INSIDER V. ISSUER: RESOLVING AND PREVENTING INSIDER TRADING COMPLIANCE POLICY DISPUTES

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During the 1990s, the use of stock-based compensation by U.S. companies skyrocketed. Many companies bound their officers and employees to insider trading compliance policies, requiring personnel to pre-clear proposed transactions in company securities with a compliance officer. These policies, however, frequently fail to stipulate the precise level of discretion afforded the compliance officer. Accordingly, if a compliance officer's decision to withhold pre-clearance results in losses in the insider's stock or stock-option portfolio, the insider can sue the issuer for breach of the covenant of good faith. In this Comment, Steven Chasin proposes a standard—analogous to the business judgment rule—to adjudicate such lawsuits: The insider must prove an improper clearance process, manifested by the compliance officer's failure to make an informed decision in good faith. The author explains that this standard is appropriate because the distinction between legal and illegal insider trading is often unclear. He shows that issuers need wide discretion to minimize their exposure to an array of potential liabilities that arise both directly and indirectly from insider trading. Finally, the author proposes several recommendations to issuers to prevent such insider lawsuits.

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INTRODUCTION

Return to early 2000, and imagine the vice president of a Silicon Valley company preparing to liquidate his stock options.[1] As required by the company's insider trading compliance policy, the VP requests that the company's compliance officer "pre-clear" his transaction.

Unbeknownst to the VP, the CEO is secretly negotiating a merger of the company. These merger discussions constitute material nonpublic information—the sort of information that, if traded upon, could engender liability for illegal insider trading.[2] Citing "insider trading concerns," the compliance officer refuses to approve the VP's transaction. As the company's stock price climbs to an all-time high, the VP desperately awaits clearance.

Then comes the April 14 NASDAQ crash. In its wake, the company's stock loses 80 percent of its value, and the VP's options become worthless. The VP sues the issuer, demanding the lost value of his options. He alleges that the compliance officer exercised bad faith in withholding pre-clearance and misconstrued the compliance policy's definition of insider trading. How should a court rule?

Issuers of publicly traded securities (such as the above company) rely on compliance policies to minimize exposure to liability stemming directly and indirectly from insider trading (IT) in issuer securities. Yet because these policies often fail to address the level of discretion afforded the compliance officer making the critical pre-clearance decision, these policies can backfire, engendering litigation rather than preventing it. This Comment proposes a standard for adjudicating such disputes: The insider must prove an improper pre-clearance process, manifested by the compliance officer's failure to make an informed decision in good faith. Absent such a showing, the issuer should have plenary discretion to withhold clearance.

Part I of this Comment examines the problematic provisions of typical IT compliance policies. Part II analyzes the potential claims an insider—like the VP above—can bring against an issuer refusing trading approval under such a policy. Part III explains why issuers need and deserve broad discretion in deciding whether to clear insider transactions. Part III also

1. During the exercise period, stock options can be easily liquidated in a one-step transaction through a broker. Rather than first pay cash to buy the option stock and then later sell it, the option holder's broker pays the exercise price to the issuer, which delivers the option stock to the broker. The broker presumably sells this stock to the public at market value, delivering the "spread" (market value less exercise price and commission) to the option holder. The above vice president is anticipating liquidating his options through such a "cashless" exercise.

2. Part III.A of this Comment explains in detail what gives rise to insider trading liability. *See generally* STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 1 (1999).

provides a brief background to IT law, describing what makes an inside transaction illegal and how such transactions directly and indirectly subject the issuer to liability. Part IV articulates a legal standard for adjudicating the insider's claims against the issuer. Finally, Part V suggests improvements issuers can make in compliance policies to obviate such lawsuits.

I. IT COMPLIANCE POLICIES

When personnel trade in the securities of their employer, they expose the company to a host of liabilities, including control person liability and the risk of class action shareholder suits.[3] The response by many public corporations has been to bind directors, officers, and upper-level employees to an insider trading compliance policy when joining the corporation.[4] While federal law imposes an affirmative duty on *broker-dealers and investment advisors* to maintain "written policies and procedures reasonably designed"[5] to prevent illegal IT, federal law does *not* impose any such duty on *issuers*.[6] Nor does federal law even expressly empower issuers to constrain trading activity by personnel.[7] Rather, the issuer must *bargain* for any restraints it imposes on its personnel. While the insider and issuer typically do not expressly

3. See Part III.B for a complete discussion of potential liabilities to issuers.

4. Ninety percent of responding public companies in a 1989 survey indicated that they maintain an insider trading (IT) policy. Alan M. Weinberger, *Preventing Insider Trading Violations: A Survey of Corporate Compliance Programs*, 18 SEC. REG. L.J. 180, 190 (1990). These policies may be merely a component of a larger ethics policy, or an elaborate memorandum exclusively devoted to insider trading. *Id.* at 190–91.

5. 15 U.S.C. § 78(o) (2000).

6. However, as Part III explains, the issuer faces control person liability for the illegal IT of its personnel. The establishment of an illegal insider trade is a predicate for such liability. Given such a violation, the enforcement of an IT compliance policy may stand in great stead in the issuer's defense.

7. While section 306(a) of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15, 18 U.S.C.), prohibits an issuer's officers and directors from engaging in certain transactions in the issuer's stock, the statute does not expressly empower or mandate the issuer to constrain such transactions. 15 U.S.C. § 7244(a). Entitled "Prohibition of Insider Trading During Pension Fund Blackout Periods," section 306(a) expressly prohibits, during blackout periods in the issuer's pension plans, an officer or a director from transacting in those equity securities of the issuer acquired in connection with his service to the issuer as an officer or director. *Id.* During a "blackout period," which an issuer typically imposes when making administrative changes to a plan, participants are locked into their existing investment choices and cannot move their funds. Insider Trades During Pension Fund Blackout Periods, 67 Fed. Reg. 69,430–01 (Nov. 7, 2002) (to be codified at 17 C.F.R. pt. 240, 245, 249). A blackout can have catastrophic consequences if plan participants are heavily invested in their employer's stock, and the employer's stock price falls sharply during the blackout period. *Id.* For instance, Enron Corporation imposed a blackout period from October 17 to November 19, 2001, to make administrative changes to its 401(k) plan. Ellen E. Schultz & Theo Francis, *Fair Shares? Why Company Stock is a Burden for Many and Less So for a Few*, WALL ST. J., Nov. 27, 2001, at A1. This prevented employees from selling Enron shares in their 401(k)'s while the stock price plummeted amid an SEC investigation into the company's accounting practices. *Id.* During this time, Enron executives who acquired

negotiate IT policy terms, the insider's acceptance of the policy is a term of the overall employment contract which the parties do expressly negotiate. In return for the insider's promise to serve the issuer and comply with, amongst other terms, the issuer's IT policy, the issuer promises compensation and other rights. Typically, the insider's "non-compliance is a ground for dismissal."[8]

A representative compliance policy provides a definition of illegal IT, describes the civil and criminal consequences of IT violations, and explains why the company has adopted its policy.[9] It then describes the rights the company has to control IT. Generally, issuers use one or more of the following control mechanisms: (1) a blanket ban on misappropriation of material nonpublic information,[10] (2) "trading windows,"[11] (3) blackout periods, and

company stock through equity compensation plans outside of the 401(k) plan were free to cash out their stock options and Enron stock. *Id.*

Section 306(a) addresses this inequity by effectively placing directors and officers in the same position as rank and file employees during a blackout period. When a substantial number of issuer employees are unable to transact in employer stock in their individual pension plans, section 306(a) prohibits the issuer's officers and directors from engaging in transactions in issuer stock acquired by dint of the officer's or director's service to the issuer. 15 U.S.C. § 7244(a). While section 306 requires the issuer to notify officers and directors of any blackout periods, it apparently places the onus of complying with the trading ban on the officer or director—the law neither empowers nor mandates the issuer to constrain such trading. *Id.* § 7244(b). Nonetheless, it is likely that issuers will utilize IT compliance policies—imposing trading blackouts or pre-clearance requirements—to prevent officer or director trading that contravenes section 306(a).

8. Alan J. Berkeley, *Form of Summary Memorandum and Sample Corporate Policy on Insider Trading*, *in* SECURITIES LAW FOR NONSECURITIES LAWYERS 457, 471 (A.L.I.-A.B.A. Course of Study, Jan. 25, 2001).

9. One sample 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." Dale E. Short & Yvonne E. Chester, *Form: Sample Insider Trading Policy*, *in* ADVISING AND DEFENDING CORPORATE DIRECTORS AND OFFICERS 437, 437 (Joseph F. Troy & William D. Gould eds., 1998).

10. One sample policy states:

> If a director, officer, or any employee knows of material nonpublic information relating to the Company, it is our policy that neither that person nor any related person may buy or sell the Company's securities or engage in any other action to take advantage of, or pass on to others, that information.

Id. at 438.

11. Professor Stephen Bainbridge explains the function of trading windows:

> [Trading windows confine trading by issuer insiders to] a specified window of time after the corporation has issued its quarterly and annual reports. . . . Because of the substantial and wide-ranging disclosures required in these reports, which are publicly available, 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.

BAINBRIDGE, *supra* note 2, at 85–86. Because the opening and closing of trading windows hinges on the timing of various disclosures, trading windows implicate little or no discretion by the compliance officer. An insider who suffers losses during a normally closed trading period has no obvious grounds for suit. Accordingly, other than in the context of supplemental blackout periods, this Comment does not focus on trading windows.

(4) pre-clearance. Unlike the former two systems, black-out periods and pre-clearance involve a high degree of judgment by the compliance officer[12] and are therefore likely to be the source of dispute. The following discussion, after describing how black-out periods and pre-clearance systems work, explains why.

When a compliance officer declares a blackout period, he bans trading by a group of insiders during an otherwise open window. The compliance officer may impose a blackout if he becomes aware of material nonpublic information about the company.[13] A blackout provision from a sample IT compliance policy follows:

> Additional black-out periods also may be imposed by the Company on Category I [all officers, directors, and other persons with potential access to inside information] or Category II persons [key employees, employees who are manager-level and above, and all employees located at the Company's principal executive office] or other employees to the extent necessary or desirable to comply with securities or other laws, and the Company will notify those persons in such an event. The Company generally will not disclose the reason for additional black-out periods.[14]

Pre-clearance, on the other hand, requires insiders to obtain permission from the compliance officer before trading. This requires that the compliance officer *specifically* consider what information the *petitioner* knows or has access to. A sample policy provides:

> All transactions in the Company's securities . . . by Category I persons [all officers, directors, and other persons with potential access to inside information] must be pre-cleared by the [compliance officer]. If you contemplate a transaction, you should contact [the compliance officer] at least <u>two business days in advance</u>.[15]

The critical flaw in the above blackout and pre-clearance provisions is their failure to articulate *how much* discretion they afford the compliance officer making these decisions. Does the compliance officer's perception of a modicum of risk justify exercising these provisions? Or must the officer have

12. The compliance officer may be the company's in-house counsel, secretary, or other individual privy to all significant, undisclosed corporate information (such as pending merger negotiations, earning estimates, new products, or discoveries, and the like) that could be the basis for illegal IT. *See* Marc I. Steinberg & John Fletcher, *Compliance Programs for Insider Trading*, 47 SMU L. REV. 1783, 1832 (1994).

13. As Part III explains, material, nonpublic information is the predicate for *illegal* insider trading. *See* BAINBRIDGE, *supra* note 2, at 1.

14. Short & Chester, *supra* note 9, at 442.

15. *Id.* at 441.

"probable cause" that the insider's transaction will violate federal law? This ambiguity is the basis of an insider's lawsuit.[16]

II. THE COVENANT OF GOOD FAITH

Under certain circumstances, the insider might sue the issuer for fraudulent inducement,[17] securities fraud,[18] or breach of fiduciary duty.[19] However, the insider's best shot against the issuer is probably breach of contract—specifically, breach of the covenant of good faith. Breach of good

16. For simplicity, this Comment will henceforth refer to both blackout and pre-clearance simply as pre-clearance. While the two are functionally different, both have the potential to engender litigation because of the ambiguity regarding compliance officer discretion. Pre-clearance is arguably the more probable basis for an insider lawsuit because it is a personal, individualized ban on trading. A blackout decision, on the other hand, usually applies to a large class of insiders.

17. Under a fraudulent inducement claim, the insider would allege that the issuer enticed the insider to accept the options in lieu of substantially higher cash compensation, from the outset never intending to allow the insider to exercise his options.

18. The fraudulent inducement theory in footnote 17 also supports a claim under SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002) (promulgated under section 10(b) of the Securities Exchange Act of 1934, ch. 404, 48 stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm)), because the issuer's fraud is "in connection with the purchase or sale of any security," and satisfies the rule's deception and scienter requirements. *See* Aaron v. SEC, 446 U.S. 680, 691 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). The insider might also claim that the issuer violated its duty to *publicly* disclose the pending development (merger negotiations, for instance) on which the issuer ostensibly based its trading ban. An issuer's affirmative duty to disclose publicly material corporate developments is unresolved. "Several lower courts have stated that the prevailing view is that a corporation has no affirmative duty to disclose material information absent the following: insider trading; a specific statute or regulation requiring disclosure; and materially inaccurate, incomplete, or misleading prior disclosures." WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 894–95 (1996). However, because these claims are highly factually dependent, this Comment does not further address them.

19. The insider could also allege the issuer fraudulently withheld *from him* information relevant to the exercise of his options. In *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), an employee of a *close corporation* who held stock in the company alleged it had a duty to disclose to him germane information when he averred his intention to sell back his stock to the company. He argued that had the company properly disclosed to him that it was secretly negotiating a merger—which would increase the value of his shares thirtyfold—he would not have sold his stock. *Id.* at 432–33. The U.S. Court of Appeals for the Seventh Circuit held that he stated a claim: "[C]lose corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts." *Id.* at 435. However, it is unclear, arguably doubtful, that this rule applies to *public corporations*. Regarding this fiduciary duty, the *Jordan* court stated, "The treatment of public and private corporations is different because of the potential effects of disclosure." *Id.* at 431. "To tell one stockholder of a *publicly traded firm* is to tell all, letting the cat out of the bag." *Id.* at 434 (emphasis added).

If the issuer fired the insider for trading in violation of its IT policy, the insider might claim that the company's duty of loyalty and good faith to its shareholders prevented it from terminating him. However, *Ingle v. Glamore Motor Sales, Inc.*, *535 N.E.2d 1311 (N.Y. 1989)*, held that "minority shareholder status" alone does not confer "a fiduciary-rooted protection against being fired." *Id.* at 1313. For our purposes, such a claim would likely fail. *Ingle* warns that it is necessary to "keep distinct the duty a corporation owes to a minority shareholder *as a shareholder* from any duty it might owe him as an employee." *Id.*

faith is appropriate because closure provisions often *do not expressly* predicate the issuer's right to close the trading window on preventing illegal IT. In the sample pre-clearance provision above, for instance, nary are the words "insider trading." At best, only the surrounding policy language implies that the issuer is closing the window because of legitimate IT concerns. Thus, the duty of good faith—implied in every contract[20]—provides the insider a claim.

Even where policies *expressly* tie closure rights to illegal IT, the tying condition is typically so broad as to be illusory, so again the insider likely resorts to claiming breach of good faith. For instance, the sample blackout provision in Part I allows closure "to the extent necessary or desirable to comply with securities or other law."[21] Such a condition does little to cabin the issuer's closure rights: The issuer can always defend its action on the ground that it was "desirable to comply with securities . . . law." Thus, here too, the insider likely sues on the basis of good faith.

What does good faith demand of the issuer? The Delaware Court of Chancery says that good faith requires parties to comply with any provisions which the parties *would have* incorporated into their agreement had the parties negotiated ex ante:

> [I]s it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter? If the answer is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.[22]

Substituting the issuer's exercise of broad discretion for the above "act," we must inquire whether the *issuer* would have bargained to give the *insider* the benefit of the doubt in deciding definitional issues of insider trading. As a general proposition, the issuer would not. As Part III explains, the issuer faces great uncertainty in ascertaining the legality of an insider's transaction. The illegality of even a single trade directly exposes the issuer to substantial liability. Moreover, even a legal trade can indirectly subject the issuer to liability. It would therefore be reasonable—and sensible—corporate prac-

20. Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986); Dalton v. Educ. Testing Serv., 663 N.E.2d 289, 291 (N.Y. 1995).

21. Short & Chester, *supra* note 9, at 442.

22. *Katz*, 508 A.2d at 880. The New York Court of Appeals provides a somewhat similar formulation of this concept: "Encompassed within the implied obligation of each promisor to exercise good faith are 'any promises which a reasonable person in the position of the promisee would be justified in understanding were included.'" *Dalton*, 663 N.E.2d at 291 (quoting Rowe v. Great Atl. & Pac. Tea Co., 385 N.E.2d 566 (N.Y. 1978)).

tice for an issuer to bargain for a wide margin of error in its evaluation of insider transactions.

III. HOW INSIDER TRADING AFFLICTS ISSUERS

A. What Constitutes an Illegal Insider Trade?

One reason an issuer maintains a compliance program is that it faces direct liability if a court deems an insider's trade illegal.[23] However, as this part explains, the distinction between legal and illegal insider trading may be obscure and difficult for the compliance officer to assess.

The seminal case *SEC v. Texas Gulf Sulfur Co.* (*TGS*) announced what has become known as the "disclose or abstain rule," which is the fundamental rule governing insider trading.[24] In the federal government's assault on IT by *issuer* personnel, *TGS* gave teeth to the hitherto edentulous SEC Rule 10b-5.[25] *TGS* holds that when *an insider possesses material nonpublic information, he must disclose this information prior to trading, or abstain from trading*[26] until the information is public.[27] *TGS* premised the insider's "disclose or abstain" duty on a theory that all investors should enjoy "equal access" to market information.[28] *TGS* cast a wide liability net: Under the "equal access" theory, the mere possession by anyone of material nonpublic information seemingly would trigger their duty to disclose or abstain from trading. A subsequent ruling—*Chiarella v. United States*[29]—replaced *TGS*'s "equal access" theory with a fiduciary relationship requirement. *Chiarella* held that it is the insider's "relationship of trust and confidence" with the counterparty to the trade—and not the possession of inside information—that trig-

23. Part III.B of this Comment explains that the issuer faces, inter alia, control person liability under sections 20(a) and 21A of the Securities Exchange Act of 1934.

24. 401 F.2d 833 (2d Cir. 1968).

25. SEC Rule 10b-5 is the statutory genesis of the modern federal proscription on IT by "classic" insiders like officers and directors. However, nary are the words "insider trading" in the rule. Rather, federal common law almost entirely informs regulation of trading by such insiders. The first case showing that insider trading through securities markets is a violation of Rule 10b-5 was *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), which was a tipping case involving brokers. *SEC v. Texas Gulf Sulfur Co.* (*TGS*), 401 F.2d 833 (2d Cir. 1968), on the other hand, showed that the ambit of the Rule 10b-5 prohibition of IT reaches "classic insiders." The SEC prevailed against officers and employees of TGS (a mining company) who bought company stock as well as call options on TGS stock based on undisclosed information about ore discoveries. *TGS*, 401 F.2d at 852–53; *see also* BAINBRIDGE, *supra* note 2, at 41–44.

26. The trading ban applies only to equity securities. *See* BAINBRIDGE, *supra* note 2, at 90.

27. *TGS*, 401 F.2d at 848. The "disclose or abstain" rule effectively requires insiders to "abstain" from trading until the issuer publicizes the undisclosed information. An insider cannot "disclose" corporate secrets without breaching his fiduciary duty of loyalty and secrecy. *See* BAINBRIDGE, *supra* note 2, at 46–47.

28. *TGS*, 401 F.2d at 848.

29. 445 U.S. 222 (1980); *see* BAINBRIDGE, *supra* note 2, at 49–57.

gers the insider's disclose or abstain duty.[30] Issuer insiders—officers, directors, and "key employees who have been given access to confidential information for corporate purposes"—owe a fiduciary duty to issuer shareholders and thus clearly satisfy *Chiarella*'s "relationship of trust and confidence" requirement.[31] However, two elements above—possession and materiality—may greatly frustrate a compliance officer's attempt to distinguish legal from illegal IT.

1. Possession

Prior to 2000, it was uncertain whether a defendant had to "use"[32] material inside information or merely have "knowing possession"[33] of it to be liable for illegal IT.[34] Then the SEC adopted Rule 10b5-1, which declares that the insider satisfies Rule 10b-5's scienter requirement when he trades "on the basis of"[35] material nonpublic information, meaning that "the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale."[36]

Rejecting the higher "use" standard, Rule 10b5-1 arguably embodies the lower "knowing possession" standard. While "knowing possession" does not constitute strict liability, it comes close. If the insider was merely aware of material, nonpublic information when he traded, he is liable;[37] it is irrele-

30. *Chiarella*, 445 U.S. at 230.

31. Professor Stephen Bainbridge explains: "Although the question of whether all corporate employees will be deemed insiders remains open, there seems little doubt that the insider trading prohibition includes not only directors and officers, but also at least those key employees who have been given access to confidential information for corporate purposes." BAINBRIDGE, *supra* note 2, at 68.

For example, *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983), states that "[i]t is well settled that traditional corporate 'insiders'—directors, officers and persons who have access to confidential information—must preserve the confidentiality of nonpublic information that belongs to and emanates from the corporation." *Id.* at 10. *Dirks v. SEC*, 463 U.S. 646 (1983), also supports this proposition:

> In the seminal case of *In re Cady, Roberts & Co.*, the SEC recognized that the common law in some jurisdictions imposes on "corporate 'insiders,' particularly officers, directors, or controlling stockholders" an "affirmative duty of disclosure . . . when dealing in securities." The SEC found that . . . breach of this common law duty also establish[ed] the elements of a Rule 10b-5 violation . . . .

Id. at 653 (citations omitted) (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 & n. 13 (1961)).

32. SEC v. Adler, 137 F.3d 1325, 1332 & n.20 (11th Cir. 1998).

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

34. *See* BAINBRIDGE, *supra* note 2, at 86–89.

35. SEC Rule 10b5-1(a), 17 C.F.R. § 240.10b5-1(c) (2002).

36. SEC Rule 10b5-1(b), *Id.* § 240.10b5-1(b).

37. SEC Rule 10b5-1(c) provides several very narrow affirmative defenses, such as trading the security through a preplanned trading program. 17 C.F.R. § 240.10b5-1(c).

vant that he did not actually employ that information in his decision to trade or did not know the illegal nature of his behavior.

To determine the legality of a proposed trade, a compliance officer must determine (in a very short time period) if the insider is "aware" of material nonpublic information. Because an employee may respond untruthfully to officer inquiries, in certain situations it may be almost impossible for the officer to make this determination empirically. This subjects the officer to the risk of a court reviewing the transaction in hindsight. If the compliance officer grants pre-clearance because he can find no indication that the employee is "aware" of pending developments, evidence may subsequently surface convincing a court that the insider possessed the information and that the trade was indeed illegal.

Issuers confront the problem of when to deny pre-clearance requests by using one of two decisionmaking strategies. The compliance officer can decide to reject transactions proposed by an insider who is apparently unaware of material inside information, but only if the insider has authorized access to it. Alternately, the officer can reject transactions by an insider who is apparently unaware of the information and lacks authorized access to it. Withholding pre-clearance under the latter standard affords the issuer greater protection. It addresses the risk that the insider has gained, or will gain, the information during the interim, by authorized or unauthorized means or merely by fortuity. As such, it eliminates the risk that courts will second-guess the compliance officer. This response is therefore sensible and reasonable because of the inherent difficulty in determining possession and distinguishing between legal and illegal IT.

2. Materiality

Materiality presents a similarly problematic determination for compliance officers. *Basic Inc. v. Levinson*[38] established a "highly fact-dependent probability/magnitude balancing approach" to determine materiality, requiring assessment of both the probability of an event's occurrence and its importance.[39] *Basic*'s probability-magnitude test is problematic because "[t]he court never tells us how high a probability nor how large a magnitude is necessary for information to be deemed material."[40] While courts have

38. 485 U.S. 224 (1988).

39. *Id.* at 239 n.16.

40. BAINBRIDGE, *supra* note 2, at 35–36. Professor Bainbridge illustrates this problem by comparing the probability-magnitude test to the Hand Formula from torts. *Id.* The two tests are similar because both require highly subjective valuations of probability and magnitude, on the one hand, and burden (B), probability (P), and liability (L), on the other. However, Professor Bainbridge shows that the probability-magnitude test is significantly more subjective. The Hand Formula is a self-contained test: Plug in values, and you get "negligence" when B<P*L. *Id.* The

deemed insider information regarding acquisitions material in some cases, they have deemed it immaterial in others.[41] This extremely subjective standard creates the significant risk that a court may second-guess the issuer's materiality determination. Given the issuer's astronomical liability—explained next—which may accrue should a court deem an insider transaction illegal, it is reasonable and sound for issuers to err on the side of materiality and consequently withhold pre-clearance.

B. Issuer Exposure

1. Direct Exposure

Section 20(a) of the Securities Exchange Act of 1934[42] (Exchange Act) imposes potential joint and several liability on an issuer for its insiders' illegal IT.[43] Because an issuer "controls" its employees, officers, and directors, any securities violation by these insiders—including insider trading—exposes the issuer to liability for an amount equal to the insider's liability.[44] Both the SEC and private parties may bring claims.[45] However, Section 20(a) provides a defense: the issuer's "good faith." "This defense provides an incentive [for issuers] to implement procedures to . . . deter insider trading."[46]

An issuer faces additional, and more substantial, control person liability under the Insider Trading and Securities Fraud Enforcement Act of 1988[47] (ITSFEA). Congress enacted ITSFEA "in response to a series of Wall Street trading scandals and in order to restore confidence in the securities markets

probability-magnitude test, on the other hand, yields a product lacking any inherent significance; it is useful only for cross-case comparison and subjective analysis. *See id.*

41. Courts have deemed information material when it concerned acquisition *of* the issuer, *see, e.g.*, SEC v. Mayhew, 121 F.3d 44, 52 (2d Cir. 1997); SEC v. Geon Indus., Inc. 531 F.2d 39, 47–48 (2d Cir. 1976), and when it concerned acquisition *by* the issuer, *see, e.g.*, United States v. Mylett, 97 F.3d 663, 667 (2d Cir. 1996). For an example of a court holding such information immaterial, see Taylor v. First Union Corp., 857 F.2d 240, 244–45 (4th Cir. 1988).

42. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm).

43. Section 20(a) of the Securities Exchange Act of 1934 provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (2000).

44. *See* Berkeley, *supra* note 8, at 462–63.

45. *Id.* at 463.

46. Steinberg & Fletcher, *supra* note 12, at 1785–86.

47. Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.). ITSFEA amends the Securities Exchange Act of 1934.

in the wake of the stock market crash of October 1987."[48] The SEC has a higher pleading burden to meet under ITSFEA than under section 20(a): It must prove that (1) the issuer "knew or recklessly disregarded" the fact that that a director, officer, or employee was "likely to engage" in insider trading and (2) the issuer "failed to take appropriate steps" to prevent such trading.[49] On the other hand, ITSFEA provides substantially higher penalties: The issuer may be liable for the greater of $1.1 million, or treble the profit gained or loss avoided by inside trader.[50] Professor Weinberger explains that Congress enacted this new control person regime to further pressure corporations to police insider trading:

> The 1988 Act recognizes the obvious inability of government to prevent insider trading. It conscripts public corporations to police employee insider trading by raising the level of risk facing employers. Congress dramatically increased the penalties that may befall employers for employee insider trading, creating a strong economic incentive for public companies to adopt and implement written policies and procedures to prevent unlawful insider trading and tipping.[51]

Despite these onerous provisions,[52] reported cases of lawsuits against *issuers* as controlling persons under sections 20(a) or 21A(b) are uncom-

48. WANG & STEINBERG, *supra* note 18, at 813. For *broker-dealers or investment advisors*, the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) expressly requires the implementation and enforcement of written compliance policies designed to prevent insider trading abuses by employees and their associated persons. 15 U.S.C. §§ 78o(f), 80b-4a. For *issuers*, there is no such requirement—compliance policies are voluntary.

49. 15 U.S.C. § 78-1. Under section 21A(b)(1)(A), the SEC must prove that the "'controlling person knowingly or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation *and* failed to take appropriate steps to prevent such act or acts before they occurred.'" Berkeley, *supra* note 8, at 463 (quoting § 78u-1(b)(1)(A)).

Private parties (contemporaneous traders) suing under ITSFEA must discharge the burden of proof set forth in section 20(a), subject to that section's "good faith" defense. *Id.* at 464.

50. The Securities Exchange Act of 1934 provides that the penalty for the controlling person "shall not exceed the greater of $1,000,000, or three times the amount of the profit gained or loss avoided as a result of such controlled person's violation." § 78u-1(a)(3).

51. Weinberger, *supra* note 4, at 182–83.

52. Under Exchange Act section 32, issuers may also face criminal prosecution as controlling persons of employees engaged in illegal IT. In this context, "corporations may receive additional incentives to adopt legal compliance programs under the criminal sentencing guidelines for organizations. Under these guidelines, a mitigating factor in determining the criminal sentence to be imposed is whether the subject organization has in place an effective and operational code of conduct." WANG & STEINBERG, *supra* note 18, at 885. "If an offense occurs despite such a program, the base fine to which the company would otherwise be subject will be reduced by as much as 20 to 60% of what it would have been in the absence of such a program." Alan L. Dye, *Securities Law Compliance Programs*, in POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW, 1043, 1055 (A.L.I.-A.B.A. Course of Study, Aug. 24–26, 2000).

It is also possible, albeit unlikely, for an issuer to be liable for an employee's illegal trade under a theory of respondeat superior and section 10(b). Respondeat superior imposes vicarious liability on a principal for its agent's illegal acts committed within the scope of employment. The seminal case of *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), casts doubt mon.[53] In one case, *Dau v. Cephalon, Inc.*,[54] the plaintiff sued the issuer as a controlling person under both section 20(a) and ITSFEA for the alleged insider trading of its employees. The *Dau* court refused to dismiss this portion of the complaint,[55] but there is no reported outcome on the merits. Yet this paucity of reported cases does not undermine the issuer's case for broad discretion. "The SEC appears to have a policy of 'zero tolerance' for insider trading violations."[56] If the SEC has a cause of action, it is fair for the issuer to assume the SEC will act upon it. Indeed, one lawyer practitioner writes, "A policy that is not enforced *effectively* often is more perilous than no policy at all."[57] Regardless of the likelihood of control person liability, the threat of ruinous securities litigation—discussed next—is seemingly ubiquitous.

2. Indirect Exposure

Arguably, shareholder litigation is the greatest indirect threat that insider trading poses to the issuer. If the issuer's stock price plummets, shareholders may file a class action suit, alleging issuer fraud and citing misleading financial statements or nondisclosure.[58] Since the enactment of the Private Securities Litigation Reform Act of 1995[59] (PSLRA), insider trading allega-

on the application of this principle to section 10(b). In *Central Bank*, the Court held that there was no aiding-and-abetting liability in private actions under section 10(b). *Id.* at 191. If this holding broadly means that private actions under section 10(b) may only be brought against buyers and sellers (and not, for instance, against their principals), then respondeat superior claims against issuers may no longer be viable. *See* WANG & STEINBERG, *supra* note 18, at 811.

53. Nonissuer defendants—such as broker-dealers—are more common. *SEC v. Haddad*, No. 92-CV-9122 (Dec. 17, 1992 S.D.N.Y.), Exchange Act Release No. 13,473, 1992 LEXIS 3294, at *1, was "the first occasion that the Commission [ ] instituted an enforcement action based upon the 'controlling person' liability provisions of ITSFEA.'" *Id.* The SEC sued Jeffrey Brooks Securities, Inc. for recklessly failing to prevent one of its brokers—the controlled person—from engaging in illegal IT. *Id.*

54. No. 99-CV-2439, 2000 WL 1469347, at *1 (E.D. Pa. Sept. 25, 2000); *see also* Carney v. Cambridge Tech. Partners, Inc., 135 F. Supp. 2d 235 (D. Mass. 2001) (dismissing the plaintiff's section 20(a) suit against the issuer because the underlying IT violation failed).

55. *Dau*, 2000 WL 1469347, at *6.

56. ROBERT W. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL 510 (5th ed. 2000).

57. Berkeley, *supra* note 8, at 467 (emphasis added).

58. When a company unexpectedly fails to meet an earnings projection and its share price consequently plummets, it is highly vulnerable to Rule 10b-5 shareholder litigation. Baruch Lev, *Disclosure and Litigation*, 37 CAL. MGMT. REV. 8, 9 (1995). In addition to a price drop, the following additional attributes characterize an issuer likely to get sued: outstanding stock performance prior to the drop, outstanding corporate earnings and revenue growth rates, a strong institutional investment and analyst following, and optimistic financial statement disclosure. *See id.* at 13, 15–18.

59. Pub. L. No. 104–67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

tions have become pivotal to the success of these suits.[60] The PSLRA introduced a heightened pleading requirement, imposing a particularized standard for the defendant's state of mind.[61] To meet the scienter requirement of Rule 10b-5, the shareholder must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[62]

Shareholders now frequently allege insider trading to meet the "strong inference" requirement.[63] Insider trading allegations work because when executives sell large volumes of stock at suspicious times, one may infer that these executives had knowledge of disappointing, material, nonpublic information. Knowing that publication of this information would precipitate a share price fall, these executives, the argument goes, had a motive to manipulate disclosure until they sold off their own shares.

The PSLRA's "strong inference requirement" has made issuer control of insider trading critical to the prevention of shareholder litigation. One study showed that prior to the PSLRA, only about 20 percent of private securities suits contained allegations of insider trading.[64] Post-PSLRA, vari-

60. The professed purpose of the Private Securities Litigation Reform Act of 1995 (PSLRA) was to stem strike suits: meritless class actions brought by entrepreneurial attorneys to obtain a negotiated settlement. HAMILTON, *supra* note 56, at 560–61. The House of Representatives Conference Report on the PSLRA stated:

> Congress has been prompted by significant evidence of abuse in private securities lawsuits to enact reforms to protect investors and maintain confidence in our capital markets. The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include . . . the routine filing of lawsuits against issuers . . . whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action . . . [and] the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle.

H.R. CONF. REP. NO. 104-369, at 31 (1995). To correct these abuses, the PSLRA changed the pleading, proportionate liability, discovery, and other provisions in securities litigation. HAMILTON, *supra* note 56, at 562–70. For an entertaining article about Bill Lerach—the preeminent class-action securities fraud attorney—and the debate surrounding the enactment of the PSLRA, see Jeffrey Toobin, *The Man Chasing Enron: Why America's C.E.O.s Hate Bill Lerach*, NEW YORKER, Sept. 9, 2002, at 86.

61. 15 U.S.C. § 78O-4(b)(2) (2000). Prior to the PSLRA, courts of appeal adopted different standards as to how plaintiffs satisfy Federal Rule of Civil Procedure Rule 9(b), which requires allegations of fraud to be made "with particularity." FED. R. CIV. P 9(b). Somewhat notoriously, the U.S. Court of Appeals for the Ninth Circuit held that the mere allegation that scienter existed satisfied Rule 9(b)'s "particularity" requirement. HAMILTON, *supra* note 56, at 568–69.

62. § 78O-4(b)(2).

63. *Id.*

64. Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience*, 29 ANN. INST. ON SEC. REG. 1998, at 241, 261 (1998) (citing Laura E. Simmons, Rule 10b-6 Litigation: An Examination of Merit and Nonmerit-Based Factors Associated with Litigation Outcomes (Aug. 1996) (unpublished Ph.D. dissertation)).

ous studies show that *between 48 percent*[65] *and 52 percent*[66] of complaints allege insider trading.[67] Because the legality of a transaction may not be determined until trial, evidence of *any* insider sale prior to a share price drop may help get the plaintiff past summary judgment. Thereafter, the plaintiff can apply settlement pressure through discovery requests.[68] Simply stated, from the issuer's perspective, insider trading is fodder for entrepreneurial attorneys.[69] The elimination of insider trading during vulnerable periods tames plaintiff's attorneys. Accordingly, the issuer needs the discretion to proscribe insider trades that may merely *appear* improper.

Another, albeit less urgent, reason why issuer directors want the benefit of the doubt in pre-clearance decisions is that they may have a fiduciary duty to enforce vigorously their IT program. In *In re Caremark International Inc.*,[70] the Delaware Court of Chancery suggested in dicta that the board has a fiduciary duty to monitor the corporation's activities.[71] Arguably, enforcing an IT compliance program is within this duty.[72] Because breach of this duty exposes the directors *personally* to liability, directors have extra incen-

65. OFFICE OF THE GENERAL COUNSEL, U.S. SECURITIES AND EXCHANGE COMMISSION, REPORT TO THE PRESIDENT AND THE CONGRESS ON THE FIRST YEAR OF PRACTICE UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (1997), *available at* http://www.sec.gov/news/studies/lreform.txt.

66. Grundfest & Perino, *supra* note 64, at 261.

67. The authors of these studies conclude that the apparent "increase in alleged insider trading is consistent with the theory that plaintiffs are increasingly relying on trading by insiders to support the 'strong inference' pleading requirement of the Reform Act." *Id.*

68. The PSLRA provides that "courts must stay all discovery pending a ruling on a motion to dismiss except in exceptional situations." HAMILTON, *supra* note 56, at 565. It is therefore strategically critical for issuers to prevent plaintiffs from winning a favorable summary judgment ruling. Eliminating IT is one of the most effective ways for the issuer to accomplish this.

69. Exchange Act section 16(a) requires classic insiders (officers and directors of a company), as well shareholders who own more than 10 percent of the company's stock, to report to the SEC any transactions in their company's equity securities. 15 U.S.C. § 78p (2000). These reports facilitate enforcement of section 16(b)'s prohibition on short-swing profits by classic insiders and 10 percent shareholders. Under section 16(b), issuer shareholders may derivatively sue these insiders or 10 percent shareholders for disgorgement of any profits earned on purchases and sales within a six-month period. *See* BAINBRIDGE, *supra* note 2, at 174–75. Because they can earn large contingent fees, plaintiff's attorneys scour section 16(a) data, looking for actionable section 16(b) violations. Thanks to the section 16(a) reporting regime, data on the trading activities of classic insiders are widely available on the internet. Even the print version of the *Wall Street Journal* now reports daily the top ten buyers and sellers among corporate insiders. *See Insiders Day by Day*, WALL ST. J., Sept. 16, 2002, at A1. In these ways, timely insider trading data are now readily available for use in complaints against issuers by entrepreneurial attorneys.

70. 698 A.2d 959 (Del. Ch. 1996).

71. Dye, *supra* note 52, at 1053 (citing *Caremark*, 698 A.2d at 971).

72. The court said that "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." *Caremark*, 698 A.2d at 971.

tive to control illegal IT. This possible fiduciary duty inclines issuers to err on the side of withholding clearance.[73]

Finally, insider trading threatens the issuer's human capital. Because "a company's human resources are apt to be its most valuable asset," protecting "against the possibility that key employees will succumb to the perils of insider trading is certainly in every corporation's interest."[74] Exchange Act section 32(b) imposes prison sentences of up to ten years and fines of up to $1 million on insider trading convicts.[75] The inexorable desire to get rich may overcome the inhibitions of normally law-abiding personnel. To avoid risking its valuable human assets—as well as its "reputation for integrity and ethical conduct"[76]—the issuer needs the benefit of the doubt in pre-clearance decisions.

Threatened with the above consequences, issuers have reason to suppress fastidiously any transaction that might be considered illegal IT, as well as even legal insider trades that might just appear suspicious. Because of the uncertainty inherent in the definition of illegal IT, it is almost inevitable that an issuer endeavoring to eliminate illegal transactions will err on the side of overincluding what may be an innocuous trade. Evaluating the issuer's good faith under the Delaware Court of Chancery standard (which examines what the parties would have agreed to had they negotiated ex ante), it is by no means clear that the issuer would bargain away any margin for error. Thus, as a general proposition, erring on the side of withholding is not a breach of good faith. But there must be a limit to issuer immunity. Precisely how much discretion should a court afford an issuer?

73. The board's breach of a duty to ensure a vigorous compliance program could start a chain of litigation. Suppose the SEC sues an issuer as a controlling person under ITSFEA. Because of the board's lax enforcement of the IT policy, the SEC shows that the issuer "failed to take appropriate steps," and forces the issuer to pay treble damages. Disgruntled shareholders may then sue the breaching directors derivatively to recompense the corporation. Thus, directors have personal motivation to ensure proper enforcement of their company's compliance program.

74. Harvey L. Pitt & Karen L. Shapiro, *The Insider Trading Proscriptions Act of 1987: A Legislative Initiative for a Sorely Needed Clarification of the Law Against Insider Trading*, 39 ALA. L. REV. 415, 435 (1988).

75. 15 U.S.C. § 78ff (2000).

76. Short & Chester, *supra* note 9, at 437. In a famous early insider-trading case brought under state law, a New York court recognized that classic IT may damage a company's reputational capital:

> [A corporation] has a great interest in maintaining a reputation of integrity, an image of probity, for its management and in insuring the continued public acceptance and marketability of its stock. When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities.

Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969).

IV. A Proposed Standard

A. The Business Judgment Rule Analogue

Issuer immunity should cease only if the compliance officer acted in bad faith or breached his duty to make an informed decision. This standard is analogous to the business judgment rule (BJR), which is the measure for evaluating decisions of a company's board of directors.[77] The rule presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[78] As such, courts will not challenge the business judgment of directors or hold them liable for the consequences of their business judgment—even for decisions that are patent mistakes—unless the directors have made an uninformed decision,[79] acted fraudulently or illegally, engaged in self-dealing, or committed waste.[80] The BJR effectively immunizes the directors' decision,[81] but not the process leading to it. Thus, if the process is proper, "there is no liability even though a decision is unreasonable."[82]

Courts should evaluate a compliance officer's pre-clearance determination under an analogous paradigm. The officer's decision in itself should be immune from review: Courts should not assay the likelihood that a court would have deemed a proposed transaction illegal, or evaluate the risk that a proposed transaction posed to the issuer. Rather, the court should examine the *process* behind the officer's determination. Like a director, the officer should be required to make an informed decision in good faith.[83] If a compliance officer withholds pre-clearance while oblivious of the details of the transaction, he is liable for breaching his duty to be advised. If he follows no rational decisionmaking process, but rather withholds pre-clearance

77. For detailed discussion of the business judgment rule, see STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 269–70 (2002).

78. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

79. Smith v. Van Gorkom, 488 A.2d 858, 874 (1985) (holding that the board's approval of a merger based on a twenty-minute oral presentation by the CEO, without reviewing the merger documents or demanding serious valuation study, was a breach of the duty to be informed).

80. ROBERT CHARLES CLARK, CORPORATE LAW 123–24 (1986).

81. Some case law on the business judgment rule suggests that courts will consider whether a board's decision was rational. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). Professor Stephen Bainbridge states that "reference to a 'rational business purpose,' properly understood, does not contemplate substantive review of the decision's merits. . . . Rather, inquiry into the rationality of a decision is a proxy for an inquiry into whether the decision was tainted by self-interest." BAINBRIDGE, *supra* note 77, at 274.

82. Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PITT. L. REV. 945, 963 (1990).

83. In this Comment, "good faith" includes a duty to abstain from self-dealing.

capriciously or arbitrarily, then he has violated his duty of good faith.[84] Like shareholders under the BJR,[85] the insider should have the burden of proving the issuer's bad faith or uninformed judgment.

This extraordinary standard is necessary because withholding clearance is the corporation's only sure self-defense against vicarious liability. It is also the best prophylactic measure against securities litigation, in which even the appearance of insider trading can fuel a suit. The compliance officer, not the court, knows when the issuer is most vulnerable and when it can least afford to risk liability. If courts do not provide issuers virtually plenary power to protect themselves, issuers may reconsider the decision to offer stock-based compensation.

B. Is This Standard Fair?

Recall the vice president who was unaware of his company's impending merger. Under this proposed standard, even if the VP lacked authorized access to this information *and* the materiality of the merger discussions was highly questionable,[86] the issuer would be immune.

It might seem perverse that the VP loses almost his entire net worth in order to give his company protection against the mere possibility of a plaintiff's attorney using his trade as evidence, should there ever be a shareholder suit. When an issuer refuses to clear a legal insider transaction, any loss falls entirely on one person: the insider. However, if an issuer errantly pre-clears a trade later deemed illegal, any resulting loss—from control person liability or shareholder litigation—falls on the company and hence on the shareholders. Of course, an individual shareholder weathers a small decline in stock price better than an insider weathers loss of an entire stock option portfolio. Thus, there is a strong argument that courts should limit issuer discretion in favor of the insider in order to *spread* the loss among those most able to bear it.

This argument ignores a critical fact: Issuers usually exempt from pre-clearance insiders who participate in a preplanned trading program.[87] Issuers

84. Another example of bad faith would be withholding pre-clearance because of personal spite against the insider. Even if the officer properly informed himself of the transaction details, he would be liable if the insider could show that the officer had no basis for withholding other than personal animosity.

85. *See* BAINBRIDGE, *supra* note 77, at 269.

86. This could be true if the vice president's company was substantially larger than the merger partner.

87. SEC Rule 10b5-1(c) provides an affirmative defense to Rule 10b-5 claims when securities are traded through a preplanned trading program. 17 C.F.R. § 240.10b5-1(c) (2002). SEC Rule 10b5-1(c) establishes this defense by stating that a "person's purchase or sale is not 'on the basis of' material nonpublic information if the person making the purchase or sale demonstrates that," inter alia, "before becoming aware of the information, the person had . . . entered into a

typically do not require pre-clearance for transactions under a program "administered by a broker or investment advisor with discretionary authority to execute transactions in the account if the timing of purchases and sales is outside the control of the Covered Person."[88] While under such a plan the insider loses the enjoyment and convenience of directly controlling his options, he gains liquidity by eliminating the risk that the issuer will hold his transaction in abeyance. While the issuer can fully protect itself only by requiring pre-clearance, the insider has a choice: participating in a preplanned program or risking loss caused by pre-clearance delay. If an insider forsakes the protection of a preplanned program, it seems fair that he bears the loss resulting from his gamble.

Finally, although this standard affords the issuer broad *legal* discretion, the market for human resources constrains its exercise. The issuer who develops a reputation for unduly trammeling insider transactions devalues its stock option plan. To attract talented personnel, such an issuer must pay additional compensation, straining its earnings. Moreover, the overly zealous compliance officer is likely to foment resentment among key personnel, spoiling the incentive character of stock-based compensation.

V. FINE-TUNING COMPLIANCE POLICIES: RECOMMENDATIONS TO ISSUERS

An issuer can take several steps to reduce the risk that its IT compliance program will backfire. First, the issuer should consider expressing in writing the level of discretion the compliance officer has in pre-clearing insider transactions. A policy might state that the compliance officer has "absolute, and uncontrolled discretion"[89] in withholding pre-clearance. Moreover, the issuer should consider adding that it may withhold merely to avoid "the appearance of an improper transaction . . . which could result, for example, when an officer engages in a trade while unaware of a pending major development."[90] The issuer should also consider adding an express warning that the issuer is not liable for any loss the insider suffers as a result of withheld pre-clearance: "Transactions by an individual trading in the

binding contract to purchase or sell the security." *Id.* Because of this affirmative defense, compliance policies typically do not require insiders to obtain pre-clearance when their transactions are occurring through a preplanned trading program. 15 U.S.C. § 78j (2000).

88. Berkeley, *supra* note 8, at 472.

89. This is language commonly found in trust instruments, articulating the amount of discretion the trustee possesses to control the disposition of trust property and income. JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS AND ESTATES 627 (6th ed. 2000). Courts interpreting this clause still require the trustee's actions to be in good faith, to some extent reasonable, and not arbitrary or capricious. *Id.* at 627–28.

90. Short & Chester, *supra* note 9, at 441.

Company's securities that may be necessary or justifiable for independent reasons (such as the need to raise money for an emergency expenditure) are not insulated from the legal restrictions described above."[91] The company should also consider expressly encouraging insiders who are planning to liquidate issuer securities in the near future to participate in a preplanned trading program in order to obviate pre-clearance altogether. Finally, as a defense against claims of arbitrariness and capriciousness, compliance officers should follow predetermined internal protocols when making pre-clearance determinations.

CONCLUSION

Drafters of IT compliance policies often fail to heed the above warnings, leaving ambiguous the compliance officer's discretion in clearing insider transactions, and failing to warn insiders of the ramifications of the clearance process. If an issuer with such a policy refuses clearance and the stock price plummets, the insider may sue for breach of good faith, alleging his transaction's legality and the insignificant risk it posed to the company. Courts adjudicating such a claim should recognize that issuers need a wide margin of error because even a *single* insider transaction can expose the issuer to devastating liability. Accordingly, courts should afford the issuer plenary discretion, imposing liability only if the insider proves the issuer's bad faith or failure to evaluate the transaction. Although this standard imposes losses on the insider, it is necessary for issuer protection, and fair because insiders have the opportunity to obviate pre-clearance by participating in preplanned trading programs.

91. *Id.* at 439.