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# SEC insider trading rule has loopholes, says study

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A rule to limit trading based on nonpublic stock information has limited effectiveness, according to a recent study by Texas McCombs Finance

Professor Robert Parrino.

Issued in 2000 by the Securities & Exchange Commission, Rule 10b5–1 requires corporate insiders to schedule the purchase or sale of a predetermined number of shares through a third-party broker up to two years in advance. Because the trades under these "plan" sales are scheduled in advance of their execution, insiders are presumed less likely to be acting on inside information.

But how effectively do such plans curb insider trading? Parrino, with co-authors Eli Fich of Drexel University and Anh Tran of City University of London, investigate this by examining 13,930 stock sales by 1,629 CEOs at 1,322 firms from 2013 to 2020.

Researchers found that Rule 10b5–1 plans are widely used, accounting for 61% of all stock sales by CEOs in their sample. As might be expected, plan sales are more common at firms when there is greater risk of litigation, such as when a sale precedes an earnings announcement that might raise insider trading accusations. Rule 10b5–1 plans give executives an affirmative legal defense against accusations of insider trading, Parrino says.

But his research also found that CEOs still have ways to game the system within a plan.

## Calling Off Trades

Executives who schedule trades within a Rule 10b5–1 plan have historically been under no obligation to proceed with them. If an executive knows nonpublic information that could deflate the company's stock price, they can cancel disadvantageous sales by selectively canceling the plan or by using limit orders within the plan. The study reports evidence consistent with the idea that sales are more likely to be cancelled when they would result in a loss.

## Corporate Decisions

CEOs who use a Rule 10b5–1 plan also can benefit when they exercise their influence in two key areas: what and how company information gets publicly reported and high-level decisions on company direction. Both kinds of decisions can bump up the stock price.

"A CEO who wants to behave opportunistically can slow down or speed up the revelation of relevant information," Parrino says.

"The CEO can also make operating decisions that affect the business in ways that weren't predictable at the time the plan was set up but that can benefit the CEO now."

The study did show that abnormal profits on CEO stock sales are smaller when executed within plans rather than outside them. That suggests the plans discourage some insider trading.

But there's one big exception: When stock being sold represents a higher percentage of the CEO's overall holdings of the firm's stock, the abnormal profits mirror those from sales outside of a plan.

"This suggests that when a lot of money is at stake, you are more likely to see more opportunism even within plans," Parrino says.

To close these loopholes, SEC financial disclosure regulations took effect in April 2023 requiring executives to wait 90 days after starting or changing a trading plan before trading any of the reported stock. They also require executives to detail their 10b5–1 plans in quarterly and annual reports. The SEC cited Parrino's study in its proposal.

"To the extent that these plans are not fully eliminating opportunistic behavior, their characteristics can be tweaked to improve their effectiveness," he says.

"When and How are Rule 10b5–1 Plans Used for Insider Stock Sales?" is published in the *Journal of Financial Economics.*

**More information:** Eliezer M. Fich et al, When and how are rule 10b5-1 plans used for insider stock sales?, *Journal of Financial Economics* (2023). DOI: 10.1016/j.jfineco.2023.04.009

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