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Despite rulings in favor of companies, prearranged stock trading plans for executives come under scrutiny

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SEC Rule 10b5-1 provides that purchases or sales of a company's stock by that company's executives do not constitute insider trading when, among other things, the transactions are made pursuant to a prearranged plan for stock trading that establishes preset amounts and dates or gives discretion for trading decisions to a broker. (*See* 17 CFR § 240.10b5-1(c)).

Courts adjudicating private securities fraud lawsuits broadly agree that trades made pursuant to Rule 10b5-1 plans generally are not suspicious as a matter of law, regardless of whether these trades occur soon after the plan's adoption.

The rationale for this rule is that if executives have decided in advance to make certain trades on a certain date (or given that discretion to someone else), they are not making those trades "on the basis of" any material, non-public information they might possess at the time of the trade. Companies typically have discretion to determine the period of time required between adopting a Rule 10b5-1 trading plan and the first trade under that plan.

Some commentators have suggested that Rule 10b5-1 trading plans may create opportunities for certain executives to realize profits based on inside information if they are allowed to make trades shortly after adopting their Rule 10b5-1 plan.

On June 7, 2021, U.S. Securities and Exchange Commission (SEC) Chairman Gary Gensler stated that the lack of a "cooling off period" before executives may make trades pursuant to a Rule 10b5-1 plan creates "a loophole to participate in insider trading." (*See* Gary Gensler, "Prepared Remarks for CFO Network Summit," https://bit.ly/3S6oZB5, last visited July 28, 2022).

On Dec. 15, 2021, citing "critical gaps" in its "insider trading regime," the SEC proposed amendments to Rule 10b5-1 that would, if adopted, require the "cooling off period" for which Chairman Gensler advocated. (*See* SEC Press Release No. 2021-256, https://bit.ly/3S7jMJg, last visited July 14, 2022).

And on June 29, 2022, The Wall Street Journal published an article claiming, among other things, that corporate insiders who sell stock within 60 days after adopting a Rule 10b5-1 plan make higher profits and are more likely to avoid downturns in the company's stock price than those who sell later after adopting their Rule 10b5-1 plan. (*See* Tom McGinty and Mark Maremont, "CEO Stock Sales Raise Questions About Insider Trading," The Wall Street Journal (June 29, 2022)). The article collects views from academics and other sources suggesting that one possible explanation for any disproportionate profits may be that certain executives have used trades scheduled shortly after the adoption of a Rule 10b5-1 plan to sell stock before the company makes adverse disclosures that may cause its stock price to decline.

Despite this recent scrutiny, courts adjudicating private securities fraud lawsuits broadly agree that trades made pursuant to Rule 10b5-1 plans generally are not suspicious as a matter of law, regardless of whether these trades occur soon after the plan's adoption. In private securities fraud lawsuits brought pursuant to the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995 (PSLRA), courts have typically rejected efforts by plaintiffs claiming that trades made pursuant to Rule 10b5-1 plans constitute evidence that corporate executives knowingly made false statements to the market to inflate the company's stock price, so that they could later profit from insider trading.

For example, in *Harrington v. Tetraphase Pharmaceuticals Inc.,* 2017 WL 1946305 (D. Mass. May 9, 2017), the plaintiffs argued that the court could infer that the defendant pharmaceutical company and its executives knowingly made misleading positive statements about clinical trial results for a new drug because some of the executive defendants sold a large amount of stock while the company's stock price was high, before later bad news about the drug trial drove the price down. (*Id.* at *7).

The defendants countered that there was nothing suspicious about their stock sales because they were prearranged under Rule 10b5-1 trading plans, and the plaintiff did not plead any facts suggesting that the executives knew the clinical trial at issue was going poorly at the time they entered into their trading plans. (*Id.*).

The court agreed with the defendants, holding that the prearranged stock sales were not suspicious as a matter of law, even though two of the defendant executives adopted their Rule 10b5-1 plans two months before the sizable stock sales. (*Id.* at *6-7 & n.11).

Some courts have concluded that trades made pursuant to Rule 10b5-1 plans support an inference of scienter, but only in rare cases with extreme facts.

Most recently, the 2nd U.S. Circuit Court of Appeals held that even when the defendant adopted the Rule 10b5-1 plan after the alleged fraud began, and conducted trades under that plan during the purported class period, the sales were still not suspicious unless the plaintiff could "allege facts indicating that the plan was not 'given or entered into in good faith' or was 'part of a plan or scheme to evade the prohibitions' of the [SEC's insider trading] regulations." (*See*, *e.g.*, *Ark. Pub. Empls. Ret. Sys. v. Bristol-Myers Squibb Co.*, 28 F.4th 343, 356 n.4 (2d Cir. 2022) (quoting 17 C.F.R. § 240.10b5-1(c)(1)(ii))).

By contrast, some courts have concluded that trades made pursuant to Rule 10b5-1 plans support an inference of scienter, but only in rare cases with extreme facts. For example, in *Employees' Retirement System of the Government of the Virgin Islands* v. *Blanford*, (794 F.3d 297 (2d Cir. 2015)), the plaintiff argued that the executive defendants' stock sales during the period when they were allegedly misleading the market about the company's business prospects were evidence that the defendant made the misstatements with fraudulent intent. (*Id.* at 308).

The 2nd Circuit did not find the defendants' Rule 10b5-1 defense persuasive because: (1) the Rule 10b5-1 plans were adopted the day after the alleged fraud began; (2) the defendants sold a large amount of stock pursuant to those plans only a week after adopting them; and (3) one of the defendants' prearranged transactions constituted her only sale of the company's stock in the previous nine years. (*Id.* at 308-309).

As these cases reflect, courts generally have not found stock sales made pursuant to Rule 10b5-1 trading plans suspicious enough to support an inference of scienter in private securities fraud cases governed by the PSLRA, even when executives make trades pursuant to such plans shortly after adopting them. Rather, plaintiffs will typically need to show much more than a short turnaround between adoption of the plan and allegedly suspicious sales, such as: (1) the defendant executive adopted the plan after the fraud began and while the defendant knew information likely to affect the company's stock price adversely; or (2) the sales were sizable and unusual relative to the defendants' trading history.

Recent public scrutiny of 10b5-1 plans notwithstanding, this well-established case law upholds the protections such plans afford in private securities fraud lawsuits absent extreme additional facts creating a strong inference of scienter.

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