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March 2, 2022

VIA ELECTRONIC DELIVERY

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Proposed Rule: Rule 10b5-1 and Insider Trading (Release No. 33-11013; 34-93782; File No. S7-20-21)

Dear Ms. Countryman:

Stern Tannenbaum & Bell LLP ("STB")[1], respectfully submits this comment letter in response to the above-referenced proposed rule issued by the Securities and Exchange Commission (the "SEC" or "Commission") on January 13, 2022 (the "Proposal")[2].

It is gratifying to see that the SEC has finally acknowledged and concurred with the conclusions of our article entitled Another Look at Rule 10b5-1 Trading Plans, *Where Does Their Reported Profit Advantage Really Come From?*[3] which we published in January 2014 (copy attached). In that article, we recommended that as a best practice, issuers should require longer waiting periods between the adoption of trading plans and the first trades under such plans. Our understanding of why this was critical was that: "[t]he mere existence of a mandatory waiting period – of any length – necessarily assumes that the executive may have material nonpublic

[1] STB is a law firm in New York City. My partner, Aegis J. Frumento, Esq., and I co-head the Financial Markets Practice Group. We currently have several corporate clients who turn to us for assistance in creating and executing numerous 10b5-1 plans for insiders of large corporations. From 2006 to 2011, Mr. Frumento headed and I was a senior attorney and then general counsel of the Executive Financial Services department of Smith Barney (when it was both a Citibank and later a Morgan Stanley affiliate). Our department was responsible for designing and administering Rule 10b5-1 trading plans for all Smith Barney customers, and we dealt personally with hundreds of such plans during our tenure.

[2] SEC Release No. 33-11013; 34-93782; File No. S7-20-21 (January 13, 2022), *available at* https://www.sec.gov/rules/proposed/2022/33-11013.pdf.

[3] The Corporate Counselor, Volume 28, Number 10, January 2014.

information, and almost certainly has advantageous knowledge, even in an open window. Acting on that reasonable assumption, a waiting period forces time to pass before executing the first trade under a plan, ensuring that whatever knowledge the executive had when adopting the plan has matured into a disclosable fact or has dissipated as ephemeral."[4]

While we expect many commenters to view the proposed 120-day cooling off period—specified amounts of time that must elapse before trading can begin under the plan for officers and directors—as excessive because it would span an entire quarter, such that no trading could occur under a Rule 10b5-1 plan until the financial results associated with that quarter are announced, we believe that this is more than an ideal amount of time and is a necessary step to establish meaningful safeguards around the adoption, modification and cancellation of Rule 10b5-1 trading plans.

As we are all aware, Rule 10b5-1 was adopted[5] by the Commission as part of a broader regulatory effort to refine prohibitions against insider trading, which the Commission recognized as an existential threat to the integrity and overall health of the U.S. capital markets.[6] The Rule clarifies the circumstances under which a purchase or sale of a security by a listed company or corporate insider in possession of material nonpublic information ("MNPI") may be subject to legal liability and potential enforcement action – an issue that, at the time, remained unsettled through conflicting case law.[7] Since its adoption, Rule 10b5-1 has provided greater clarity to company insiders as to how to handle the need to trade in company securities without running afoul of insider trading prohibitions; however, it has not fully achieved its purpose to enhance investor protection and confidence in the fairness of the capital markets. The reason for that is, as we wrote in 2014, statistical evidence demonstrated that executives in trading plans outperformed their peers by 6% to 10%.[8]

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[4] *Id.*

[5] 17 CFR § 240.10b5-1

[6] *See* U.S. Securities and Exchange Commission, Final Rule: Selective Disclosure and Insider Trading, https://www.sec.gov/rules/final/33-7881.htm ("[T]he prohibitions against insider trading in our securities laws play an essential role in maintaining the fairness, health and integrity of our markets. We have long recognized that the fundamental unfairness of insider trading harms not only individual investors but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets.")

[7] *Id.*

[8] *See* Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade* (February 1, 2009). Management Science, February 2009, Available at SSRN: https://ssrn.com/abstract=541502. *Also see*, Susan Pulliam and Rob Barry, *Executives' Good Luck in Trading Own Stock* at https://www.wsj.com/articles/SB10000872396390444100404577641463717344178 (November 12, 2012).

STERN TANNENBAUM & BELL

Since we published our article even more support has been found for the theory that some insiders may be using Rule 10b5-1 plans to engage in opportunistic trading against the intent behind the rule. Specifically, the timing of plan adoptions, modifications, and cancellations, appear to present a heightened risk of potential abuse. This is of course concerning. A more recent examination of 20,000 10b5-1 trading plans (representing $105 billion in trading activity) by academics at Stanford University and The Wharton School provides further evidence of opportunistic selling through plans.[9] Researchers found that the first trades in Rule 10b5-1 trading plans with cooling-off periods of less than 30 days were associated with a subsequent industry-adjusted return of -2.5%, while initial trades in plans with cooling off periods of 30 to 60 days were associated with a subsequent -1.5% return. The authors also found that the average trade size in plans with cooling-off periods of less than 30 days was roughly 50% larger than trades in plans with a cooling-off period of six months or more. These impacts largely disappeared when initial trading occurred at least four months following plan adoption[10].

We fully support the Proposal's addition of two new cooling-off periods to the availability of the Rule 10b5-1 affirmative defense, namely: for officers and directors, as part of their 10b5-1 plans, a *120-day cooling off period* after the adoption of the plan, including modification of a trading arrangement, before any trading can commence[11] and for issuers, as part of their plans, a *30-day cooling-off period* after adoption or modification of the plan before trading can commence. We believe these cooling-off periods should ameliorate concerns that companies and insiders may be adopting or modifying plans based on MNPI. As described in our article, we believe these additional requirements are needed to enhance the effectiveness of the affirmative defense offered by the rule and that these modifications will strengthen existing regulation of Rule 10b5-1 plans to ensure the protection of the investing public continuing to permit the legitimate use of these plans by corporate insiders and issuers.

We would, however, suggest a modification with respect to plans entered into by officers and directors. Currently, Rule 10b5-1 requires plans simply to be adopted at a time when officers and directors have no MNPI. In practice, that often is interpreted to require plans to be adopted during a so-call "open trading window." However, one study cited in our article showed that insiders who simply traded within open windows (not in Rule 10b5-1 plans) outperformed insiders who could only trade with the prior consent of the consent of general counsel by about the same percentage as those who traded in Rule 10b5-1 plans (generally adopted in open windows)

[9] David L. Larcker et al., Gaming the System: Three "Red Flags" of Potential 10b5-1 Abuse, Stan. Closer Look Series, Corp. Governance Res. Series 1 (Jan. 2021) at https://www.gsb.stanford.edu/sites/default/files/publication-pdf/cgri-closer-look-88-gaming-the-system.pdf

[10] *Id.*

[11] This 120-day period for insiders intends to deter them from capitalizing on MNPI by covering essentially a quarter plus after adoption – meaning that the quarter's financial results would be announced prior to trading under the plan.

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outperformed the market.[12] This corroborated our overarching conclusion that even in open trading windows there was enough MNPI to provide insiders a trading edge. "It is no coincidence," we then wrote, "that the profit advantage of a trading windows policy is in the same range as that typically found for Rule 10b5-1 trading plans. The profit advantages of trading plans have nothing to do with the plans themselves, and everything to do with the open windows when those plans were adopted."

By requiring a 120-day cooling off period, the proposed Rule 10b5-1 acknowledges the common sense conclusion that even in open trading windows, insiders have better knowledge of their own companies than the rest of the market. But if that is so, then it makes no difference whether or not a trading plan is adopted in an open window. A long cooling off period assumes that the insider has MNPI when he adopts the plan, and then lets that MNPI dissipate naturally over the passage of time. Consequently, a restriction that only permits plans to be adopted in open trading windows is superfluous—Rule 10b5-1 trading plans with a long 120-day cooling off period should be permitted to be adopted at any time.

Therefore, we respectfully suggest that the clause "Before becoming aware of the information" be deleted from §240.10b5-1 (c)(1)(i)(A) of the proposed Rule, so that it would begin simply "(A) The person had:".

Very truly yours,

Stephanie Korenman
Partner

Enclosure (as stated)

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Allison H. Lee, Commissioner
The Honroable Caroline A. Crenshaw, Commissioner

[12] Alan D. Jagolinzer, David F. Larcker, and Daniel J. Taylor, Corporate Governance and the Information Content of Insider Trades, 49 *J. Accounting Research* (*JAR*) 1249 (Dec. 2011).

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Another Look at Rule 10b5-1 Trading Plans

Where Does Their Reported Profit Advantage Really Come From?

By Aegis J. Frumento and Stephanie Korenman

By establishing a prearranged plan to trade their companies' stock in compliance with SEC Rule 10b5-1, corporate executives avail themselves of the only formally codified affirmative defense against a charge of insider trading. However, statistical evidence demonstrating that executives in trading plans outperform their peers by 6% to 10% have twice brought trading plans under academic and journalistic scrutiny. Each time ultimately voices the recurring fear the rest of us have that executives who use such plans are getting away with insider trading.

Aegis J. Frumento and **Stephanie Korenman** co-head the Financial Markets Practice of Stern, Tannenbaum & Bell LLP in New York City. From 2006 through 2011, Mr. Frumento headed, and Ms. Korenman was senior counsel of, the Executive Financial Services department of Citigroup Smith Barney and later Morgan Stanley Smith Barney, responsible for all Rule 10b5-1 trading plans for Smith Barney (now Morgan Stanley) customers. They now represent broker-dealers, issuers, and executives implementing Rule 10b5-1 trading plans, and can be reached at afrumento@sterntannenbaum.com and skorenman@sterntannenbaum.com, respectively.

Background

There is no consensus as to why these enhanced profits exist. Elementary logic shows that properly designed and implemented trading plans, in and of themselves, cannot confer any additional informational advantage to their trading executives. Stock trades in a Rule 10b5-1 trading plan can only reflect what knowledge an executive had when he or she adopted the plan. Therefore, any informational advantage that a plan might exploit must have existed when it was adopted, typically during a conventional "open trading window."

Professor Alan Jagolinzer first showed the profit advantage of trading in Rule 10b5-1 trading plans in 2006 and 2007. Jagolizner found that executives using trading plans outperformed those not using them by about a 6%. *See* Alan D. Jagolinzer, Do Insiders Trade Strategically Within the SEC Rule 10b5-1 Safe Harbor? Stanford University, September 2007, http://bit.ly/J08TER. This led *Business Week* to run a series of articles in late 2006 and early 2007 suggesting that executives were "gaming" Rule 10b5-1 trading plans to trade on inside information under the Rule's guise.

In response, the SEC's then-Director of Enforcement promised a "hard look" at Rule 10b5-1. *See* Remarks of Linda Chatman Thomsen at the 2007 Corporate Counsel Institute, March 8, 2007, http://1.usa.gov/1heqtlb. But nothing ever came of it.

Over the past year, the apparent profit advantages of using trading plans was again in the news, with a series of articles *The Wall Street Journal* ran from November 2012 through May 2013. The *WSJ* did its own analysis and concluded that executives in plans outperformed their peers by about 10%. Susan Pulliam and Rob Barry, Executives' Good Luck in Trading Own Stock, *The Wall Street Journal*, Nov. 27, 2012. This prompted another round of hand-wringing about executives "abusing" Rule 10b5-1 trading plans to garner outsized profits. But this time around, the SEC announced no intention to do anything about it. Michael Siconolfi and Jean Eaglesham, SEC Is Pressed to Revamp Executive Trading Plans, *The Wall Street Journal*, May 9, 2013.

Why the Enhanced Profits?

A number of hypotheses might explain this profitable phenomenon. Trading results might by skewed by executives' power to terminate plans at will (one cannot trade on inside information if one does not trade at all), giving them an "option" to effect beneficial trades, but avoid disadvantageous ones. *See* Alexander P. Robbins, The Rule 10b5-1 Loophole: An Empirical Study, Working Paper, May 3, 2008, http://bit.ly/1dGQeIu. Or, executives might manipulate the timing and content of company news to give their own trading plans an advantage. *See* Stanley Veliotis, Rule 10b5-1 Trading

Plans and Insiders' Incentive to Misrepresent, 47 Am. *Bus L.J.* 313 (2010).

While those are plausible explanations, we, after having seen many plans in operation, discount them. Plans are not terminated that often, and at the release of important company news, more often than not the issuer itself suspends all executive trading plans. Moreover, there would by now have been prosecutions in the wake of such manipulations, and there have been none.

The most likely explanation for the enhanced profits may be that trading plans simply impose investment discipline. Almost all trading plans execute limit orders automatically once certain prices are reached. Executives in trading plans are usually selling at the peaks of a stock's up-and-down market movements, cherry-picking the best prices. Such disciplined traders will naturally outperform others, and there is nothing nefarious about it. *See, e.g.*, Rik Sen, Are Insider Sales Under 10b5-1 Plans Strategically Timed?, New York University, June 2008, http://bit.ly/18vehfp. But none of that animates the headlines. Outsized profits suggest insider trading, and that is what we explore here.

How Rule 10b5-1 Works

Most Rule 10b5-1 stock trades are executed at a time when the executive is in possession of material non-public information. The affirmative defense to insider trading arises because, if the Rule is complied with, the decision to effect that trade — determining in advance the trade's quantity, timing and price — was made when the executive did not have material non-public information. Assuming that the executive did not have material non-public information when he or she adopted the trading plan, and assuming compliance with all of Rule 10b5-1's other requirements, simple logic dictates that the later-executed trades cannot be influenced by inside information.

In a properly implemented Rule 10b5-1 trading plan, the plan's trades are executed by algorithm. Most trades are automatically released to the market without human intervention. Only larger orders will go to a manned trading desk, where a trader will decide when to execute trades so as to maintain an orderly market. The trading executive is not a party to the trader's decisions, and the trader is not privy to any inside information. The execution of pre-planned orders cannot be influenced by material non-public information, because there is no conduit to carry this information, and even if there were, such information could not alter those executions.

Therefore, if a properly implemented Rule 10b5-1 trading plan is infected by inside information, the executive must have had that information when he or she first established the plan. And yet, all trading plans are adopted when an issuer certifies that there is no material non-public information, and almost always within an "open trading window." Thus, any profit advantages of Rule 10b5-1 trading plans necessarily begs the question whether "open trading windows" sufficiently insulate executives from exploitable information.

'Inside Information' and Mental States

The continuum of mental awareness begins with a vague notion and ends with a hard fact. Over the decades, courts have required that "inside information," to be actionable in a securities fraud case, be factual, not mere speculation, inchoate thoughts or plans. Over a half century ago, it was established that federal securities law "requires nothing more that the disclosure of basic facts. … " *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). The practical requirements of litigating real cases drives this emphasis on facts — an element of a claim must be amenable to being proven true or false by evidence. As mental states become increasingly conjectural, they become harder and ultimately impossible to prove. Ideas, goals, plans, hunches, feelings, gut instincts and the like are not factual enough to support an insider trading charge. Not even such quasi-factual matters as motives and legal consequences are enough to support a securities fraud charge. *See, e.g., Stedman v. Storer*, 308 F. Supp. 881 (S.D.N.Y. 1969).

When an issuer opens a trading window, it assumes that whatever mental states then extant have not yet evolved into actionable inside information. But that assumption raises two practical concerns. First, even in an open window, how confident are we that an executive does not have actionable inside information? The conventional thinking followed by most issuers is that a trading window should close six to eight weeks in advance of an earnings release. But that convention assumes actionable inside information first appears when quarterly financial results begin rolling up from divisions for consolidation into the issuer's quarterly or annual reports.

However, most companies adopting Rule 10b5-1 plans are information companies like technology, Internet and pharmaceutical concerns. Executives in such enterprises surely know well in advance of any formal financial reporting what is generally happening in their companies. The information they have may not be concrete enough for periodic reports or even an earnings expectation statement, but it can still provide a trading edge. This is especially true toward the end of the open-window period. Many, perhaps most, trading plans are adopted very late in the open-window period, often in the last week. Relying on convention to close the trading window six to eight weeks ahead of an earnings release may give issuers some comfort, but in truth they cannot really know when informal knowledge has gelled into actionable inside information. They can never quite be sure that they have closed an open window soon enough.

The second question is related: Can even speculative knowledge confer a trading advantage? Ideas, hunches, feelings and gut instincts are not actionable inside information, but it seems unrealistic to say that they do not put an executive in a better position to trade his company's stock. Modern executives bring creativity, imagination and insight to bear on the prospects of their companies, and if they don't one should well wonder why they are paid so much. One need only imagine a Steve Jobs forming a mental picture of the iPod while in Apple's open window. Would not that alone give him a trading advantage, even though nothing exists that can yet be called material non-public information? Looked at in this light, the surprise is perhaps not that executives outperform their peers by 6% to 10%, but that they outperform them by only that much.

Some companies require their executives to seek personal permission to trade from their general counsel, avoiding general open windows. In the face of general counsel's probing questions about the executive's knowledge, some executives may not be permitted to trade or establish plans, and others may not even attempt to. In 2011, Professor Jagolinzer and colleagues published a report that deserves more widespread attention, because it compares how profitable executive trading is between open-window and individual preclearance trading policies. Alan D. Jagolinzer, David F. Larcker, and Daniel J. Taylor, Corporate Governance and the Information Content of Insider Trades, 49 *J. Accounting Research* (*JAR*) 1249 (Dec. 2011). Professor Jagolinzer concluded that executives trading in open windows outperformed those trading with individual preclearance by 7.2%, "suggest[ing] that restricted trading windows, by themselves, are not effective at reducing informed trading." *Id*. at 1252.

This result corroborates our own analysis. But because most Rule 10b5-1 trading plans are adopted in companies using a trading windows policy, the profit advantages of using trading windows apply with equal force to trading plans adopted in such windows. It is no coincidence that the profit advantage of a trading windows policy is in the same range as that typically found for Rule 10b5-1 trading plans. The profit advantages of trading plans have nothing to do with the plans themselves, and everything to do with the open windows when those plans were adopted. The knowledge executives had in the open windows may or may not be actionable inside information, but it is advantageous all the same.

Best Practices

All this suggests two best practices. First, those issuers requiring longer waiting periods between the adoption of trading plans and the first trades under such plans are on the right track. This is not a new suggestion, but now at least we have a better understanding of why it is important. The mere existence of a mandatory waiting period — of any length — necessarily assumes that the executive may have material non-public information, and almost certainly has advantageous knowledge, even in an open window. Acting on that reasonable assumption, a waiting period forces time to pass before executing the first trade under a plan, ensuring that whatever knowledge the executive had when adopting the plan has matured into a disclosable fact or has dissipated as ephemeral. How much time should pass depends on the particulars of the company, but we would recommend at least 60 days.

Second, if open windows alone are not to be trusted, then all executives should be subjected to such a waiting period, and that means that executives should only trade in properly designed Rule 10b5-1 trading plans having long waiting periods.

Conclusion

And so we come full circle to a surprising conclusion. Rule 10b5-1 trading plans cannot logically give executives a trading advantage over other traders; establishing plans in open trading windows appear to do that. Rather than being the culprits, trading plans with appropriate waiting periods provide the best available mechanism to mitigate the profit advantages of an open-window trading policy. Serious policing of executive stock trading requires more, not fewer, Rule 10b5-1 trading plans.

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