason for Rule 10b5-1 is to prevent insiders from capitalizing on private information, it is not surprising that many still seem to be doing just that. A study published several years after the rule was promulgated indicated that corporate officials who had adopted such plans were experiencing abnormal returns on their trades.[37]

Insider sales, it discovered, were above average preceding the publication of news about negative firm performance, and their purchases were likewise abnormally high after price dips that followed it. Sales by company officials were thus suspiciously occurring right before a stock drop, and their purchases were happening immediately before a price rise. The study also found that 46% of the plans involving preordained sales were terminated in advance of positive news so that officials could keep their shares and enjoy the gains resulting from the release of that information.[38] Despite the alarming implications of that study, it did not lead to an increase in insider trading prosecutions.[39]

A later investigation that also reviewed trading patterns by individuals with Rule 10b5-1 plans concluded that such abnormal profits occur even after corporate officials reveal that they have adopted them. Insiders, it found, then begin strategically engaging in purchases and sales using their programs as cover against charges of illegal activity.[40] The study called this tactic "hiding in plain sight"[41] because Rule 10b-5-1 plans seemed to be immunizing corporate officials from insider trading charges even though they were engaging in that very activity.[42]

Following that, several detailed pieces in the Wall Street Journal reported particular instances of such misconduct occurring. They pointed to

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36. Allan Horwich, *The Legality of Opportunistically Timing Public Company Disclosures in the Context of SEC Rule 10b5-1*, 71 Bus. Law. 1113, 1119–20 (2016).

37. *See* Jagolinzer, *supra* note 34, at 232–33.

38. *See id.* at 235.

39. *See* Kaplan, *supra* note 27, at 1.

40. *See* M. Todd Henderson, Alan Jagolinzer & Karl Muller, *Hiding in Plain Sight: Can Disclosure Enhance Insiders' Trade Returns?* 2–3, (Coase-Sandor Working Paper Series in Law & Econ. No. 411, 2012).

41. *Id.* at 2.

42. Companies and their officials could do that by heading off securities fraud suits or making them more likely to be dismissed at the pleading stage. Their plans would provide prima facie evidence against such wrongdoing before any discovery could dig deeper into what was really going on. Prosecution of insider trading cases could also be made more difficult because the test for wrongful use of information would likely be applied when defendants started their plans, not at the time they executed their trades. *See* Jagolinzer, *supra* note 34, at 226–27.

a number of top corporate officials with those plans and described how they were using them to make very beneficial trades before news became public that moved the price of their shares.[43] Many of these trades involved sales made shortly before the release of unfavorable news, which allowed the officials to get out of the market ahead of a substantial price drop.[44] Some of them were even more suspicious because the executives made trades under new plans that they apparently established just to allow those sales.

VI. POTENTIAL AMENDMENTS TO RULE 10B5-1

These concerns have given rise to a number of proposals to reform 10b5-1 to prevent such abuses. The first proposal came from the SEC itself just two years after it promulgated the rule. It would have required a company whose officials adopted one of those arrangements to report the plan publicly "to provide investors with prompt disclosure of this information."[45] As the Commission cogently put it, "[a] director's or executive officer's termination or modification of a Rule 10b5-1 [plan] may indicate a change regarding the company's prospects, and thus may be valuable information to investors."[46] After setting forth that proposed amendment to the rule, however, the Commission took no steps to implement it and gave no reason for its inaction.[47]

Recently, Professors Taylan Mavruk and H. Nejat Seyhun have made more ambitious suggestions to reform Rule 10b5-1.[48] As background, they surveyed over 1,500,000 transactions between 2003 and 2013 made by more than 14,000 insiders.[49] The professors found no statistical difference between 10b5-1 and non-10b5-1 transactions. In both situations, "positive abnormal returns follow their purchases and negative abnormal returns follow their sales" indicating that in both instances the transactions were motivated by "material non-public information."[50] The authors thus concluded their findings with this blunt assessment: "insiders exploit their material non-public information using both 10b5-1 planned

43. *See* Susan Pulliam & Rob Barry, *Executives' Good Luck in Trading Own Stock*, WALL ST. J. (Nov. 27, 2012, 11:17 PM), https://www.wsj.com/articles/SB10000872396390444100404577641463717344178.

44. *See* Susan Pulliam, Jean Eaglesham & Rob Barry, *Insider-Trading Probe Widens*, WALL ST. J. (Dec. 10, 2012, 8:33 PM), https://www.wsj.com/articles/SB10001424127887323339704578171703191880378.

45. Form 8-K Disclosure of Certain Management Transactions, Exchange Act Release No. 33-8090 (Apr. 12, 2002), 2002 WL 538909, at *1. The company's disclosure would have to name the official, give the date she entered into plan and state its duration. It would also have to describe the trading program itself and name the broker who would execute its orders. In addition, the company would have to report any transaction executed under the plan and describe in general terms any alteration of it.

46. *Id.* at *14.

47. *See* Allan Horwich, *The Legality of Opportunistically Timing Public Company Disclosures in the Context of SEC Rule 10b5-1*, 71 BUS. LAW. 1113, 1134 (2016).

48. *See* Mavruk, *supra* note 33, at 134–37.

49. *Id.* at 146–47.

50. *Id.* at 160, 164.

and non-planned transactions."[51] In addition, the professors put forth examples to show how two aspects of Rule 10b5-1 trading allows such abusive conduct. It permits executives to set up programs to trade their shares under a formula or algorithm, but at the same time, they can also condition those purchases or sales on the market price of their stock.

If, for instance, insiders know from privileged sources that their shares are not likely to fall below their current price but will be overvalued when they rise to a certain level, their plans can provide for sales at that high point. Conversely, if executives have private knowledge about a stock drop that might be permanent, they can set sale orders for when their shares go below a certain level.[52] Citing those illustrations, the professors conclude that Rule 10b5-1 gives insiders "wide latitude to fully incorporate their material non-public information right into the safe harbor plan's trading formula."[53]

After laying out the reasons why Rule 10b5-1 is "quite problematic,"[54] Marvuk and Seyhun then offer their own proposal for reforming it. First, a plan's initial trades "must be scheduled no less than six months after the plan is filed" and any amendments to the plan would have to reset that timetable.[55] Second, they propose that the SEC substantially limit the rule's reach. The Commission should "repeal its permission regarding [the use of] prices, formulas, and computer programs and insist that . . . trading decisions [under the safe harbor] cannot be conditioned on future stock price or market conditions."[56]

The parameters of 10b5-1 plans would thus be greatly restricted. As the professors proposed in their scaled-down version of the rule, "[i]nstead, insiders must simply submit the number of shares to be purchased or sold and the dates for those proposed transactions."[57] Third, companies must publicly disclose the details of these plans. In that way, "both the SEC and investors can verify that the executives are actually complying with their own proposed rules."[58]

In the same vein, the Council of Institutional Investors ("the Council") just recently renewed the request to reform the rule that it had made several times earlier to the Commission. Its goal was to stop what it called a "long running abuse of the spirit of [Rule 10b5-1]."[59] To forestall such flagrant wrongdoing, the Council proposed what it called "protocols and

51. *Id.* at 164.
52. *See id.* at 138–39.
53. *Id.* at 139.
54. *Id.* at 138.
55. *See id.* at 136.
56. *Id.* at 137.
57. *Id.*
58. *Id.*
59. Letter from the Council of Institutional Investors to the Hon. Jay Clayton, Chairman, SEC, (Jan. 18, 2018) (on file with author). As an egregious example of conduct that the rule apparently condones, the Council cited a $39 million sale of Intel stock in November 2017 by the company's CEO. He made that within 30 days of revising his trading plan for the second time that year and just weeks before the announcement of a design flaw in Intel's chips. *Id.*

guidelines" that all Rule 10b5-1 plans should have.[60]

The first of those would lessen the ability of executives to have private information when they adopt their plans by only allowing insiders to make them during company sanctioned trading windows—typically the interval after the announcement of a firm's quarterly financial results and before the close of the next one.[61] Then, to prevent the use of non-public information once corporate officials have adopted such a plan, a mandatory waiting period, preferably three months, should apply before they can take action under it.[62]

Similarly, wrote the Council, the rule should not allow insiders to make multiple overlapping plans or to frequently modify or cancel them.[63] Companies and their officials should also be required to disclose their programs and any transactions made under them, along with any amendments to them and their terminations.[64] Lastly, boards of companies that allow these plans should adopt policies governing them and monitor their usage.[65] Directors should also make sure that those protocols include discussions of their firm's guidelines or requirements on equity hedging, holding, and ownership.[66]

VII. PESSIMISM ABOUT REFORMS

These well thought-out suggestions give ample specifics on how the SEC might tighten up the rule so that corporate officials cannot use it as a protection for the wrongful conduct that commentators and business journalists have identified. Yet, given the Commission's history of inaction on such proposals (one that the SEC itself made, and others submitted several times by groups like the Council of Institutional Investors), it is unlikely that any such reforms will be forthcoming, even though the Commission's mission is to safeguard investors from just such fraud. In apparent frustration, one financial reporter has even gone so far as to urge that the rule be repealed outright because investors would be better off without the false assurance it gives that insiders are making their purchases and sales innocently.[67]

On top of that, a well-considered piece by Professor Allan Horwich that reviews this distressing situation comes to the negative conclusion that there is very little that can be done about the issue under existing law.[68] He accepts the studies showing that corporate executives use mar-

60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*
67. Stephen Gandel, *SEC Needs to Quit Taking Executives' Word on Stock Sales: Prearranged 10b-5-1 Plans Push the Envelope on Insider Trading*, BLOOMBERG GADFLY (Jan. 9, 2018, 6:30 AM), https://www.bloomberg.com/gadfly/articles/2018-01-09/sec-needs-to-quit-taking-executives-word-on-stock-sales [https://perma.cc/8AX8-WCGV].
68. *See* Horwich, *supra* note 47, at 1150.

ket timing to achieve abnormal returns in their Rule 10b5-1 trades.[69] He also acknowledges that those preordained programs even allow for the use of non-public information to game the prohibitions against such fraudulent purchases and sales.

Yet, Horwich says that, absent amending the Rule, such actions are permissible because the federal securities laws only mandate disclosure of information in certain specific situations, and that timing disclosure to coincide favorably with planned trades is not one of them. Therefore, according to Professor Horwich, Rule 10b5-1 as it is currently stated does not cover such illegal activity, nor can the SEC change it to make it do so, because the Commission's anti-fraud rule-making is constrained by its enabling statute—§ 10(b) of the Exchange Act—as construed by the Supreme Court.[70]

The professor supports that largely by focusing on the Court's opinion in *Santa Fe Industries, Inc. v. Green* that limited the reach of Rule 10b-5.[71] The plaintiff in that case claimed that the defendant corporation that was buying his shares in a short form merger was fraudulently paying inadequate consideration for them. The Supreme Court however focused on the specific language of § 10(b)[72] and held that any regulations promulgated under it, such as Rule 10b-5, had to involve conduct that was "manipulative or deceptive."[73]

Horwich rules out the first of those terms from applying to abuses of 10b5-1 even though he concedes, "[market timing 10b5-1 plans] might be characterized colloquially as manipulation of the corporate disclosure process."[74] Instead, he cites this language in *Santa Fe* which defines the term narrowly: "[m]anipulation . . . when used in connection with securities markets . . . refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[75]

While Horwich does allow that "deception," by contrast, generally involves a materially misleading statement or omission, he asserts that its reach does not cover market timing, because silence alone absent a duty to speak does not constitute deception. However, he acknowledges that there are situations where one has an obligation to make disclosure of known material facts, such as when SEC regulations mandate it or where one must do so to correct a "half-truth."[76] Yet, a scheme to profit by Rule 10b-5-1 market timing is not such a situation, he says.

Horwich does, however, recognize one interesting caveat to his claim

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69. *See id.* at 1136–37.
70. *See id.* at 1124–27.
71. *See id.* (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977)).
72. *See supra* note 9 and accompanying text.
73. *Santa Fe*, 430 U.S. at 473–74.
74. Horwich, *supra* note 47, at 1124.
75. *Santa Fe*, 430 U.S. at 476.
76. *See* Horwich, *supra* note 47, at 1124–27.

that such activity is not securities fraud.[77] The rule itself provides that its affirmative defense is only available if a Rule 10b5-1 program is "entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section."[78] As such, someone, who at its inception contemplates using such a program to gain an unfair trading advantage, would then not have initiated it in good faith. The safe harbor would therefore not apply, and transactions made while aware of private information would constitute unlawful insider trading.

After generally ruling out federal law from prohibiting such market timing activity, however, Horwich recognizes that the corporate law of a number of states may forbid it. Such activity may well be a breach of the duty of loyalty that officers and directors owe to their shareholders not to make secret profits in their dealing with them. He cites a decision from Delaware, *Brophy v. Cities Service Co.*,[79] for that conclusion and points to recent examples of cases involving spring-loading and bullet-dodging,[80] where shareholders also successfully asserted such claims under state law against corporate management.[81]

VIII. SHAREHOLDERS DO HAVE WAYS TO REDRESS THIS WRONGDOING

Even though state officials and the SEC may be unlikely to pursue such claims,[82] shareholders who feel victimized by this wrongdoing may well pursue civil actions (i.e., derivative suits)[83] to remedy it and vindicate the integrity of our trading markets.

First, suspicious purchases or sales such as those identified here may indicate, as Professor Horwich acknowledges, that such Rule 10b5-1 plans were made in bad faith and therefore never effective. Information about that can come directly from sources like whistleblowers or indirectly from strong circumstantial evidence. For instance, statistics about questionable trading plans led courts to sustain claims for illegal activity in numerous options backdating cases.[84] Second, aggrieved shareholders can also bring

77. *See id.*

78. Rule 10b5-1(c)(1)(ii).

79. *See* Brophy v. Cities Serv. Co., 70 A.2d 5 (Del. 1949); *see also* Diamond v. Oreamuno, 248 N.E.2d 910 (N.Y. 1969).

80. In "spring-loading," companies award options to their executives before they release good news that sends their stock price higher. In "bullet-dodging," companies issue them right after the release of bad news, making their exercise price correspondingly lower. *See* Horwich, *supra* note 47, at 1141–44.

81. *Id.* at 1141–47.

82. There have apparently only been two enforcement actions by the SEC involving Rule 10b5-1 wrongdoing. *See id.* at 1119.

83. The author has written extensively about this as the ideal mechanism to remedy corporate corruption. *See generally* Daniel J. Morrissey, *Shareholder Litigation After the Meltdown*, 114 W. VA. L. REV. 531 (2012); Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973 (2007); Daniel J. Morrissey, *New Rulings Threaten the Derivative Suit—Will the "Needed Policeman" Keep Walking the Beat?*, 36 S.C. L. REV. 631 (1985).

84. Executives engaged in that wrongful conduct by selecting times before those options were issued when the underlying shares were trading for a much lower price. They

state actions against wrongdoing corporate officials for breaches of their duty of loyalty.[85] Defendants in such actions will not be able to claim the protection of Rule 10b5-1's safe harbor because that affirmative defense is only available against charges of federal insider fraud—not breaches of the fiduciary duties that corporate officials owe to their companies.

Third, even though *Santa Fe v. Green* can be read as providing a narrow definition of "manipulative" activity, as Professor Horwich concedes, the plain meaning of that term can cover market timing activity.[86] And one may even more readily find Rule 10b-5 "deception" in that activity when an insider conceals his market timing plans. As expert commentators have noted, the federal securities laws find that as wrongful activity when one has a duty to speak,[87] and such an obligation certainly exists when corporate officials keep silent about material, non-public information while purchasing shares from their stockholders.[88] How is market time activity in Rule 10b5-1 trades any different from that? The executives there are not disclosing a key fact that their counterparties in the transaction would want to know, i.e. their scheme to defraud them by making their purchases or sales coincide with news that will favorably affect the price of their shares.

IX. CONCLUSION

There is much evidence that the Rule 10b5-1 safe harbor is being abused by a number of corporate officials and may even be used to cover illegal insider trades. As discussed in this article, inaction by government regulators should not inhibit frustrated shareholders from initiating their own legal actions to remedy this wrongdoing. In doing that important work, they will be safeguarding the integrity of our securities markets and preserving the legacy of *Texas Gulf Sulphur*.

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would then secretly change their grant dates to make it appear that those rights were awarded at that earlier time—making it possible for those corporate officials to fraudulently enhance their gain when they exercised them. *See, e.g.*, *In re* F5 Networks, Inc., 207 P.3d 433, 435 (Wash. 2009); *see also* Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 Or. L. Rev. 973, 982–87 (2007).

85. *See* Horwich, *supra* note 47, at 1148–50.

86. *See* Horwich, *supra* note 47, at 1124–27.

87. For a good discussion on when failure to disclose material facts constitutes securities fraud, see Marc I. Steinberg, Wendy G. Couture, Michael J. Kaufman, & Daniel J. Morrissey, Securities Litigation 193–95 (2016).

88. *See* Chiarella v. United States, 445 U.S. 222, 232–33 (1980) (noting silence is fraudulent upon a showing of "a duty to disclose" which "arises from a specific relationship between two parties," such as the relationship of "agent, . . . fiduciary, . . . [or] a person in whom the sellers had placed their trust and confidence.").