INSIDER TRADING BY OTHER MEANS

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For more than thirty years, perhaps the most prevalent strategy for insider trading has gone undetected and unaddressed. This Article uncovers the techniques by which executives and directors sell overvalued stock worth more than $100 billion per year, shifting losses to ordinary investors. The basic idea is that insiders conceal their suspicious trades by publicly reporting them (as they are required to do) in ways that confuse or discourage investigators. We develop a taxonomy of concealment strategies, complete with suggestive examples. We then empirically test our taxonomy using a database of essentially all stock trades since 1992. We find that insiders who trade using the subterfuges we describe outperform the market by up to 20% on average. Worse yet, we find evidence that this simple subterfuge works. Essentially no one has ever been prosecuted for undertaking one of these suspicious trades. Nor do journalists or scholars seem to appreciate them. Accordingly, we call for scholars and prosecutors to cast a wider net in their studies and market surveillance, then discuss implications for the design of insider-trading reporting requirements and related legal rules.

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Introduction

Bernie Ebbers was CEO of WorldCom at the time it crashed, in the nation's largest financial fraud. *The New York Times* reported on July 3, 2002, that Ebbers had not sold WorldCom stock since 1996.[1] The implication of such coverage was that "Bernie Ebbers was unlike the other corporate titans whose reputations have crashed in the past 18 months. He alone kept faith with the company he ran, holding on to WorldCom shares right to the end. He was a baron of bankruptcy who never bailed out."[2] But Ebbers was no such tragic hero. Just a few months earlier, on April 3, Ebbers had sold 3 million WorldCom shares for 70 million dollars.[3] While the *Times* had many nasty things to say about Ebbers, this large insider trade escaped scrutiny for years.[4] This omission is curious, since insiders such as Ebbers are required to publicly disclose their trades, so Ebbers' illicit transactions were plainly visible.

How were millions of dollars of insider trades hidden in plain sight? The simple answer is that securities law permits insiders to report trades in ways that investigators are likely to misunderstand or overlook.[5] If public transaction reports are confusing, prosecutors and journalists may not bother scrutinizing them. With their trades obscured, officers and directors needn't obey insider trading law.[6]

Should we be worried that insiders often violate federal law in plain sight? Only if three things are true. First, there would need to be some easy way for insiders to apparently satisfy their public reporting obligation while nevertheless concealing the true nature of their trade. Second, this concealment would need to actually fool investigators. Third, many insiders would need to know this strategy and put it to work. Then we would have a problem.

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[1] David Leonhardt, *WorldCom Officer Sold Almost All His Shares*, N.Y. Times (July 3, 2002), https://www.nytimes.com/2002/07/03/business/worldcom-officer-sold-almost-all-his-shares.html [https://perma.cc/7L7T-N5Z8].

[2] Thomas Catan & Stephanie Kirchgaessner, *How WorldCom's "Big Fraud" Began*, Nat'l Post (Dec. 24, 2002), 2002 WLNR 8223914 (Westlaw NewsRoom).

[3] Dennis R. Beresford, Nicholas deB. Katzenbach & C.B. Rogers, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of WorldCom, Inc. 315–22 (2003), https://www.sec.gov/Archives/edgar/data/723527/000093176303001862/dex991.htm#ex991902_89.

[4] Of course, the other challenge is that the 2002 transfer was reported in 2000, when the cash was delivered. *Id.* at 316–17. This is because the transfer was pursuant to a forward sale agreement entered into in September of 2000 with a delivery date in April of 2002. *Id.* at 316. Ebbers reported the transaction in a Form 4 on October 9, 2000. *Id.* at 317.

[5] This Article will use the word "investigator" to refer to anyone who has an interest in detecting insider trading. Thus, the term includes the Department of Justice and Securities and Exchange Commission, but also journalists, plaintiffs' lawyers, and scholars.

[6] Plato, Republic, 360b-d ("If you could imagine any one obtaining this power of becoming invisible, and never doing any wrong or touching what was another's, he would be thought by the lookers-on to be a most wretched idiot.").

Unfortunately, this Article demonstrates that there is a large loophole in our insider trading enforcement system, as all three points are true. Indeed, this loophole is so large it likely represents the predominant form of insider trading in America today.

Our first contribution is to catalog the techniques by which insiders minimize the legibility of their suspicious trades. We call these techniques "insider trading by 'other' means."[7] This name refers to an essential feature of many strategies. When insiders report transactions, they are required to characterize the transaction using one of twenty transaction codes. Most trades fit into tidy boxes such as purchase (P) or sale (S). Insiders who disclose a "P" at a low price followed by an "S" at a high price will face scrutiny, since they appear to have purchased and then sold at a profit.

Traders who want to avoid scrutiny may prefer to dispose of their shares under code "J." That designation is reserved for transactions that fit into none of the predetermined templates. Its meaning is "other." Hence, insider trading by "other" means. This Article explains how insiders report ordinary sales under a fig leaf of "other." We identify and explain six distinct techniques and, for each, provide suggestive examples drawn from real insider filings from insiders at WorldCom, Peloton, Nikola, and others.[8] In each case, insiders disposed of vast quantities of stock at princely prices shortly before the company disclosed information material to its demise. And in each case, the insiders covered their sale under the label of "other."

Second, we show that obfuscation succeeds. We look for signs that prosecutors, civil plaintiffs, journalists, or scholars are aware that some J-coded transactions may be illegal insider trading. Unfortunately, we find the opposite. Despite being a potential proxy for suspicious trading, J-coded transactions are mentioned in essentially no criminal indictments, civil complaints, news articles, or scholarly papers.[9] Insiders are right to think it safe to insider trade by "other" means.

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[7] In part, this label alludes to the protean quality of insider trading, where substitutes for insider trading exist and may enjoy different legal status. *See* Ian Ayres & Joe Bankman, *Substitutes for Insider Trading*, 54 Stan. L. Rev. 235 (2001). Of course, the "by other means" idiom is a reference to Clausewitz. Carl von Clausewitz, On War 645 (Michael Howard & Peter Paret trans., Princeton University Press, 1984) ("War is merely the continuation of policy by other means.").

[8] While suspicious, we acknowledge that any of the examples might be benign and lawful. These examples are meant to be illustrative rather than conclusory. Fortunately, our case does not rest on innuendo and anecdote.

[9] Accordingly, our article joins a rich literature of articles demonstrating loopholes in the reporting environment and failures of market observers to fully appreciate trade disclosures outside of the heartland of filings. *See, e.g.*, Alma Cohen et al., *The 8-K Trading Gap*, Columbia L. & Econ. Working Paper No. 524, (2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2657877 [https://perma.cc/RU6D-J4BF]; Robert J. Jackson, Jr., Bradford Lynch-Levy, and Daniel J. Taylor, *Holding Foreign Issuers Accountable*, NYU Law and Economics Research Paper No. 22-16, (2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4072797 [https://perma.cc/EW55-VJFQ]. *See also* Sehwa Kim & Seil Kim, *Fragmented Securities Regulation,*

Third, we demonstrate that insiders have learned the forgoing lessons, such that a large volume of suspicious trading is now concealed as we have described. We conduct an empirical analysis of essentially all publicly-reported trades. We find that trades whose filings fit the patterns described above substantially outperform the market, suggesting that insiders opt to obfuscate their can't-lose bets. The effect becomes stronger when we look at proxies for strategic use of the J code, such as transactions appearing to lack justification for invoking the J code. The scale of this practice is huge, with more than $1.5 trillion transacted under "other" during our sample period.[10]

The theoretical and normative implications of our findings are profound. Theoretically, it appears scholars know less about insider trading than we think we do. Insider trading is a vastly studied subject, with empirical work estimating its prevalence and nature. Yet without considering the rich seam of barely hidden trades, the existing literature understates the extent of insider trading. Insider trading may have been rife just outside of the spotlight.

Normatively, investigators must update their search and audit patterns, recognizing that J-coded transactions are more, not less, suspicious than their S-coded peers. Relatedly, the Securities and Exchange Commission ("SEC") should consider issuing more guidance on J-code use and prosecuting miscoding. We also consider deeper reforms that go to the root of the problem.

Our Article proceeds as follows. Part I briefly introduces insider trading law and policy. Part II describes the related system of mandatory public reporting of insider trades. Part III illustrates abuses of the reporting system: mischaracterizing one's trade or changing the form of the trade in order to be able to characterize it differently. That Part offers suggestive examples to help concretize the explanation.

Those examples set the stage for our empirical analysis. In Part IV, we describe our method for identifying trades that were likely based on material, non-public information. We find that insider trades marked "other" greatly outperform outsiders' trades, particularly when proxies for miscoding are considered. In other words, insider trading by other means tends to be quite profitable.

Part V analyzes implications of our findings, both theoretical and normative. We then conclude.

Information-Processing Costs, and Insider Trading, Baruch College Zicklin School of Business Research Paper No. 2019-07-01, (2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3416204 [https://perma.cc/V3FG-8MKV]; Tom McGinty & Ben Foldy, *Signature Bank Insiders Sold $100 Million in Stock During Crypto Surge*, Wall St. J. (Apr. 4, 2023), https://www.wsj.com/articles/signature-bank-insiders-sold-100-million-in-stock-during-crypto-surge-a9f77615 [https://perma.cc/5ZHV-59TN].

[10] *Infra* Part IV.A.2.

I. Insider Trading

Insider trading law seeks to vindicate a number of policy goals. It seeks to cultivate loyal and productive managers.[11] It seeks to protect ordinary investors, from whom insiders' profits are unfairly[12] derived.[13] It seeks to protect the market as a whole from the demoralization and caution which might otherwise spread.[14]

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[11] If insiders can trade, they may be distracted from their duties as they focus their attention on trading and acquiring information. *See* James D. Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 Duke L.J. 628, 659 (1986) ("The prohibition against insider trading . . . stems from the shareholders' expectation that a manager is paid to look after the shareholders' welfare, not his own."). They may mismanage the firm in order to generate trading opportunities. Insiders can sabotage the firm in order to profit from a short position. Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 Va. L. Rev. 117, 149 (1982) ("[T]he temptation of profit might actually encourage an insider to act against the corporation's interest."). *But see* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857, 875 (1983) ("[I]t seems likely that the critics of insider trading have exaggerated the magnitude of the perverse incentives associated with short selling."). Even without sabotage, insiders can increase risk taking, knowing that they will know before the public which risks have paid off and which flopped. Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 Sup. Ct. Rev. 309, 332 (1982) ("[Insider traders] may select riskier projects than the shareholders would prefer, because if the risk pays off they can capture a portion of the gains in insider trading and, if the project flops, the shareholders bear the loss."). They may sometimes delay public disclosure in order to preserve their informational advantages. Victor Brudney, *Insider, Outsiders, and Informational Advantages Under the Federal Securities Laws,* 93 Harv. L. Rev. 322, 335 n.53 (1979) ("If the insider is allowed to use such information for his personal gain, he will be tempted to . . . [decide] to delay . . . the release of the information so as to serve his trading or borrowing needs . . . ."). Other times, their trades may intentionally or unintentionally spill the beans on information that the corporation had a legitimate need to keep secret. *See* James D. Cox, *Seeking an Objective for Regulating Insider Trading Through Texas Gulf Sulphur*, 71 SMU L. Rev. 697, 707 (2018). For example, when mining executives buy their company's shares en masse, it may hint to other prospectors where they should dig to find valuable minerals. Andrew Verstein, *Insider Trading in Commodities*, 107 Va. L. Rev. 447, 490–91 (2016).

[12] *See* Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 Tex. L. Rev. 375, 376 (1999) (arguing that "insider trading is wrong because it is a kind of fraud"). Of course, fairness is a deeply contested concept.

[13] Manne argued that no trader was victimized. *See* Henry G. Manne, Insider Trading and the Stock Market 93–104 (1966). Wang showed this to not be true. *See* William K. S. Wang, *Trading on Material Non-Public Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sure Whom Under SEC Rule 10b-5?*, 54 S. Cal. L. Rev. 1217, 1234–40 (1981); William K. S. Wang, *Stock Market Insider Trading: Victims, Violators and Remedies, Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect*, 45 Vill. L. Rev. 27 (2000). A more sophisticated account by Fox, et al. shows non-insiders may not be harmed on an ex-ante basis because they can discount the price of stock by their expected future trading losses. Merritt B. Fox, Lawrence R. Glosten & Gabriel V. Rauterberg, *Informed Trading and Its Regulation*, 43 J. Corp. L. 817, 850–51 (2018). Accordingly, unsophisticated investors may pass their trading losses onto initial issuers of stock and the entrepreneurs before them.

[14] The conventional explanation is that capital formation requires retail investor confidence, and that insider trading impedes this confidence. The empirical basis for this claim has been questioned. But there is little question that insider trading decreases stock market liquidity, as market makers seek to offset their trading costs. *See* Merritt B. Fox, Lawrence R. Glosten & Gabriel V. Rauterberg, *The New Stock Market: Sense and Nonsense*, 65 Duke L.J. 191, 218–19 (2015). Either way, a vibrant market requires some boundary to informed trading.

Yet insider trading policy is not unidirectional. Other policy objectives caution against overly broad restrictions on insider trading. Harsh trading restrictions may discourage stock-based compensation.[15] Insider trading can also improve stock price efficiency.[16]

To serve the forgoing objectives, the law prohibits many forms of trading. Some prohibitions are generally applicable, proscribing categories of trade regardless of the trader's identity. It is illegal to trade based on information one obtained by conferring personal benefit onto someone to breach their duty of trust and confidence to the ultimate information source.[17] Thus, it is a crime for anyone to bribe a corporate executive to receive and trade on a hot tip about the company.[18] It is illegal for anyone to trade based on information that a tender offer is likely (and where the source can be traced back to one of the companies' management teams or their advisors).[19] It is illegal to trade based on information one used fraud to obtain.[20] It is illegal to selectively disclose corporate secrets to shareholders who are likely to trade.[21] Common sense

[15] That is because stock-based compensation is only valuable insofar as insiders can practically sell it. If insiders are in legal jeopardy whenever they sell, or if they can only safely sell on a few designated days of the year, they will resist stock-based compensation. Yet stock-based compensation can be otherwise efficient: It lets cash-strapped startups hire and it aligns the incentives of managers with the shareholders they serve.

[16] When insiders know that their company is concealing problems, they are tempted to sell the stock short in order to profit from the eventual revelation. If their sales can be observed (directly or indirectly), other market participants will infer bad news about the stock, leading to a decline in stock price and possible further investigations. Here, we focus on trading by insiders such as managers. The goal of improving price accuracy is also vindicated by substantially legalizing trading for non-insiders. Outsiders such as hedge funds may improve price accuracy by researching and combining information in service of their trading strategy. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 723 (2006).

[17] "[T]he misappropriation theory holds that a person commits securities fraud 'when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information" such as an employer or client." Salman v. U.S., 580 U.S. 39, 46 n.2 (2016) (quoting U.S. v. O'Hagan, 521 U.S. 642, 652 (1997)).

[18] Dirks v. SEC, 463 U.S. 646, 660 (1983) ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.").

[19] 17 C.F.R. § 240.14e-3 (2024).

[20] *See* United States v. O'Hagan, 521 U.S. 642, 659 (1997). A duty of trust and confidence can arise formally, or informally. 17 C.F.R. § 240.10b5-2(b)(1), (2) (2023). The SEC presumes that such confidences exist whenever two people have a "history, pattern, or practice of sharing confidences." *Id.* § 240.10b5-2(b)(2). Thus, a psychiatrist may not trade based on corporate secrets, disclosed by a client seeking care. *See* Complaint, SEC v. Gangavarapu, 2009 WL 3028066 (No. 1:09-CV-231) (E.D. Tenn. Aug. 31, 2009). An outside lawyer for a corporation must keep her client's confidences by not trading on the basis of them. *O'Hagan*, 521 U.S. at 648. Such unprofessional behavior defrauds their clients who probably shared information because of an implicit assurance that it would not be used for trading.

[21] 17 C.F.R. § 243.100(b)(1)(iv) (2024).

suggests large shareholders who nevertheless receive such information will have implicitly agreed not to trade.[22]

The forgoing prohibitions apply even to individuals who are truly "outsiders" to a corporation. Nevertheless, the main focus of insider trading law is on "insiders:" officers, directors, and large shareholders whose positions and power confer special access to the corporation and its secrets.

In addition to the generally applicable rules above, two additional rules constrain insiders. First, the "classical theory" prohibits corporate fiduciaries from trading the corporation's stock based on material non-public information, even if the corporation grants them permission to trade.[23] Thus, insider trading restrictions become mandatory and expansive, rather than subject to modification and proviso. This theory and those listed before it are subject to criminal prosecution,[24] civil enforcement,[25] and treble damages in private civil suits.[26]

Second, the "short-swing profits" constrains statutory insiders (officers, directors, and owners of greater than 10% of shares).[27] Under this rule, any profits insiders make from trading their company's stock within a six-month window are redeemable back to the corporation. Thus, a trader who sells her company's stock on April 1 and buys it back on May 1 for a profit must disgorge the profit back to the corporation. This is true even if the insider traded "innocently," without any special information at all.[28]

None of these prohibitions are self-enforcing. Each requires a proponent, such as a civil plaintiff or prosecutor, to detect and prove violations of the law. But lawbreaking can be challenging to spot and verify. Trading in our securities market is, at a first approximation, anonymous. Individuals trade through brokers, who are not obliged to disclose their clients' names—nor could they practically do so in today's light-speed electronic trading environment. Traders do not know against whom they trade, nor can they request live updates on whether company executives happen to be trading today. Prosecutors cannot see a live report from the stock exchange about which individuals

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[22] If shareholders receive such information from any insider, they will have implicitly assumed that insider's duty to all shareholders. Michael Guttentag, *Selective Disclosure and Insider Trading*, 69 Fla. L. Rev. 519, 559 (2017).

[23] A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. Rev. 13, 17 n.19 (1998) ("[T]he misappropriation theory [of insider trading] is subject to contractual waiver by the owner of the information, while the classical theory is not.").

[24] 15 U.S.C. § 78ff(a) (allowing for up to 20 years of imprisonment).

[25] *Id.* § 78u-1.

[26] *Id.* § 78u-1(a)(2).

[27] *Id.* § 78p(b).

[28] Magma Power Co. v. Dow Chem. Co., 136 F.3d 316 (2d Cir. 1998) (Section 16(b) "operates mechanically, and makes no moral distinctions, penalizing technical violators of pure heart, and bypassing corrupt insiders who skirt the letter of the prohibition.").

have profited today, nor can companies and their shareholders peer into their directors' brokerage accounts. In a faceless market, no eyewitness can pick suspects out of a lineup.

Enforcing insider trading law necessarily depends in part on systems of surveillance, but the most important precondition for law enforcement is Section 16 of the Securities Exchange Act, which requires timely public disclosure of all trades by insiders. With those trades public, it is feasible for violations to be detected and proven. It is to Section 16 that we now turn.

II. Insider Trading Reports

Insider trading law has long been the subject of controversy. What no one disputes is that it is important to know accurate information about insider trading.[29] This public information is vital for scholars who wish to understand the extent and nature of insider trading—whether to praise or criticize it. It is helpful to prosecutors seeking to spot violations of the law. Even proponents of deregulation, who think companies ought to be allowed to opt out of insider trading law, tend to think Section 16 is sensible: everyone agrees *some* forms of insider trading (such as short-selling by insiders or short-swing profits) are problematic, and shareholders benefit from a legible report on what exactly is happening at their company.

This Part discusses the law and policy of trade reporting and misreporting, and the coding decisions that can make the difference between them.

A. Reporting Obligations

1. Reporting Law

Section 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act")[30] contains reporting requirements for public companies' "insiders."[31] Such insiders include individuals and entities who are the issuer's directors, officers, or beneficial owners of more than ten percent of the shares (each, a "reporting

[29] This broad acceptance stands in stark contrast to most other aspects of insider trading law, including other aspects of Section 16. *See* Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 Hastings L.J. 391, 393 (1991) ("Section 16 of the Securities Exchange Act (Exchange Act) is probably the most criticized provision of the federal securities statutes."). Thel is, of course, referring to the non-disclosure parts of 16, which penalizes insiders who trade in proscribed ways.

[30] Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p.

[31] 17 C.F.R. § 240.16a-2 (2023) (requiring such disclosures for companies that have registered a class of equity securities under Section 12 of the Exchange Act).

person").[32] Reporting persons who acquire or dispose of the company's securities are required to provide timely public notice of that transaction.[33]

Reporting law contains several anti-evasion principles intended to close "unforeseen 'loopholes' that seek to use form to evade substance or to comply with technicalities while violating the 'spirit' or intent of regulatory provisions."[34] Thus, insiders must file in connection with shares she directly *or indirectly* owns, so an individual must file even in cases where the transfer is not a plain vanilla sale from her brokerage account. For example, an insider in XYZ Corp must report trades if she wholly owns a company that sells shares to XYZ Corp.[35] The reporting person must likewise report transactions of shares for which she is a *beneficial* owner, even if she is not a *legal* owner.[36] For example, an investor must report transactions of securities she does not own outright if the nominal owner has agreed that the investor gets to dictate how the shares are voted and whether they are ever sold.[37] Reporting by indirect and beneficial owners addresses simple subterfuge strategies, such as transferring shares to a non-insider friend who sells the shares and returns the money to the insider, that might otherwise frustrate reporting law's policy objectives.[38]

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[32] *Id*. Officers include the executive officers identified pursuant to Item 401(b) of Regulation S-K and any other officer or person who performs a policy-making function for the issuer. *Id.* § 240.16a-1(f). A person is a beneficial owner subject to Section 16 reporting requirements if that person holds or shares, directly or indirectly, voting power or investment power of greater than ten percent of the shares of the issuer. *Id.* § 240.16a-1(a)(1). Beneficial ownership means having a pecuniary interest, whether direct or indirect, to profit or share in the profits from a transaction in the securities. *Id.* § 240.16a-1(a)(2). Control over the security also amounts to beneficial ownership. *Id*. § 240.13d-3(b).

[33] *See* Statement of Changes of Beneficial Ownership of Securities (Form 4) General Instructions, SEC 1475 (02-23), 2, https://www.sec.gov/about/forms/form4data.pdf.

[34] CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 654 F.3d 276, 303 (2d Cir. 2011) (Winter, J., concurring).

[35] *See* Bartel, Exchange Act Release No. 97084, 2023 WL 2455410, at *1 (SEC Mar. 9, 2023).

[36] 15 U.S.C. § 78p(a)(1) (requiring the filing statements from "[e]very person who is directly or indirectly the beneficial owner" of applicable securities).

[37] *See* Editek, Inc. v. Morgan Capital, L.L.C., 150 F.3d 830, 832–34 (8th Cir. 1998); Huppe ex rel. WPCS Int'l Inc. v. Special Situations Fund III QP, L.P., 565 F. Supp. 2d 495, 499–500 (S.D.N.Y. 2008).

[38] Although indirect and beneficial ownership extend the reach of reporting law, it is nevertheless perforated with exceptions and imitations. For example, no reporting may be required if retirement plan securities are transferred in connection with a divorce. Securities Exchange Act of 1934, 17 C.F.R. § 240.16a-12 (2023) ("The acquisition or disposition of equity securities pursuant to a domestic relations order . . . shall be exempt from section 16 of the Act."). Likewise, if an entity distributes securities to its investors, and those investors had previously reported their beneficial ownership in the underlying securities (by dint of their ownership of the entity), those investors need not report their direct acquisition of the securities. However, the entity must still disclose its disposition of the distributed securities. *Id.* § 240.16a-13 ("A transaction, *other than the exercise or conversion of a derivative security* or deposit into or withdrawal from a voting trust, that effects only a change in the form of beneficial ownership . . . shall be exempt from section 16 of the Act.") (emphasis added); Division of Corporation Finance, *Exchange Act Section 16 and Related Rules and Forms* § 217.02, SEC (updated Oct. 7, 2022), https://www.sec.gov/divisions/corpfin/guidance/sec16interp.htm ("[T]he scope of Rule 16a-9(a) is limited to persons subject to Section 16 who experience an increase or decrease in the number of

2. Reporting Policy

Trade reporting law serves numerous important policies. First, and most obviously, it discourages insiders from trading based on inside information.[39] Some insiders may be embarrassed to have their well-timed trades publicized.[40] More importantly, reporting increases the riskiness of illegal trades. Investigators can use reports to spot suspicious trades in order to sue or prosecute the traders.[41] Shareholders who observe insider trading patterns may take account of these trades as they evaluate the merits of the company and its executives. Executives who trade a great deal may appear disloyal,[42] distracted,[43] opportunistic,[44] or just overpaid.[45] Shareholders who observe insider trades can opt to sell their shares or vote for new management.[46]

Second, and relatedly, reporting may discourage misbehavior other than insider trading, such as market manipulation.[47]

Third, reporting may encourage officers and directors to hold large amounts of their company's stock.[48] It will do this by alerting shareholders to officers and directors who sell their stock and rendering credible any managerial assertion of continuous ownership. Shareholders tend to benefit from manager ownership, since it aligns their interests and leads to more efficient pursuit of corporate objectives.[49]

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securities held as a result of a stock distribution or reverse stock split effected by the distributing party . . . .); SEC Division of Corporation Finance, *Manual of Publicly Available Telephone Interpretations* § R, Question 9 (July 1997) (same); 1 Arnold S. Jacobs, Section 16 of the Securities Exchange Act § 2:91 (2023); 1 *id.* § 3:17 n.54.50 and accompanying text.

[39] Thel, *supra* note 29, at 419 n.77 and accompanying text.

[40] *Id.* at 419–20.

[41] *See* Wang v. Cloopen Grp. Holding Ltd., 661 F. Supp. 3d 208, 223 (S.D.N.Y. 2023) ("When presented with a motion to dismiss a complaint, . . . [t]he Court can take judicial notice of public disclosures that must be filed with the SEC . . ."); Fresno Cnty. Emps.' Ret. Ass'n v. comScore, Inc., 268 F. Supp. 3d 526, 535 (S.D.N.Y. 2017).

[42] Levmore, *supra* note 11, at 149 (warning of the potential for a corporate insider to be tempted by profits to act against the corporation's interest).

[43] Cox, *supra* note 11, at 659 (describing insider trading prohibitions as stemming from shareholders' expectation that a manager not be distracted from his duties by his private investment agenda).

[44] Brudney, *supra* note 11, at 335 n.53 (noting that a change in corporate policy or acceleration of income can be used by an insider as opportunities to generate personal profits at the corporation's expense).

[45] Carlton & Fischel, *supra* note 11, at 891 (determining compensation).

[46] *But see* Thel, *supra* note 29, at 420–21 nn.81–82 and accompanying text (arguing that shareholders will tend not to act against insider trading).

[47] *See* Andrew Verstein, *Benchmark Manipulation*, 56 B.C. L. Rev. 215, 256 (2015) (describing how selective disclosure of trades can enable an actor to manipulate price benchmarks and, thereby, the market).

[48] Thel, *supra* note 29, at 422–24.

[49] Nitzan Shilon, *Replacing Executive Equity Compensation: The Case for Long-Term Performance*, 43 Del. J. Corp. L. 1, 10 (2018) ("[B]y tying pay directly to the change in a firm's stock price, it is expected to align the interests of managers with those of shareholders . . .").

Fourth, disclosure sends signals about company quality.[50] When insiders sell their shares—even legally—it may hint at pessimism among those with the most knowledge. Stock prices are more efficient if the public can observe these informative trades.

3. Misreporting

Misreporting is illegal.[51] The Exchange Act authorizes the SEC to initiate enforcement proceedings to for violations of 16(a), including its transaction reporting requirements.[52] Possible remedies include an injunction,[53] a bar on future officer and director service,[54] disgorgement,[55] and civil monetary penalties.[56] The Department of Justice ("DOJ") can bring criminal penalties for willful violations of the statute.[57] There is some uncertainty about whether

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[50] *See* Carlton & Fischel, *supra* note 11, at 892.

[51] Arguably, any trade misreported has not been reported. Some other (fictional) trade was reported. If that is correct, the consequences for misreporting include all consequences for non-reporting. *See* SEC v. Ali, 454 F. Supp. 3d 1281, 1300 (N.D. Ga. 2020) (failed to file Form 4); SEC v. Blackburn, 431 F. Supp. 3d 774, 800, 816–17 (E.D. La. 2019) (same); SEC v. Verdiramo, 890 F. Supp. 2d 257, 273 (S.D.N.Y. 2011) (same); SEC v. Sierra Brokerage Servs. Inc., 608 F. Supp. 2d 923, 956–59, 974 (S.D. Ohio 2009) (same). And there are many consequences to delayed reporting. For example, the two-year limitations period provided in § 16(b) is tolled while § 16(a) reports are delinquent. Whittaker v. Whittaker Corp., 639 F.2d 516, 530 (9th Cir. 1981); *see also* Thel, *supra* note 29, at 448 n.191 (suggesting that this sanction is neither effective nor onerous).

[52] Securities Exchange Act of 1934, 15 U.S.C. § 78u(c); *see, e.g.*, SEC v. Shattuck Denn Mining Corp., 297 F. Supp. 470, 477 (S.D.N.Y. 1968) (defendant failed to disclose disposition of some of his stock on the appropriate Form 4, and was enjoined from further § 16(b) violations and ordered to file an accurate revision); Burns, Exchange Act Release No. 66738, 1 (2012) (default order); Bartel, *supra* note 35, at *5–6.

[53] Securities Exchange Act of 1934 § 21(d), 15 U.S.C. § 78u(d)(1); *see, e.g.*, Burns, *supra* note 52 (noting that the respondent "misrepresented his . . . stock holdings in proxy statements and Forms 4," and was accordingly permanently enjoined from future violations of the Exchange Act, as well as ordered to pay disgorgement plus prejudgment interest and barred from acting as an officer or director of a public company).

[54] Burns, *supra* note 52, at *1.

[55] Securities Exchange Act of 1934 § 21(d)(3)(A)(ii), 15 U.S.C. § 78u(d)(3)(A)(ii); *see, e.g.*, SEC v. Teo, No. 2:04-CV-01815, 2010 WL 3184349, slip op. at *11 (D.N.J. Aug. 10, 2010); Burns, *supra* note 52, at *1.

[56] Securities Exchange Act of 1934 § 21(d)(3)(A)(i), 15 U.S.C. § 78u(d)(3)(A)(i); SEC v. Govil, No. 1:21-CV-6150, 2021 WL 3188325, slip op. at *2 (S.D.N.Y. July 28, 2021); SEC. v. Olins, 762 F. Supp. 2d 1193 (N.D. Cal. 2011); Bartel, *supra* note 35, at *5–7 (ordering a civil monetary penalty of $100,000 when the respondent filed a Form 4 that correctly disclosed a purchase but incorrectly stated his total beneficial ownership).

[57] Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff(a) ("Any person who willfully violates any provisions of [the Act], or any [related] rule or regulation . . . shall upon conviction be fined . . . or imprisoned . . . or both . . . but no person shall be subject to imprisonment under this section . . . if he proves that he had no knowledge of such rule or regulation."). *See, e.g.*, United States v. Guterma, 281 F.2d 742, 752 (2d Cir. 1960).

private plaintiffs, such as those who sell shares in reliance on a false Form 4, can sue.[58]

A trader's misreporting can have consequences for the company whose securities are traded.[59] Regulation S-K Item 405 requires corporations to periodically report on their insiders' degree of reporting compliance.[60] This is one reason many companies file reports on behalf of their insiders.[61] A false trade report could therefore lead to consequences for the issuer. If the issuer is culpable in misfiling a trade report or failing to accurately disclose the poor coding of their insiders' own filings, it violates Regulation S-K.

There are consequences for misreporting. However, the risks may be manageable, given the paucity of oversight and the weak sanctions for violations. "Relatively few cases substantively address Section 16(a), considering its importance."[62] There is seemingly no serious appetite to audit transaction codes or test these filings' accuracy. We discuss the risk of detection and prosecution in Part II.F.

4. Coding

The form used to report most transactions is called Form 4 (Statement of Changes of Beneficial Ownership of Securities).[63] A sample Form 4 is shown here:

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[58] 1 Jacobs, *supra* note 38, § 2:1 ("[I]t is unlikely that a Section 16(a) private right of action exists today . . . If there is a Section 16(a) private right of action, it should redress a late filing, a false filing, or a failure to file at all.").

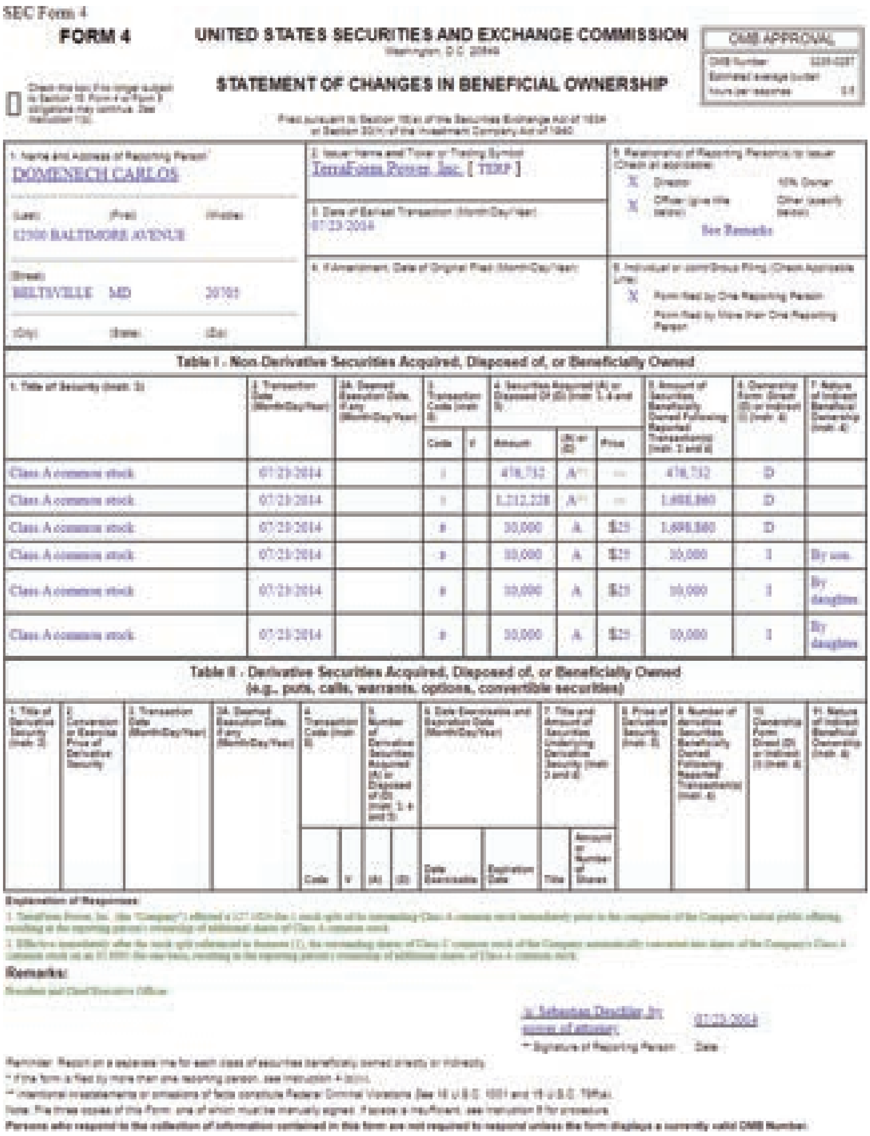
[59] Additionally, whoever controls the misfile may be held liable. Securities Exchange Act of 1934 § 20, 15 U.S.C. § 78t; *cf.* SEC v. Markusen, 143 F. Supp. 3d 877, 892 (D. Minn. 2015) (holding the controlling person of a beneficial owner liable for the beneficial owner's failure to file required forms).

[60] Regulation S-K Item 405, 17 C.F.R. § 229.405 (2023); *see* Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 28,869, 56 Fed. Reg. 7242, at § VI.B (Feb. 21, 1991) (adopting Item 405).

[61] Thomas Lee Hazen, 4 Treatise on the Law of Securities Regulation § 13:3 (2023) ("[M]any companies try to assure their insiders' compliance with the section 16 reporting requirements by filing the Form 4 on the insider's behalf.").

[62] 1 Jacobs, *supra* note 38, § 2:1.

[63] Form 5 (Annual Statement of Beneficial Ownership of Securities) may be used to give notice of transactions for which timely filing on a Form 4 was not necessary. 17 C.F.R. § 240.16a-3(f) (2023); Statement of Changes of Beneficial Ownership of Securities (Form 4) General Instructions, *supra* note 33. For example, certain acquisitions of less than $10,000 aggregate market value in the last six months need not be timely filed in a Form 4, but if not otherwise filed, need to be noted in a Form 5. SEC v. Nutra Pharma Corp., No. 18-CV-5459(JS) (ST), 2022 U.S. Dist. LEXIS 157474, *13 (E.D.N.Y. Aug. 31, 2022). Form 5 is due 45 days after the end of an entity's fiscal year, such that some transactions reported on a Form 5 are quite stale. 17 C.F.R. § 240.16a-3(f)(1) (2023). An exempt transaction on January 1, 2023, concerning an entity with a fiscal year ending on December 31, 2023, would not have to be disclosed until February 15, 2024.



SEC Form 4

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

OMB APPROVAL

1. Name and Address of Reporting Person: DOMENECH CARLOS, 12500 BALTIMORE AVENUE, BELTSVILLE MD 20705
2. Issuer Name and Ticker or Trading Symbol: TerraForm Power, Inc. [TERP]
3. Date of Earliest Transaction (Month/Day/Year): 07/23/2014
5. Relationship of Reporting Person(s) to Issuer: X Director; X Officer (give title below); See Remarks
6. Individual or Joint/Group Filing: X Form filed by One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security	2. Transaction Date	2A. Deemed Execution Date	3. Code	V	4. Amount	(A) or (D)	Price	5. Amount of Securities Beneficially Owned Following Reported Transaction(s)	6. Ownership Form	7. Nature of Indirect Beneficial Ownership
Class A common stock	07/23/2014		J		478,732	A(1)	—	478,732	D	
Class A common stock	07/23/2014		J		1,212,228	A(2)	—	[illegible]	D	
Class A common stock	07/23/2014		P		10,000	A	$25	[illegible]	D	
Class A common stock	07/23/2014		P		10,000	A	$25	10,000	I	By son
Class A common stock	07/23/2014		P		10,000	A	$25	10,000	I	By daughter
Class A common stock	07/23/2014		P		10,000	A	$25	10,000	I	By daughter

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

Explanation of Responses:

Remarks:

President and Chief Executive Officer

/s/ Sebastian Deschler, by power of attorney 07/23/2014

** Signature of Reporting Person Date

As this figure indicates, Form 4 has separate tables for disclosing transactions in non-derivative securities (such as ordinary common stock) and derivative securities (such as call options).[64] Insiders must disclose their name and address, the name and ticker or trading symbol of the issuing company, the date of the earliest transaction, the relationship of the reporting person to

[64] Statement of Changes of Beneficial Ownership of Securities (Form 4), SEC, https://www.sec.gov/files/form4.pdf.

the issuer, and an indicator of whether the form is being filed individually or jointly.[65] For each transaction, the reporting person must provide information about the number and price of the shares. The reporting person must mark "A" if the transaction was an acquisition (increasing the investor's ownership) or "D" for a disposition (reducing ownership).[66]

Most central to our purposes, the reporting person must also mark an identifying code for each transaction, from the options below.[67]

P	Open market or private purchase of non-derivative or derivative security
S	Open market or private sale of non-derivative or derivative security
V	Transaction voluntarily reported earlier than required
A	Grant, award or other acquisition pursuant to Rule 16b-3(d)
D	Disposition to the issuer of issuer equity securities pursuant to Rule 16b-3(e)
F	Payment of exercise price or tax liability by delivering or withholding securities incident to the receipt, exercise or vesting of a security issued in accordance with Rule 16b-3
I	Discretionary transaction in accordance with Rule 16b-3(f) resulting in acquisition or disposition of issuer securities
M	Exercise or conversion of derivative security exempted pursuant to Rule 16b-3
C	Conversion of derivative security
E	Expiration of short derivative position
H	Expiration (or cancellation) of long derivative position with value received
O	Exercise of out-of-the-money derivative security
X	Exercise of in-the-money or at-the-money derivative security
G	Bona fide gift
L	Small acquisition under Rule 16a-6
W	Acquisition or disposition by will or the laws of descent and distribution
Z	Deposit into or withdrawal from voting trust
K	Transaction in equity swap or instrument with similar characteristics
U	Disposition pursuant to a tender of shares in a change of control transaction
J	Other acquisition or disposition (describe transaction)

The most familiar transaction codes are "P," indicating a stock purchase, and "S," an ordinary stock sale. At the very bottom of this list is "J," a transaction code representing some transaction "other" than the nineteen types preceding it.

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[65] *Id*.

[66] This is in section 4, the central column for table I.

[67] Statement of Changes of Beneficial Ownership of Securities (Form 4) General Instructions, *supra* note 33. This table below includes verbatim quotations of the transaction codes, but headings have been omitted and codes reordered.

The SEC instructs individuals to "indicate . . . the character of the transaction reported. Use the code that most appropriately describes the transaction. If the transaction is not specifically listed, use transaction Code 'J'; and describe the nature of the transaction in the space for explanation of responses."[68] Thus, if one code fits best, that is the one that is required. And if no code fits, the answer is J.

The SEC provides more guidance on the interpretation of these codes,[69] and a substantial secondary literature has emerged to guide lawyers and their clients on best reporting practices. Romeo and Dye's two-volume handbook offers more than 1000 pages of practical guidance focused on the details of how to fill out the one page Form-4 and its peers. Romeo and Dye also publish a treatise on Section 16 law more generally. Nor are their handbooks and treatises the only ones.[70] Section 16 filings appear to be an area of law where the law abides partially in the craft wisdom about what is commonplace and acceptable, supervening on a framework of rules that cover the easy cases.

What does that lore indicate about the proper use of the "other" code? Many strange transactions fit the bill.[71] A few examples:

- Shares acquired in a stock split.[72]
- Securities paid as consideration to redeem a poison pill.[73]
- The insider had previously acquired exchange-traded call options on the company's stock, but the options are now gone because they expired unused.[74]
- Shares previously granted to a Grantor Retained Annuity Trust that are returned in substitution for other assets.[75]

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[68] *Id.*

[69] For example, the SEC has issued no-action letters to clarify the filing requirements for various forms of arguable beneficiary ownership. *See, e.g.*, Prudential-Bache Sec., Inc., SEC Staff No-Action Letter, 1985 WL 55643, at *1 (Dec. 2, 1985) (clarifying that purchases and sales made by broker-dealers for the purpose of market-making need not be disclosed).

[70] *See also* Hazen, *supra* note 61; Lawrence D. Levin & Adam R. Klein, 2014 Handbook for Preparing SEC Annual Reports and Proxy Statements (2013); Securities and Exchange Commission, A Plain English Handbook: How to Create Clear SEC Disclosure Documents (1999).

[71] We reviewed the two leading handbooks on Section 16 filings. Both Jacobs and Romeo & Dye identify 24 instances in which Code J is proper and one in which it may not be inferior, but some other transaction code is a better fit. Romeo and Dye additionally identify two instances where J and K should *both* be selected, and five cases where either J or P are both equally proper. *See* 1 Peter J. Romeo & Alan L. Dye, Section 16 Forms & Filings Handbook Model Form 47 (9th ed. 2021); 1 Arnold S. Jacobs, Section 16 of the Securities Exchange Act § 2:91 (2023).

[72] 1 Jacobs, *supra* note 38, § 8:25.

[73] 1 *id.* § 8:29.

[74] 1 *id.* § 8:60.

[75] 1 Peter J. Romeo & Alan L. Dye, Section 16 Forms & Filings Handbook Model Form 47 (9th ed. 2021).

- The execution of an equity swap agreement.[76]
- Shares received because of the rescission of a transaction.[77]

As the forgoing litany indicates, Code J is not used for everyday sales and purchases. It is properly limited to special cases, as we will discuss.

Yet hundreds of thousands of trades end up coded as J, and our findings in Part IV indicate they are (on average) highly profitable. How might "other" transactions gain such prominence? Part III lays out case studies in how some traders found J-codes to be convenient. But the following section (III.D.) introduces the notion that codes are, at least in part, discretionary.

B. "Other" Opportunism

1. Opportunistic Coding

Opportunistic trade reporting means reporting trades in a manner that reduces risk of scrutiny. One such form of opportunism is selecting transaction codes that are subject to less scrutiny. At a high level, opportunistic reporting exists on a spectrum of legality. At one extreme are highly fraudulent codings, where the insider selects a transaction code without any legal basis. For example, a brazen miscoder might simply apply a G code (indicating a gift) to conceal a sale. We can call this approach "miscoding."

At the other extreme, the insider may have a strong legal basis for the coding selection, but the coding remains opportunistic because the insider intentionally structured her affairs in order to qualify for the preferred coding. For example, a trader who wishes to sell shares might instead gift the shares to a child or investment partner, who then sells the shares. Such an indirect transaction may sometimes properly incur a code other than S (sale) for the insider, even though the economic substance is similar to an outright sale. Largely lawful coding strategies, which are nevertheless selected in part to conceal, can be called "trade laundering."

In between are cases where there is some legal basis for the selection, perhaps because the trader structured their affairs to create such a basis, but where the best application of the law would still call for some other code.[78]

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[76] 2 *id.* Model Form 201, Reporting Principle 5. Note that here, the authors recommend using "'J/K' ('J' accompanied by 'K')", rather than just J.

[77] 2 *id.* Model Form 234, Reporting Principle 3.

[78] 1 JACOBS, *supra* note 38, § 8:66. For example, imagine a stock-for-stock merger in which employees of one company will lose their stock options but be given cash equal to what the employee would have received if they had exercised those stock options and then sold the stock. One could code it as X or O (representing an exercise of an option) followed by S (for a sale), because this transaction is economically equivalent to an exercise and sale. But the transaction was not actually an exercise and sale. So, J is the better coding.

There are transactions about which reasonable doubt may exist as to the best filing, such as when it is not clear whether a transaction has yet occurred.[79] Any transaction that could be coded S (sale) but which has peculiar features might be better characterized as J or S/J; a trader can introduce unusual features in order to plausibly depart from S. Indeed, there are even cases where the leading treatises disagree on the appropriateness of the J code.[80] A coding can have some legal basis (thus, not pure miscoding) but that basis is weak (thus, not pure trade laundering).

Whichever form of opportunistic coding is considered, traders are likely to succeed more easily and safely because of the transaction code "J," which represents "other." The next Section explains why.

2. The Power of "Other"

Opportunistic coding may help conceal the nature of a potentially suspicious or objectionable insider trade. When insiders code opportunistically, they may exhibit a preference for the J code, representing "other." This is because the subjective and vague nature of the "other" categorization lends itself to both opacity and plausible deniability.

In theory, any coding can serve as a substitute for the highly suspicious S (sale) and P (purchase) codings. But most codings can be quickly understood and audited by investigators. A trader who sells in the open market can simply omit the S code and punch in G, thereby asserting (falsely, and with no basis) that it is a bona fide gift. But investigators can easily audit such a transaction, asking for a gift receipt or questioning why the "gift" led to trading profits. And such miscodings would be so implausible that a prosecutor could easily establish that the miscoding was intentional or willful.[81]

A J selection may be preferable because prosecutors cannot easily understand the transaction and its proper coding. J is at the penumbra of every transaction, so it is imaginable that one might complicate a transaction to

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[79] Someone who thinks the transaction has occurred would report it; someone who does not might not report it. Reporting it under J can itself be an arguable accommodation to uncertainty. Peter J. Romeo & Alan L. Dye, Section 16 Deskbook 354 (2022) [hereinafter Romeo & Dye Deskbook] (when there is reasonable doubt as to whether a purchase or sale occurred, "the insider should not report a transaction using transaction code 'P' ('Open market or private purchase or non-derivative or derivative security') or 'S' ('Open market or private sale of non-derivative or derivative security'), but instead should use transaction code 'J' ('Other acquisition or disposition') and explain the nature of the transaction in a footnote."); *see* 1 Peter J. Romeo & Alan L. Dye, Section 16 Treatise and Reporting Guide 633 (2019) [hereinafter Romeo & Dye Treatise and Reporting Guide].

[80] *See, e.g.*, 1 Jacobs, *supra* note 38, § 8:52 (noting a disagreement regarding whether a J code or an X code is more appropriate in the case of a former director settling her phantom stock within six months of the termination of her directorship).

[81] Intentional wrongdoing establishes scienter for civil securities litigation. Willfulness establishes criminal liability.

obtain J characterization. And a trader who incorrectly codes their transaction as J may be wrong, but how can prosecutors establish that the miscoding was willful or even negligent? Absent some smoking gun emails (containing bragging or confessions), a trader may risk detection without risking the most serious consequences.[82] Prosecutors know the challenges they face and may be discouraged from expending their effort. Moreover, prosecutors might just trust that the transaction is benign. Many transactions properly coded "J" are both confusing and useless for insider trading. For example, J is proper when there is a stock split. A stock split is a decision by the company to double the number of shares (and halve their per-share value). Such a transaction poses no risk of insider trading, so prosecutors may implicitly trust a J-coded transaction as likely to be anodyne.

Not only might investigators give J-coded transactions a pass, but we have strong evidence that they do so. As we discuss in the following Section, investigators do not catch and prosecute transactions erroneously coded as J.

C. Lack of Scrutiny

Investigators do not spot and interrogate the underlying J-coded transactions. Use of a J code seems to occlude any oversight of otherwise suspicious trades. We scoured the public record and can find no case, enforcement action, or other investigatory material addressing transaction code J.[83]

We examined the public record for evidence that the Department of Justice[84] or the SEC had prosecuted insiders for trades undertaken with the

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[82] All of this is different for miscoding without J. A trader who wrongly asserts that an open market sale (S) was a bona fide gift (G) will usually have no justification for their selection and will therefore appear to have acted willfully and with scienter.

[83] The closest we found was a motion in which a filer apologized for *not* using code J. Defendant David H. Smith's Memorandum of Law in Support of His Cross-Motion for Summary Judgment and in Opposition to Plaintiff's Motion for Summary Judgment, Morales v. Quintiles Transnational Corp., 25 F. Supp. 2d 369 (S.D.N.Y. 1998), 1997 WL 34714875 ("In the SEC filings, Dr. Smith's counsel mistakenly entered the transaction code 'P' to refer to the October 19, 1995 substitution transaction when they should have entered the transaction code 'J' and an explanatory description of the transaction. This was a clerical error; the substitution transaction was not actually a purchase of Quintiles securities within the meaning of Section 16 because Dr. Smith was already the sole beneficial owner of the Quintiles securities held by the Smith Family Trusts before the transaction, as had been reported on previously filed Form 4s.") (citations omitted).

[84] We read every DOJ information, plea agreement, complaint, and indictment going back to mid-2017. We found these by searching Bloomberg Law, with the keywords "insider trading" and "'insider trading' AND '10b-5'." In the "Federal NOS" section in the column, we clicked the checkbox for "criminal." We compiled a similar list from Lexis Courtlink. We searched for "insider trading," and then read each information, etc. This approach yielded 50 matters. For each one, we downloaded all Form 4s filed by defendants in the case. We read the Form 4s to see if any contained J-coded transactions. Almost none did. Where they did, we still did not see the DOJ refer to these J-coded transactions as possible insider trading.

J code.[85] We found none. This was true even where insiders were prosecuted for securities fraud[86] or insider trading, and where suspicious J-coded transactions had occurred.[87] Prosecutors focused on the S trades and left the J codes to the side.

We checked whether plaintiffs bringing individual and class actions cited suspicious J-coded trades in their complaints.[88] They did not, even in cases where the plaintiffs otherwise build their case around suspicious trades, and even where suspicious J-coded transactions existed and could have been cited.[89]

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[85] From June 14, 2017, to June 30, 2023, the SEC litigated 177 insider trading suits. In none of these cases did the suspect transaction involve a J code. We read every complaint and opinion from SEC insider trading suits from June 14, 2017, to June 30, 2023. We found these by searching Bloomberg Law, with the keywords "insider trading" and "'insider trading' AND '10b5-1'." In the "Federal NOS" section in the column, we clicked the checkbox for "Statutes: Securities / Commodities." Then, for each docket, we read the complaint to determine whether the SEC alleged insider trading had occurred. We followed a similar methodology to find court opinions on SEC-litigated insider trading suits. We searched "insider trading" on Lexis+, limiting the search to civil cases from U.S. district courts. After having sorted the results by date, we read through all results to determine if insider trading was alleged; occasionally, if the opinion discussed the details of the case in a cursory manner, we opened the "Filings" to read the complaint. If the SEC alleged insider trading, we determined whether the complaint or opinion mentioned that a company insider was alleged to have done the trading themselves. If the complaint or opinion did mention this, then we read the Form 4s containing the alleged insider trading transactions to determine whether they contained J-coded transactions. Almost none did. In the few cases where the defendant did make a J-coded transaction, the SEC's complaint or court's opinion did not mention these trades.

[86] Trevor Milton filed J-coded transactions when he swapped stock options for real estate, a transaction for which he was prosecuted. But the prosecution was for fraud, not for insider trading. Chris Dolmetsch, *Nikola Founder Bought Utah Ranch with 'Worthless' Options*, BLOOMBERG (Sept. 29, 2022, 1:15 PM), https://www.bloomberg.com/news/articles/2022-09-28/nikola-founder-bought-utah-ranch-with-worthless-stock-options [https://perma.cc/L3UH-BMRP].

[87] When the SEC and DOJ prosecuted Nikola insiders for fraud, they did not accuse them of insider trading in connection with the J-coded transactions. *See* Complaint, SEC v. Milton, No. 1:21-CV-6445 (S.D.N.Y. filed July 29, 2021), https://www.sec.gov/litigation/complaints/2021/comp-pr2021-141.pdf; Jack Ewing, *Trial Begins for Truck Maker Accused of Duping Investors*, N.Y. TIMES (Sept. 12, 2022), https://www.nytimes.com/2022/09/12/business/trevor-milton-nikola-trial.html [https://perma.cc/58ZN-HJQZ]. This is true even though there were suspicious J-coded transactions as we describe in the paper.

[88] Again, we obtained the Form 4s corresponding to all insider trading defendants. From August 23, 2022, to June 30, 2023, shareholders filed 46 lawsuits alleging that company executives, while in possession of material non-public information or while perpetrating a fraudulent scheme, traded company securities.

[89] For example, a shareholder class action accused Nikola executives of insider trading. *See* Public Version of the Verified Stockholder Derivative Complaint, In re Nikola Corp. Derivative Litig., No. 2022-0023 (Del. Ch. Jan. 12, 2022), 2022 WL 144305. It mentions several S trades, such as when Jeffrey Ubben (whose venture capital fund distributed Nikola stock at the best of all moments) had allegedly offloaded 1,400,000 shares on August 11, 2020, in violation of his lock-up agreement, a few weeks before the company's fraud was disclosed. *Id.* at 29. But despite its various accusations, this complaint does not consider J-coded transactions. Nikola Corp., Statement of Changes in Beneficial Ownership (Form 4) (Aug. 13, 2020), https://www.sec.gov/Archives/edgar/data/1731289/000090266420003008/xslF345X03/ownership.xml. Nevertheless, we did find one case in which the plaintiff refers to J-coded transactions. Amended Complaint at ¶¶178, 181, Victor J. NG v. Berkeley Lights, Inc., No. 4:21-CV-09497-HSG (N.D. Cal. July 25, 2022), 2022 WL 4234694. It cites two investment funds' distribution of stock as evidence of scienter for fraud, but even that complaint fails to address suspicious "other" filings. *Id.* at ¶181 (citing the March 16th Form 4 filing, but not the March 11th Form 4 filing).

We likewise checked whether journalists had spotlighted suspicious J-coded transactions. None had. To the contrary, respected newspapers frequently accused insiders of suspicious trading, but did not include the J-coded transactions in their tallies. We mention WorldCom insiders in the introduction, but they are far from being alone. Consider WorldCom's rival in perfidy, Enron. In December 2001, Enron was the world's seventh largest company.[90] Within a year, the stock was worthless. In that intervening year, Enron directors and officers sold $50 million worth of shares to outside investors who didn't know about any problems. Like all stock trades by insiders, these transactions were publicly reported. However, no Enron insider was ever prosecuted for these sales, even though they were almost certainly illegal insider trading.

To be sure, Enron's leadership was prosecuted for many other violations, including other acts of insider trading. But *these* $50 million transactions were never mentioned in any civil complaint or criminal indictment.[91] Nor did journalists report on them.[92] This omission is curious, since these insider trades

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[90] Permanent Subcommittee on Investigations of the Committee on Governmental Affairs U.S. Senate, 107th Congress, The Role of the Board of Directors in Enron's Collapse 1 (2002), https://www.govinfo.gov/content/pkg/CPRT-107SPRT80393/pdf/CPRT-107SPRT80393.pdf.

[91] *See, e.g.*, Complaint at ¶ 36, Newby v. Enron Corp., 188 F.Supp.2d 684 (No. 4:01-CV-03624) (S.D. Tex. filed Oct. 24, 2001) (accusing Enron CEO Kenneth Lay of insider trading 400,000 shares of Enron stock). The complaint fails to note an additional 264,382 shares Lay sold just a few days before the first transaction the complaint cites. *See* Enron Corp., Statement of Changes in Beneficial Ownership (Form 4) (Dec. 18, 2000). At the time, those shares were worth $79.56 each, or about $21 million. *See* Douglas O. Linder, *Enron Stock Price Chart and Data*, Famous Trials, https://www.famous-trials.com/enron/1791-stockchart (last visited Jan. 17, 2025). The complaint ultimately alleges $100 million in insider trading. First Amended Complaint and Demand for Jury Trial at 40, Newby v. Enron Corp., 188 F.Supp.2d 684 (No. 4:01-CV-03624) (S.D. Tex. 2002). So, this omission amounted to 20% of the allegation. The SEC's complaint against Lay likewise omits mention of this trade. *See* Second Amended Complaint, SEC v. Lay, No. H-04-0284 (S.D. Tex. 2004), https://www.sec.gov/litigation/complaints/comp18776.pdf.

[92] Mitchell Pacelle & Cassell Bryan-Low, *Belfer Family Is Big Loser in Collapse of Enron Stock,* Wall St. J. (Dec. 5, 2001), https://www.wsj.com/articles/SB1007504552303214600 [https://perma.cc/MMX5-L85M] (reporting that Ruben had sold 148,920 shares). The trades discussed in the first paragraph here numbered 295,942. Enron Corp., Statement of Changes in Beneficial Ownership (Form 4) (Dec. 20, 2000); Enron Corp., Statement of Changes in Beneficial Ownership (Form 4) (Dec. 22, 2000); Enron Corp., Statement of Changes in Beneficial Ownership (Form 4) (Jan. 8, 2001); Enron Corp., Statement of Changes in Beneficial Ownership (Form 4) (Sept. 5, 2001); Enron Corp., Statement of Changes in Beneficial Ownership (Form 4) (Nov. 1, 2001); Enron Corp., Statement of Changes in Beneficial Ownership (Form 4) (Nov. 9, 2001); Enron Corp., Statement of Changes in Beneficial Ownership (Form 4) (Nov. 30, 2001). The Wall Street Journal missed two thirds of Ruben's sales in the relevant period. The New York Times missed these transactions too. Leslie Wayne, *ENRON'S COLLAPSE; Before Debacle, Enron Insiders Cashed in $1.1 Billion in Shares*, N.Y. Times (Jan. 13, 2002), https://www.nytimes.com/2002/01/13/business/enron-s-collapse-before-debacle-enron-insiders-cashed-in-1.1-billion-in-shares.html [https://perma.cc/445E-6Y9B]. It reported that "between early 1999 and July 2001," Enron CEO Kenneth Lay sold "sold as many as 100,000 shares" at a time. *Id.* The Times appears to have missed his December 18, 2000, sale of 264,382 shares, worth $21 million. *Id.*

were visible in public filings—the very public filings that prosecutors and journalists used to successfully identify many other insider trades.[93]

We likewise checked whether scholarly articles examine the profitability of J-coded transactions. We believe this Article is the first to do so, so insiders were (until now) also evading scholarly notice.

Prosecutors, plaintiffs, journalists, and scholars all overlook J-coded transactions. Almost no transaction marked "other" has ever led to adverse consequences, nor has anyone ever been punished for wrongly using the J code. These facts suggest that insiders would be wise to conceal their trades with J codes–to insider trade by other means. Is it plausible that insiders might do so? What would that look like? Those are the questions that drive the next few parts of the paper.

III. Insider Trading by "Other" Means

Insiders may try to conceal suspicious trades as "other" in order to avoid scrutiny. What would that look like, and is there any reason to think they actually do this? Surely there is bound to be great variety. Yet some patterns may emerge. This Part acquaints readers with three patterns of opportunistic coding. In Part III.A., we consider transactions that are arguably miscoded. We identify widespread patterns of coding that seem to violate the best practices for coding. We surmise that insiders may not be making random filing errors–they may decide to pick a code with less legal justification that, nevertheless, provides superior cover against investigations.

In the next two Parts, we turn away from probable miscoding to trade laundering. In Part III.B., we consider how insiders may distribute stock to their own upstream investors. These later investors can sell the stock without any public oversight because they are not subject to reporting requirements. In Part III.C., we consider how insiders may use their influence to cause the corporation to sell them stock (or buy it back) at the moments insiders know will be the most advantageous. Finally, in Part III.D., we discuss how forced, or mandatory sales, classified as other, are from an economic perspective almost identical to open market sales and may involve informed trading.

For each type, we describe how the opportunistic coding works and provide an anecdotal example of the strategy in action. We do not select these examples in order to accuse the filers of misconduct.[94] Our goal is to help

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[93] Unfortunately, we are not able to directly view those Form 4s now. The SEC's data retention policy curiously required them to be destroyed. We report on the contents of these Form 4s based on their recordation in the Thompson Reuters database.

[94] It is possible in each case that facts outside of the filing serve to justify the filing. Even where the filing is miscoded, it may be that the miscoding was in good faith, based on a reasonable disagreement about the law's obligations. Even where the miscoding was unreasonable, it may not have been a willful effort to subvert the law. And even where knowing that the misfiling had occurred, it may not have been to conceal insider trading.

make tangible the plausibility of opportunistic coding so that the statistical proofs in the following sections do not seem abstract or implausible.

A. *Miscoding*

It is reasonable to suppose that transactions that apply an incorrect or deceptive transaction code might be more likely to exhibit other suspicious signs, such as exceptionally good timing. In this part, we consider five such coding scenarios, with suggestive examples illustrating each.

1. 10b5-1 Plans

10b5-1 plans permit traders to trade despite having acquired material, nonpublic information, so long as the trader has committed to the trade (or series of trades) in good faith and at a time when the trader has no such information. These plans are obviously suspicious.[95] An insider could trade illegally, but then concoct a fictional trading plan, after the fact, for cover. Or a trader could draft a trading plan in advance of the trade, but at a time that the trader actually knows inside information. Or a trader could make numerous trading plans but cancel any trading plan that appears to be unprofitable in light of subsequently acquired nonpublic information. These possible abuses seem widespread and have attracted substantial scholarly and regulatory interest in recent years.

With that in mind, let us consider the 10b5-1 trading plan of Mel R. Brashears, Chairman of the Board at Irvine Sensors.[96] He sold 40,000 shares on April 13, 2004.[97] The footnote explained that this transaction was "pursuant to Rule 10b5-1 Trading Plan effectuated February 27, 2004."[98] Consistent with the forgoing, Brashears's trading was well-timed.[99] The day after his trade, the stock dropped 11%.[100] Three months later, the stock price had almost

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[95] *See* Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, 55 MGMT. SCI. 224, 235 (2009) (noting that insiders' trades pursuant to 10b5-1 plans, "on average, generate abnormal trade returns"). Accordingly, the SEC recently acted to constrain abusive deployment of these plans. SEC, Press Release 2022-222, SEC Adopts Amendments to Modernize Rule 10b5-1 Insider Trading Plans and Related Disclosures (Dec. 14, 2022), https://www.sec.gov/news/press-release/2022-222.

[96] *Brashears, Kelly Join Irvine Sensors Board*, L.A. TIMES (Jan. 7, 2001), https://www.latimes.com/archives/la-xpm-2001-jan-07-fi-9367-story.html [https://perma.cc/8J39-UV5F].

[97] Irvine Sensors Corp., Statement of Changes in Beneficial Ownership (Form 4) (Apr. 13, 2004), https://www.sec.gov/Archives/edgar/data/357108/000118143104020464/xslF345X03/rrd39408.xml.

[98] *Id.*

[99] *Id.*

[100] The price of Irvine Sensor's stock, IRSN, at the open of trading on April 14, 2004, was $4.34, and at the close, it was $3.82. The stock has since been delisted from the NASDAQ, but historical prices of IRSN are available from the Center for Research in Security Prices (CRSP).

halved.[101] The cause of the drops may have been bad mid-year results (including a 24% drop in revenues) and a dilutive equity issuance[102]—both of which a chairman would have known about before they were made public. Brashears earned an extra $69,046 by selling his shares on April 13, 2004, rather than three months later.[103] Although it was allegedly pursuant to a plan of trading, no obvious pattern of planned trading exists for his trades.[104] This transaction is suspicious.

It is also miscoded. Sales pursuant to these plans are plainly reportable under S, not J.[105] Traders were not required to make reference to 10b5-1 plans in their trade reports until a few months ago.[106] They were permitted to do so, and leading commentators urged their inclusion.[107] The SEC considers disclosure of the 10b5-1 plan in a filing to be evidence of good faith in connection with the plan.[108] But a trader who wants to disclose this 10b5-1 plan

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The CRSP database is a subscription-only database that comes with a subscription to the Wharton Research Database. *See Wharton Research Data Services*, Wharton Sch. Univ. of Pa., https://wrds-www.wharton.upenn.edu (last visited July 18, 2023) [https://perma.cc/E85T-TNDX].

[101] *Id.*

[102] *Irvine Sensors Releases Mid-Year Results*, PR Newswire, May 7, 2004, Factiva; *Irvine Sensors Closes Private Placement Common Stock and Warrant Financing of Approximately $2.75M*, PR Newswire, Jun. 23, 2004, Factiva; *Final Court Approval of Irvine Sensors Class Action Settlement*, PR Newswire, Jun. 7, 2004, Factiva. Insider trading with respect to the equity issuance was alleged by the SEC,though not with respect to Brashears.

[103] Brashears sold his shares for a total of $160,246 on April 13, 2004. Irvine Sensors Corp., Statement of Changes in Beneficial Ownership (Form 4) (Apr. 13, 2004), https://www.sec.gov/Archives/edgar/data/1195205/000118143104020464/xslF345X02/rrd39408.xml. If he had sold them three months later on July 13, 2004, his shares would have been worth a total of $91,200. *Wharton Research Data Services*, *supra* note 100.

[104] He sold 3,750 shares on February 24, 2004, which was roughly two months before the transaction in question. Irvine Sensors Corp., Statement of Changes in Beneficial Ownership (Form 4) (Feb. 24, 2004), https://www.sec.gov/Archives/edgar/data/357108/000118143104011718/xslF345X03/rrd34500.xml. He then sold the 40,000 shares on April 13, 2004, which is the suspected insider trading. Irvine Sensors Corp., Statement of Changes in Beneficial Ownership (Form 4) (Apr. 13, 2004), https://www.sec.gov/Archives/edgar/data/1195205/000118143104020464/xslF345X02/rrd39408.xml. The next time that he sells any shares is on August 20, 2007. Irvine Sensors Corp., Statement of Changes in Beneficial Ownership (Form 4) (Aug. 21, 2007), https://www.sec.gov/Archives/edgar/data/1195205/000118143107053352/xslF345X03/rrd170143.xml. He has a number of transactions for stock options, but they also do not seem to conform to a pattern. *See id.*

[105] 1 Romeo & Dye, *supra* note 75, at Model Form 66, Reporting Principle 16. The explanatory footnote attached to the S code in Romeo and Dye's model form states "[t]he sales reported in this Form 4 were effected pursuant to a Rule 10b5-1 trading plan adopted by the reporting person on January 27, 2020." *Id.*

[106] 1 Romeo & Dye Treatise and Reporting Guide, *supra* note 79, at 652. Insider Trading Arrangements and Related Disclosures, 87 Fed. Reg. 80,362, 80,409 (Dec. 29, 2022) (to be codified at 17 C.F.R. pts. 229, 232, 240, 249) (requiring insiders indicate by "checkbox . . . that a reported transaction was intended to satisfy . . . Rule 10b5-1(c)(1)" and to disclose "the date and adoption of the trading plan"). However, it remains inappropriate to code J where S (even with a footnote) will suffice. *Id.* at 80,431.

[107] 1 Romeo & Dye Treatise and Reporting Guide, *supra* note 79, at 652.

[108] *Id.* However, there is a division of enforcement policy as to how a 10b5-1 plan ought to be weighed in determining whether an insider acted with scienter. *Compare* In re Nutrisystem, Inc. Derivative Litig., 666 F. Supp. 2d 501, 518 (E.D. Pa. 2009) (stating that a defendant's 10b5-1 plan, with which the allegedly illegal trades were in accordance, "counter[ed] any inference

information is permitted to do so under code S, and leading commentators assert that this is the correct choice.[109] That is true even if the trade was somehow more complicated, like that it was executed by a broker given discretionary authority to cause the trade.[110] Traders accordingly miscode when they report a 10b5-1 trading plan transaction under code J.

In some cases, this miscoding may be simple error, despite the uniformity of guidance mentioned above. In other cases, it may be intentional miscoding. If a trader wishes to avoid risk for insider trading, asserting that the trade is under a 10b5-1 trading plan may help. But the trade is still a highly profitable "S" transaction, so it is going to be flagged as a suspicious sale. Applying the "other" label could help the trader avoid automatic detection as a well-timed S trade.[111]

2. Other Trades That Need an Explanation

In keeping with the previous example, a grab-bag of trades may end up in the J code with no excuse other than that they require some explanation. Whether willful or negligent, this reasoning is plainly erroneous. Although J codes require an explanation, explanations do not require J codes. Yet J-coding may provide the trader with some strategic benefits, as an example at Nikola goes to show.

Nikola Corporation is the electric truck startup that briefly impressed the world with videos of its zooming electric truck[112]—surreptitiously filmed on a hill, so the inoperative truck could roll.[113] Nikola's stock skyrocketed to

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that the trades were made on the basis of insider knowledge") *with* Indiana Public Retirement System v. Pluralsight, Inc., 45 F.4th 1236, 1265–66 (10th Cir. 2022) ("[T]he text and history of Rule 10b51 shows that such plans can be manipulated easily for personal financial gain and thus cannot rebut the inference that personal financial gain was a motive for Defendants' material misrepresentations.").

[109] 1 Romeo & Dye, *supra* note 75, at Model Form 66, Reporting Principle 16.

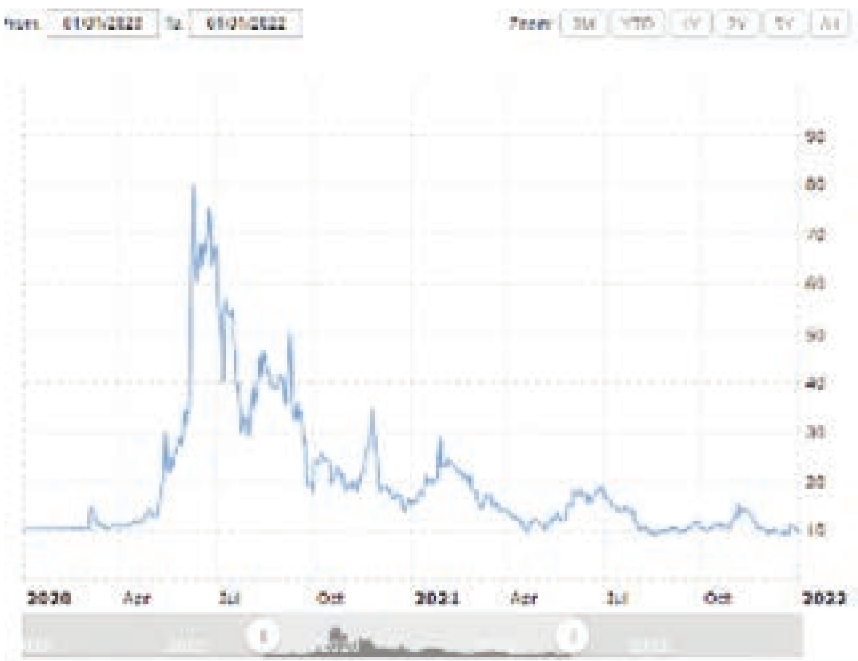
[110] *Id*.

[111] As another example, Oxford Industries director Reese Lanier, Sr. sold 2,500 shares on November 21, 2005, pursuant to a Rule 10b5-1 plan through an S code. Oxford Industries, Inc., Statement of Changes in Beneficial Ownership (Form 4) (Nov. 23, 2005), https://www.sec.gov/Archives/edgar/data/1216102/000120919105059545/xslF345X03/doc4.xml. One and a half weeks later, Lanier made an identical transaction with an identical justification, but with the J code. Oxford Industries, Inc., Statement of Changes in Beneficial Ownership (Form 4) (Dec. 5, 2005), https://www.sec.gov/Archives/edgar/data/1216102/000120919105061141/xslF345X03/doc4.xml. This inconsistent treatment suggests an error, and the migration toward the J code suggests some sense that this code provides slightly more cover.

[112] For a re-upload of such a video, see Авторынок-News, *Nikola One in Motion*, YouTube (Jan. 29, 2018), https://www.youtube.com/watch?v=b5TPIjiCd5c [https://perma.cc/P7AR-UHYV].

[113] Timothy B. Lee, *Nikola Admits Prototype Was Rolling Downhill in Promotional Video*, Ars Technica (Sept. 14, 2020, 1:58 PM), https://arstechnica.com/cars/2020/09/nikola-admits-prototype-was-rolling-downhill-in-promotional-video [perma.cc/H827-PE5Q].

$28.77 billion in June 2020, based on promises of a fully functional hydrogen powered truck.[114]



However, on September 10, 2020, Hindenburg Research released a report accusing Nikola of fabricating claims about its capabilities.[115] This report catalyzed a precipitous plummet in stock price.[116] By September 15, 2020, both the SEC and DOJ had begun an investigation into these claims, and Trevor Milton (founder and executive chairman) resigned from the board on September 21.[117] In November 2020, GM backtracked on a partnership with

[114] Ewing, *supra* note 87; *Nikola Corporation (NKLA) Interactive Stock Chart*, Yahoo Finance!, https://finance.yahoo.com/quote/NKLA/chart (last visited July 8, 2023).

[115] *Nikola: How to Parlay an Ocean of Lies into a Partnership with the Largest Auto OEM in America*, Hindenburg Research (Sept. 20, 2020), https://hindenburgresearch.com/nikola [https://perma.cc/3FFE-ZNYG].

[116] Akanksha Rana & Munsif Vegattil, *Nikola Threatens Hindenburg with Litigation, Short-Seller 'Welcomes It'*, Reuters (Sept. 11, 2020, 3:48 PM), https://www.reuters.com/article/us-nikola-hindenburg-idUSKBN2621WR [https://perma.cc/9QY6-ELVL].

[117] Matt Robinson & Edward Ludlow, *SEC Examining Nikola over Short Seller's Fraud Allegation*, Bloomberg (Sept. 14, 2020, 5:26 PM), https://www.bloomberg.com/news/articles/2020-09-14/sec-said-to-examine-nikola-over-short-seller-s-fraud-allegations [https://perma.cc/9N76-RH65]; Claire Bushey et al., *US Justice Department Inquires into Nikola Fraud Claims*, Fin. Times (Sept. 15, 2020), https://www.ft.com/content/a45a6638-167b-4e27-a9fd-576e7229f959 [https://perma.cc/C2KE-JE8J]; Charles Riley & Peter Valdes-Dapena, *Nikola Founder Trevor Milton Steps Down as Chairman in Battle with Short Seller*, CNN Bus. (Sept. 21, 2020, 3:00 PM), https://www.cnn.com/2020/09/21/investing/nikola-trevor-milton/index.html [https://perma.cc/B7P3-AM8N].

Nikola, and, in late July 2021, a U.S. federal grand jury returned an indictment against Milton, saying he had lied about "nearly all aspects of the business."[118] The closing price for Nikola's stock on September 8, 2020 was $54.56; by the end of the year, on December 30, 2020, the closing price was $15.98.[119] One year after Hindenburg's report, the closing price was $9.95.[120]

With such a precipitous drop in stock price, anyone who knew about the company's problems would have known to sell at almost any point in the landslide. Some insiders did sell. [121] And some of these sales were J-coded, without any sufficient justification.

On December 3, 2020, Milton filed a Form 4 with the SEC, disposing of 2,744,543 shares in a J-coded transaction.[122] The first footnote explains the sale as consideration for a previously negotiated transaction for the purchase of real estate.[123] The federal criminal trial of Milton shed more light on this transaction. Trevor Milton contacted Peter Hicks in March 2020 with an offer to purchase real estate.[124] Hicks eventually accepted Milton's offer of $8.5 million in cash and $8.5 million in Nikola stock options, impressed by Milton's account of the company's growth and capabilities.[125] The deal closed in August 2020, when the shares were worth roughly $40 apiece. Milton sold when the shares were worth $18.98,[126] and the stock price only plummeted from that point onward.

Instead of simply realizing the value of the inflated shares by selling them, as would be typical with most insider trades, Milton exchanged cash and stock options for real estate. But the sale of stock to obtain cash, even if the cash is promised to a real estate seller, does not entitle the seller to foreswear the S-Code typical for an open market sale. Perhaps Milton selected "J" because he wished to explain that the sale was required in order to meet his liquidity needs, but such an explanation is neither obligatory nor does it require a J-Code.

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[118] Ben Foldy & Mike Colias, *General Motors Will No Longer Take a Stake in Nikola*, WALL ST. J. (Nov. 30, 2020, 5:20 PM), https://www.wsj.com/articles/gm-nikola-agree-to-scaled-down-supply-agreement-11606742652 [https://perma.cc/E9MB-2WJ4]; Michael Wayland, *Grand Jury Indicts Trevor Milton, Founder of Electric Carmaker Nikola, on Three Counts of Fraud*, CNBC (July 29, 2021, 4:16 PM), https://www.cnbc.com/2021/07/29/us-prosecutors-charge-trevor-milton-founder-of-electric-carmaker-nikola-with-three-counts-of-fraud.html [https://perma.cc/YMM8-VME7].

[119] *Nikola Corporation (NKLA) Interactive Stock Chart*, *supra* note 114.

[120] *Id.*

[121] Jeffrey Ubben, a director mentioned in the Introduction to this Article, for example, was able to precede this drop in stock price by offloading 1,400,000 shares on August 11, 2020, in violation of his lock-up agreement. Public Version of the Verified Stockholder Derivative Complaint, *supra* note 89, at 29.

[122] Nikola Corp., Statement of Changes in Beneficial Ownership (Form 4) (Dec. 7, 2020), https://www.sec.gov/Archives/edgar/data/1731289/000114036120027541/xslF345X03/form4.xml.

[123] *Id.*

[124] Dolmetsch, *supra* note 86.

[125] *See id*; United States v. Milton, No. 21-cr-00478, 2024 U.S. Dist. LEXIS 32501 (S.D.N.Y. Feb. 26, 2024).

[126] Nikola Corp., Statement of Changes in Beneficial Ownership (Form 4) (Dec. 7, 2020).

One can affix footnotes to any transaction code. Milton knew this, since he affixed footnotes to other transactions on the very same Form 4, including transaction codes that do not specifically require footnoted explanations. The fact that he sold the stock for real estate is immaterial. S is the proper code for a sale of stock, regardless of the consideration one receives in return. The SEC's instructions clearly address sales for non-cash consideration—they call for the use of an explanatory footnote, but there is no hint that the J code is appropriate.[127]

The transaction's J code likely helped Milton avoid scrutiny for insider trading. Neither the criminal prosecution of Milton nor the SEC's complaint for fraud accused him of insider trading.[128]

3. Gifts

There are two ways to miscode with J in gift-related contexts. First, one can use J when a G ("gift") code is more appropriate. In general, bona fide gifts should be reported under G, rather than J. J is only appropriate for very unusual gift transactions, such as re-acquisition of stock previously "given" to a grantor retained annuity trust or charitable remainder trust.[129] But in general, a trader who selects "other," but then describes a gift, has misfiled.

A second form of miscoding involves the use of J and a *purported* gift in order to conceal an ordinary sale. A trader willing to simply mischaracterize a sale as a gift can use the G code, but doing so is quite risky. It will often be easy to establish that no gift occurred. If the transaction is a gift, where is the gift receipt? The name for the G code is not just "gift" but "bona fide gift." That suggests a trader is at fault for selecting G for borderline gifts. An *arguable* gift may have been a gift, but it is a *bona fide* gift? An erroneous coding of "gift" might be mere negligence, but erroneously calling a sale a bona fide gift sounds positively willful. A trader who wished to hide behind the mantle of a gift might prefer to soften the vehemence of the excuse.

Perhaps a little more wiggle room is retained when the characterization is J. A Form 4 reporting a gift by way of J code asserts that there was a gift, but it does not claim that it was a *bona fide* gift, and there may be some suggestion that the transaction was unusual (and, hence, not obviously and willfully misfiled).

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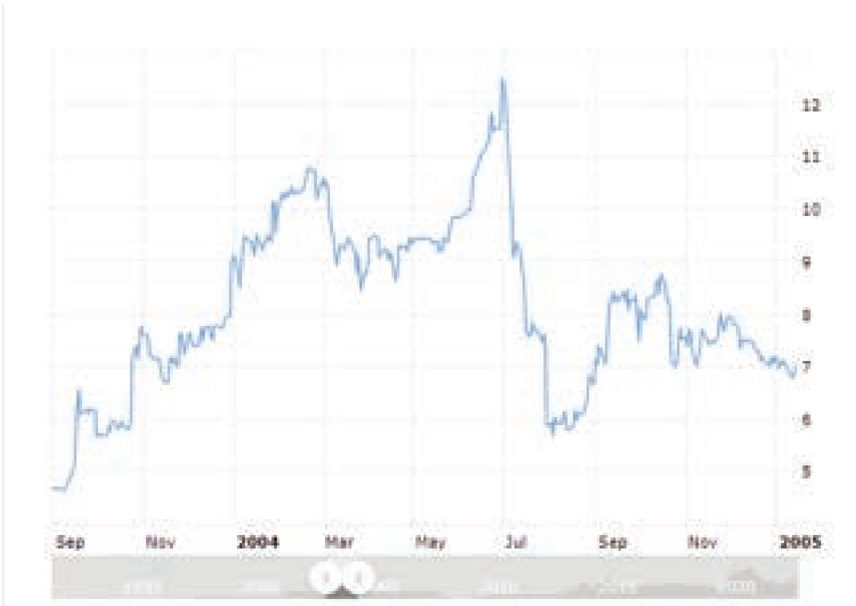
[127] *See* Statement of Changes of Beneficial Ownership of Securities (Form 4) General Instructions, *supra* note 33, at 6.

[128] *See* Complaint, *supra* note 87; *see also* Matthew Goldstein & Niraj Chokshi, *Nikola Founder Is Charged with Fraud in Rebuke to Wall Street*, N.Y. Times (July 29, 2021), https://www.nytimes.com/2021/07/29/business/nikola-trevor-milton-fraud.html [https://perma.cc/TEX2-VU6Q].

[129] 1 Romeo & Dye, *supra* note 75, at Model Form 46, Reporting Principle 8, Model Form 58.

Would anyone ever misfile in these ways? Consider Escalade, Inc., a manufacturer of archery bows, trampolines, and other leisure or sporting accessories. From October 2003 to June 2004, Escalade stock price doubled from $5.72 per share up to $12.11 per share.[130] During that window, Robert E. Griffin (an officer and director) made four J-coded dispositions of stock.[131] For each, the explanation offered was merely "charitable contribution."

The stock lost its luster in July, when its quarterly earnings reported a substantial decline in net profits.[132]



[130] *Escalade - 31 Year Stock Price History*, MacroTrends https://www.macrotrends.net/stocks/charts/ESCA/escalade/stock-price-history [https://perma.cc/3RJX-DNAV] (last visited Sept. 29, 2024). This figure accounts for stock splits. Actually, the apparent price of the shares was much higher at the start of this period, but only due to an economically insignificant doubling of the number of shares on May 26, 2004. *Escalade - 31 Year Stock Split History*, MacroTrends https://www.macrotrends.net/stocks/charts/ESCA/escalade/stock-splits [https://perma.cc/3J2K-ACC9] (last visited Sept. 29, 2024).

[131] Robert E. Griffin's J-coded transactions were reported on Oct. 3 and Dec. 12 of 2003 and Jan. 20 and Jun. 24 of 2004. *EDGAR Full Text Search*, SEC, https://www.sec.gov/edgar/search/#/dateRange=custom&category=form-cat2&entityName=0000033488&startdt=2003-10-01&enddt=2004-06-30 (last visited July 14, 2023) (each Form 4 referenced above can be herein identified by the filer's name and date of filing).

[132] *See* Dune Lawrence, *Escalade, Janus, Netgear, Opnet, Suntron: U.S. Equity Movers*, Bloomberg Law (July 30, 2004, 10:32 AM), https://www.bloomberglaw.com/product/blaw/document/I1O5Q01A74E9 [https://perma.cc/Y3S4-NKX5]; *see also Escalade Announces Third Quarter Results*, Bloomberg Law (Oct. 22, 2004, 10:55 AM), https://www.bloomberglaw.com/product/blaw/document/I5ZQTA3TCF0H [https://perma.cc/AW7Q-K3XF]. The prices dropped prior to the disclosure, which may suggest some leakage of information.

The transactions were well-timed, and one might suspect that Griffin knew on June 3 something about the problems that the July 30 earnings report would contain.[133] But what kind of well-timed, suspicious transaction was it?

This might have been a genuine, if well-timed, gift. In that case, it was misfiled. Griffin offers no excuse for using the J code instead of the proper G code. Perhaps Griffin erred. Or perhaps he thought that G codes faced a slightly higher chance of discovery than J codes. Journalists and scholars do *sometimes* take a look at suspicious G-coded transactions.[134]

But it could be more interesting than that. Griffin's Forms 4s indicated non-zero disposition prices. Indeed, he seems to have received the prevailing market price in return for his gift. That is obviously atypical for a gift. Gifts typically report a disposition price of zero, because one received no consideration in return for the gift.[135] It is possible that this was a deeply miscoded gift, erroneously stating that he received consideration when he did not. Or perhaps the transaction was a sale, masked as an "other" transaction.

4. Empty Footnotes

The simplest way to miscode is to take an ordinary sale and apply a J code instead of an S code, without any explanation or pretense justify the atypical coding. J-coded transactions are required to have such an explanation, and this requirement is one of the main constraints on J code use. A trader can make easier recourse to this transaction code if they ignore that requirement. Perhaps surprisingly, they often do. Consider an example involving one of the world's most prominent venture capital firms.

Align Technology Inc. is a company that manufactures products to fix misaligned teeth without the use of wires or brackets.[136] In 2003 to 2004, more

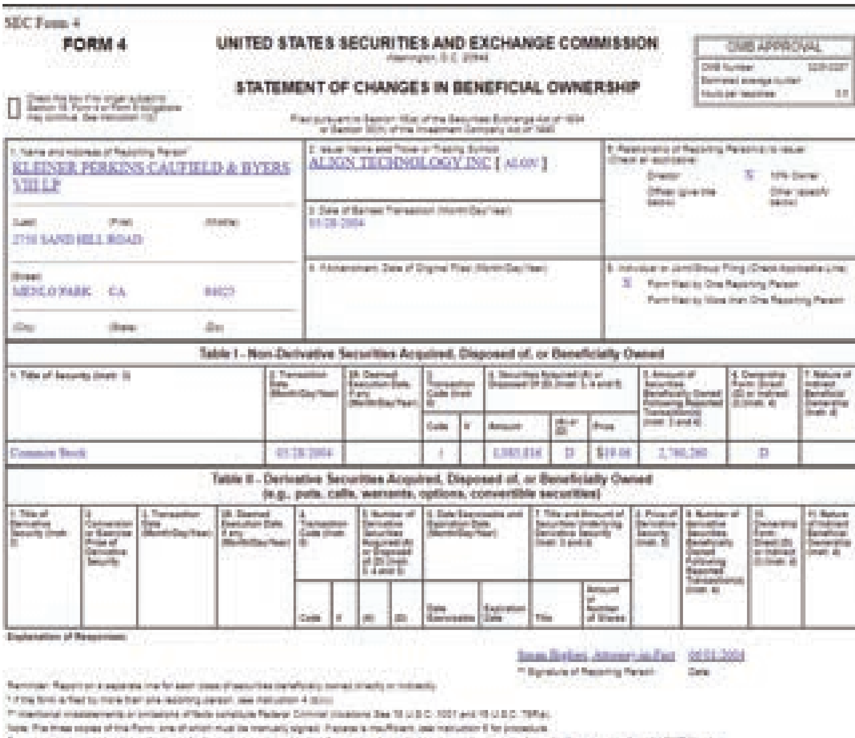
[133] The quarter ended on July 10, meaning that Griffin would have already observed about 60% of the quarterly results. Escalade, Inc., Quarterly Report Pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 (Form 10-Q) (July 30, 2004), https://www.sec.gov/Archives/edgar/data/33488/000101905604001006/escalade_q.txt.

[134] *See e.g.*, S. Burcu Avci, Cindy A. Schipani, H. Nejat Seyhun & Andrew Verstein, *Insider Giving*, 71 Duke L.J. 619 (2021); S. Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Manipulative Games of Gifts by Corporate Executives*, 18 U. Penn. J. Bus. L. 1131 (2016); Theo Francis, Mark Maremont & Geoffrey Rogow, *Kodak Insider Makes Well-Timed Stock Gift of $116 Million to Religious Charity He Started*, Wall St. J. (Aug. 11, 2020, 4:51 PM), https://www.wsj.com/articles/kodak-insider-makes-well-timed-stock-gift-of-116-million-to-religious-charity-he-started-11597154826 [https://perma.cc/99GW-JSU2]; Andrea Fuller, *Hundreds of People Made Gifts of Stock with Great Timing*, Wall St. J. (Dec. 21, 2017, 1:34 PM), https://www.wsj.com/articles/hundreds-of-people-made-gifts-of-stock-with-great-timing-1513881239 [https://perma.cc/7F9M-2XXM] (chronicling how hundreds of people donated stock to charities near price peaks to take advantage of potential tax deductions).

[135] More than half the J-coded transactions (about 63%) in our survey likewise list zero for the price or list no price at all.

[136] *Align Technology Files Lawsuit*, PR Newswire (Feb. 2, 2005, 8:13 PM), https://www.bloomberglaw.com/product/blaw/document/IBBA2Z3TCF0H [https://perma.cc/DK7R-XKNM].

than 10% of its shares were held by Kleiner Perkins Caufield & Byers VIII LP.[137] Throughout these years, Kleiner Perkins disposed of many shares under the J code without footnotes to explain their purpose. For example, on May 28, 2004, Kleiner Perkins made disposed of 1,085,816 shares in Align for $19.06 per share using the J code; Kleiner Perkins did not include a footnote explaining the transaction or the use of the J code.[138]


SEC Form 4

FORM 4

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP

OMB APPROVAL

1. Name and Address of Reporting Person: KLEINER PERKINS CAUFIELD & BYERS VIII LP

2750 SAND HILL ROAD

MENLO PARK CA

2. Issuer Name and Ticker or Trading Symbol: ALIGN TECHNOLOGY INC [ALGN]

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

Common Stock

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

Explanation of Responses:

** Signature of Reporting Person Date

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB Number.

This transaction was particularly well-timed. On October 21, 2004, Align announced its 3rd quarter results, reporting that its revenue and profit per share had fallen short of analysts' estimates.[139] Align's stock price plummeted 33% on this date, from $14.82 to $9.90.[140] By selling its shares on May 28, 2004, Kleiner Perkins made $20,695,653. If it had waited until October 21, 2004,

[137] Align Tech. Inc., Statement of Changes in Beneficial Ownership (Form 4) (Nov. 4, 2003), https://www.sec.gov/Archives/edgar/data/1032458/000117911003009992/xslF345X03/edgar.xml.
[138] Align Tech. Inc., Statement of Changes in Beneficial Ownership (Form 4) (June 1, 2004), https://www.sec.gov/Archives/edgar/data/1032458/000117911004011888/xslF345X03/edgar.xml.
[139] Danny King, *Align Shares Fall on 3rd-Qtr Profit, 2004 Forecast, Dow Says*, BLOOMBERG (Oct. 21, 2004, 4:48 PM) https://www.bloomberglaw.com/product/blaw/document/I5YCGX1A74E9 [https://perma.cc/VJ2X-2Y35].
[140] *Id.*

it would have only earned $10,749,578.40 from this transaction. Therefore, Kleiner Perkins saved $9,946,074.60 by selling these shares when he did.[141]

Why omit an explanation? Perhaps because Kleiner Perkins lacked any justification and feared that a true explanation (that there is no explanation) would increase the risk of detection and prosecution for misfiling and insider trading. The insider might have fabricated an explanation, but any untrue explanation might later be proven false by prosecutors, in such a way as to generate proof of willful fraud.

Yet, filers are required to explain their use of the J code. The official name of the J code selection is "Other acquisition or disposition (describe transaction)." A trader plainly must describe the transaction. And SEC guidance repeatedly concurs with this commonsense observation. The law provides no justification for blank footnotes, nor do any secondary sources advise the absence of explanation.[142] Anyone who selects "J" without providing an explanation has misfiled, in that their J-filing was not handled properly, and many such filers may have been improper in selecting J at all. Accordingly,

[141] This is not the only instance of Kleiner Perkins selling under a J code, without any explanation, at Align. On November 10, 2004, Kleiner Perkins made a disposal of 1,267,839 shares in Align for $11.12 per share using the J code. Align Tech. Inc., Statement of Changes in Beneficial Ownership (Form 4) (Nov. 11, 2004), https://www.sec.gov/Archives/edgar/data/1032458/000117911004021188/xslF345X03/edgar.xml. On January 26, 2005, Align announced its 4th quarter results. *Align Technology, Inc. Reports Revenues of $43.7M for Q4 2004*, Bloomberg (Jan. 26, 2005, 8:00 AM), https://www.bloomberglaw.com/product/blaw/document/IAXDHB3TCF0J?criteria_id=9b520fb2f894438c94909d3c367e347b&searchGuid=ef5c7b37-18df-4713-b8a9-ca8173e1fce7 [https://perma.cc/5NJ6-3G5Z]. They were poor, showing lower sales than the previous year. *Id.* These results coincided with a drop in stock price, with the stock opening at $10.26 on January 24, 2005 and closing at $7.99 on January 31, 2005. *Align Technology, Inc. (ALGN) Interactive Stock Chart,* Yahoo Finance!, https://finance.yahoo.com/quote/ALGN/chart (last visited July 24, 2023). More significantly, on February 3, 2005, news broke that OrthoClear Holdings Inc., a competitor of Align, had poached 10% of Align's sale force. Laure Edwards, *Amazon.com, FEI, Fluor, Labor Ready, Maytag: U.S. Equity Movers*, Bloomberg (Feb. 3, 2005, 3:00 PM), https://www.bloomberglaw.com/product/blaw/document/IBCQ8C1A74E9 [https://perma.cc/N4C3-Z2V3]. Contemporaneously, Align also filed a lawsuit against OrthoClear alleging that it had stolen Align's trade secrets and intellectual property. *Id.* On this news, Align's stock fell 71 cents to $7.99. *Id.* Kleiner Perkins earned $14,098,369.70 from its transaction. *Id.* On the other hand, if it had sold its shares on February 3, 2005, it would have only earned $10,130,033.60. Therefore, Kleiner Perkins saved $3,968,336.10 by selling its shares when it did.

[142] Interestingly, among the hundreds of fictional examples of filings printed in practitioner guides, we were able to discover exactly four instances in which a J code was reported without any explanation. *See* 1 Jacobs, *supra* note 38, § 8:15; 1 *id.* § 8:41; Romeo & Dye Deskbook, *supra* note 79, at 353; 2 Romeo & Dye, *supra* note 75, at Model Form 100. However, it is not natural to infer that these sources endorse a blank form in these cases. For one thing, such an endorsement is plainly incompatible with nearby writings. For example, with respect to one of these explanation-lacking forms, the authors write, "[T]he insider could use transaction code 'J' ('Other acquisition or disposition,' ***with a footnote explanation***) to report the option grant. [The Insider] has reported her option grant using transaction code 'J' and has explained the transaction in a footnote." *Id.* (emphasis added). It seems plausible that the authors omitted the explanation because they wished to focus the reader on some other aspect of the form that they were highlighting. It is perhaps equally likely that the explanations were omitted erroneously.

we can be confident that this insider has misfiled, as has any other traders with footnote omissions.[143]

5. Disguised Sales

If "sales" are likely to be scrutinized, insiders may seek transactions that are much like sales, but not technically a sale, in order to select a preferable coding. We discussed WorldCom CEO Bernie Ebbers in Part II.C., whose opportunistic sales largely avoided notice for some time. Later investigations reveal the nature of his insider trading as a kind of forward sale. A forward sale is an agreement to sell something in the future for a price largely specified now.[144]

Ebbers had borrowed $70 million in 2000. The terms of the loan permitted him to repay the money or just hand over 3 million shares. At the time of the borrowing and at the moment of repayment, Ebbers knew the shares weren't really worth much, so he surrendered shares in lieu of his loan. This transaction was functionally an agreement to sell 3 million shares for $70 million.

Forward sales can be preferable to ordinary sales for many reasons. One involves deferring taxes. If you sell today, you owe taxes today. But if you agree now to sell in the future, you may only owe taxes in the future (even though you have gotten cash today).[145] Another advantage is the potential to conceal insider trading, since it may be easier (if still not appropriate) to delay reporting. A related transaction concerns a loan: trader who wishes to sell $70 million shares before fraud is discovered can pledge the shares as collateral and then default on the loan, surrendering only worthless shares.

Whether as part of a loan or a forward sale, transfers of share as collateral are properly coded as J.[146] So a forward sale conceals the sale as an "other."

[143] Some insiders report trades without an explanatory footnote, but they do include an explanation in the "remarks" section of the Form 4. *See*, *e.g.*, Pier 1 Imports Inc., Statement of Changes in Beneficial Ownership (Form 4) (May 28, 2013), https://www.sec.gov/Archives/edgar/data/1527042/000114420413031875/xslF345X03/v346377_4.xml. This is also misfiling. The Remarks section is intended to permit commentary on parts of the Form 4 for which the SEC's EDGAR filing system does not permit commentary to be appended. 1 PETER J. ROMEO & ALAN L. DYE, SECTION 16 FORMS AND FILINGS HANDBOOK Model Form 14, Reporting Principle 8 (8th ed. 2014). For example, there is no way to tag a footnote explanation as explaining Box 2 of the Form 4, the name of the company. Accordingly, it can be appropriate to discuss it in Remarks. The same is not true of transactions reported in Table I, such as the J-coded transactions we discuss. *See* SEC, EDGAR FILER MANUAL, VOLUME II: "EDGAR FILING," VERSION 66 § 8.1.4.3.5 (2023) (explaining that footnotes can be attached to transactions in Table I). These can and should have their explanation noted in linked footnotes.

[144] BERESFORD ET AL. , *supra* note 3.

[145] A common variant of this transaction is called variable prepaid forward sale contract. 2 ROMEO & DYE, *supra* note 75, at Model Form 199. These contracts are ones where an insider takes cash now in return for a variable number of shares in the future.

[146] 1 *id*. 626; 2 *id*. Model Form 231 Reporting Principle 5. This transaction, by itself, is ordinarily not reportable. 1 ROMEO & DYE TREATISE AND REPORTING GUIDE, *supra* note 79, at 625.

And if anyone ever questions the trader, she can claim this complex play helped minimize her taxes.

In Ebbers case, the transaction was even more complicated because he returned not shares, but options to buy shares. The transfer of stock options has its own reporting pattern,[147] but one could imagine coding an options transfer with a "J" if it were wrapped up in a variable prepaid forward sale. Thus, Ebbers may have engaged in trade laundering, insider trading by other means to avoiding detection (for a while).

B. Transferring or Distributing Stock to Investors

One form of opportunistic trading involves transferring the shares to someone without a reporting obligation. An important example concerns J-coded distributions by an investment partnership of shares, which the recipient investors then sell.[148] For example, a partnership might invest money on behalf of its members. In the process, it might incur reporting obligations as a greater than 10% shareholder. Its well-timed sale of stock right before a decline in value would be noticed—investigators could inquire as to whether the partnership knew something nonpublic about the company's prospects. However, the partnership might instead distribute shares (under a J code) as a return of capital or dividend to its investors. Those investors would receive the shares and could do with them what they like. The investors might understand that these distributions tend to occur at times that it is prudent for them to sell. If they do, the partnership and its partners will have accomplished a well-timed sale, but there will be no public filing of the sale. Once distributed, the partners individually do not hold greater than 10% of the shares and thus are not obliged to disclose. Like a parent to its child, an investment fund is not the beneficial owner of shares it gives to its investors. And like a parent, an investment fund nevertheless has a motive to enable its investors to profit on inside information.

Similar principles would motivate a director or officer to cause transfers or distributions by a fund that they control. The director or officer might fear selling her shares to capitalize on her inside information, but she might feel comfortable causing an entity to make a distribution (to fee-paying investors who care grateful for the chance to sell).

To see this, consider Peloton, a company known for its stationary bike and fitness class subscriptions.[149] Peloton prospered as the COVID-19 pandemic

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[147] One can use S on Table II.

[148] Third, an investor or investors (either individually or collectively) who owns more than 10% of a company's stock need disclose her trades. But once her ownership drops to 10% or less, she need not. A trader who sells or gives away enough shares as to drop to 10% ownership can promptly dispose of the remaining shares without any disclosure. Thus, a 15% owner can give away 5% of her stock and then sell 10% without any public record of a profitable sale.

[149] Dan Gallagher, *Peloton Back to No Pain, No Gain*, WALL ST. J. (Aug. 27, 2021, 8:04 AM), https://www.wsj.com/articles/peloton-back-to-no-pain-no-gain-11630065863 [https://perma.cc/5T74-QCK5].

shut down much of the world.[150] With gyms remained closed, fitness-seekers turned to home exercise companies, such as Peloton, to meet their fitness needs.[151] Starting at a stock price around $20 in early March 2020, Peloton's stock price skyrocketed to around $130 by October 2020.[152]

This luck was not to last. On November 9, 2020, Pfizer announced that its COVID-19 vaccine candidate was found to be more than 90% effective.[153] Some might have guessed that this might dim Peloton's prospects, but company executives aggressively resisted that conclusion. For example, in February 2021, Peloton's CEO explained,

> When the vaccine was announced in the fall, you saw a reaction to the stock but we did not see any reaction to our sales or demand. We still have not seen any softening since that vaccine was announced and since the vaccine has been rolling out. So other than investors getting nervous, the consumers are still feeling like they want to work out at home.[154]

Similarly, the company's President stated,

> We do research on consumer perceptions around home fitness and going back to the gym . . . . And what's clear is the shift into the

[150] *Id.*

[151] *See id.*

[152] *Peloton Interactive, Inc. (PTON) Interactive Stock Chart*, YAHOO FINANCE!, (last visited July 9, 2023), https://finance.yahoo.com/quote/PTON/chart [https://perma.cc/R3AH-YTMW].

[153] *Pfizer and BioNTech Announce Vaccine Candidate Against COVID-19 Achieved Success in First Interim Analysis from Phase 3 Study*, PFIZER (Nov. 9, 2020, 6:45 AM), https://www.pfizer.com/news/press-release/press-release-detail/pfizer-and-biontech-announce-vaccine-candidate-against [https://perma.cc/CV5G-T658].

[154] Q2 2021 Peloton Interactive Inc Earnings Call Transcript at 8 (Feb. 4, 2021), https://investor.onepeloton.com/static-files/3c86e15c-d9fb-4f41-b592-0142d2705906 [https://perma.cc/XG32-ZUYR].

> home is not a COVID-led phenomenon. It has accelerated it. But we see, if anything, as we emerge to whatever the new normal is that the norms haven't changed. There is a secular shift into fitness in the home . . . . And so everything we've seen in the data, I think Jill has talked in the past about some of the bespoke research we've done on going back to the gyms and consumer perception on that vis-a-vis home workout suggests that certainly, COVID has been a tailwind for our demand. But in terms of demand for Peloton products and Connected Fitness in the home, we see continued momentum in foreseeable future.[155]

Statements such as these implied that the company had proprietary information, supportive of its post-lockdown prospects. However, the truth was that the company really was losing ground as people could leave their home. Sales languished.[156] Subsequent quarterly reports were dismal, leading to lower stock prices as markets adjusted to this new information.[157]

Company insiders presumably would have known that, in fact, Peloton didn't have a dependable plan for growth in the post-vaccine era. Multiple suits accused executives of Peloton for insider-trading alleged this, claiming that the executives' sale of shares during 2021 despite public assurances of the company's continued success represented insider trading.[158] However, this complaint only dealt with S-coded transactions (along with one G-coded transaction).[159] The SEC and DOJ also investigated Peloton for insider trading, but only for trades immediately before the treadmill recall.[160]

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[155] *See id* at 11.

[156] *See id*.

[157] *See* Parkev Tatevosian, *Peloton's Stock Crashes After Reporting Earnings: Is the Fall Justified?*, Motley Fool (Nov. 9, 2021, 11:35 AM), https://www.fool.com/investing/2021/11/09/is-pelotons-stock-crash-justified [https://perma.cc/2LEQ-87W9].

[158] *See e.g.*, Public Version of the Verified Stockholder Derivative Complaint for Breach of Fiduciary Duty, Unjust Enrichment, Indemnification, and Contribution, *Manzella v. Cortese*, No. 2023-0224 (Del. Ch. filed Feb. 24, 2023), 2023 WL 2329508; *see also* Mike Leonard, *Peloton Board Faces Insider Trading Suit on Pandemic Hype Claims*, Bloomberg Law (Feb. 27, 2023, 5:12 PM), https://www.bloomberglaw.com/product/blaw/document/RQRF0OT0G1KW [https://perma.cc/PK88-9Z35]; *Robeco Capital Growth Funds SICAV – Robeco Global Consumer Trends v. Peloton Interactive, Inc.*, No. 21-CV-9582, 2023 BL 106880 (S.D.N.Y. filed Mar. 30, 2023); Public Redacted Version of the Verified Stockholder Derivative Complaint, *Banks v. Foley*, No. 2023-0340 (Del. Ch. filed Mar. 23, 2023), 2023 WL 2687639; Verified Stockholder Derivative Complaint, *Smith v. Boone*, No. 2022-1138 (Del. Ch. filed Dec. 12, 2022), 2022 WL 17735639; Verified Stockholder Derivative Complaint, *Genack v. Foley*, No. 1:21-CV-4583 (E.D.N.Y. filed Aug. 13, 2021). Callaghan, discussed below, was named as a defendant in one of these complaints. Public Version of the Verified Stockholder Derivative Complaint for Breach of Fiduciary Duty, Unjust Enrichment, Indemnification, and Contribution at 1, *Manzella v. Cortese*, No. 2023-0224 (Del. Ch. filed Feb. 24, 2023), 2023 WL 2329508.

[159] *Id.*; *see* "Lawsuit Citations" below.

[160] *Peloton Under Investigation by the SEC and Department of Justice*, CNN Bus. (Aug. 28, 2021, 3:19 PM), https://edition.cnn.com/2021/08/28/business/peloton-investigations/index.html [https://perma.cc/NQN5-5EK2].

Yet, a broader view of insider transactions reveals more opportunities to unload stocks before predictable drops in stock prices. Jon Callaghan is the co-founder of True Ventures, a venture capital firm.[161] Callaghan joined Peloton's board in 2015, and, later that year, True Ventures invested in Peloton.[162] As a director on Peloton's Board, Callaghan had internal information about the company's revenue and business projections. On November 10, 2020, one day after Pfizer's announcement, Callaghan's entities distributed 6,088,433 Peloton shares to their investors.[163] The closing price for the stock on November 10, 2020 was $105.210,[164] for a total of 640,564,036.

If Callaghan had distributed them a year later, they would have been worth less than $300 million. Assuming the shares were sold shortly after being distributed, Callaghan earned himself and his investors $342,535,241 more by distributing the shares when he did as opposed to a year later.[165] Neither the SEC, DOJ, nor the litany of private lawsuits against Peloton made note of these transactions, however.[166] It is possible that Callaghan used material

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[161] Jon Callaghan, TRUE VENTURES, https://trueventures.com/team/jon-callaghan [https://perma.cc/FS4D-ZP28] (last visited July 9, 2023).

[162] Michael J. de la Merced, *Cycling Start-Up Peloton Raises $30 Million*, N.Y. TIMES: DEALBOOK (Apr. 16, 2015), https://www.nytimes.com/2015/04/17/business/dealbook/cycling-start-up-peloton-raises-30-million.html [https://perma.cc/7Z2J-9WD7].

[163] *See* Peloton Interactive, Inc., Statement of Changes in Beneficial Ownership (Form 4) (Nov. 12, 2020), https://www.sec.gov/Archives/edgar/data/1639825/000110465920124605/xslF345X03/tm2035899-1_4.xml.

[164] *See Peloton Interactive, Inc. (PTON) Interactive Stock Chart*, *supra* note 152.

[165] On November 18, 2020, Callaghan made another pro-rata, in-kind distribution of 58,713 shares in Peloton from True Venture Management, L.L.C. Peloton Interactive, Inc., Statement of Changes in Beneficial Ownership (Form 4) (Nov. 20, 2020), https://www.sec.gov/Archives/edgar/data/1639825/000110465920128070/xslF345X03/tm2035899-4_4.xml [https://perma.cc/3WRX-DP2L]. This trade was also auspiciously timed. On November 18, 2020, the closing price for the stock was $104.49. *Peloton Interactive, Inc. (PTON) Interactive Stock Chart*, *supra* note 152. One year later, on November 18, 2021, the closing price for the stock was $48.40. The shares were worth a total of $6,134,921.37 when they were sold in 2020, while they would have been worth $2,841,709.20 if they had been sold in 2021. Therefore, Callaghan earned himself and his investors $3,293,212.17 by distributing the shares at this time.

[166] The overlooked transactions were William J. Lynch's transactions reported on Feb. 2, Feb. 18, Apr. 16, May 24, Jun. 16, July 16, Aug. 18, and Sept. 16 of 2021; Hisao Kushi's transactions reported on Feb. 10, Mar. 15, Apr. 14, May 13, Jun. 16, July 14, Aug. 16, Sept. 15, and Oct. 21 of 2021; John Foley's transactions reported on Feb. 18, Mar. 17, Apr. 19, May 19, Jun. 17, July 19, Aug. 18, and Sept. 3 of 2021, and Feb. 14 of 2022 (the last of which shows a G-coded gift); Tom Cortese's transactions reported on Feb. 17, Mar. 15, Apr. 14, May 24, Jun. 23, Jun. 28, Jun. 30, July 14, Aug. 16, and Sept. 15 of 2021; Mariana Garavaglia's transactions reported on Mar. 24, Apr.7, May 18, May 28, Jun. 2, Jun. 8, Jun. 30, July 8, July 30, Aug. 5, Aug. 17, Aug. 19, Sept. 1, Sept. 8, Sept. 29, Oct. 5, Oct. 29, and Nov. 5 of 2021; Pamela Thomas-Graham's transactions reported on Feb. 18, May 19, and July 22 of 2021; Karen Boone's transactions reported on Feb. 10, Feb. 11, and Feb. 17 of 2021; Jill Woodworth's transactions reported on Feb. 18, May 19, and Sept. 16 of 2021; Howard C. Draft's transactions reported on Feb. 18, Mar. 18, Apr. 21, May 19, Jun. 22, July 21, Aug. 19, and Sept. 21 of 2021; and Jon Callaghan's transactions reported on Feb. 11, Mar. 11, Apr. 16, May 13, Jun. 10, July 16, Aug. 13, Sept. 9, and Oct. 14 of 2021. *See EDGAR Full Text Search*, SEC, https://www.sec.gov/edgar/search/#/dateRange=custom&category=form-cat2&entityName=0001639825&startdt=2021-01-01&enddt=2021-12-31 (last visited Oct 1, 2024) (each Form 4 referenced above can be herein identified by the filer's name and date of filing).

non-public information to help his investment fund avoid substantial losses, but no record shows it because the ultimate sales were not subject to public reporting. If this is true, the insider trades had been laundered.

C. Transactions with the Corporation

When insiders buy from or sell to the corporation, the transactions are subject to public reporting, just like any other transaction. However, many of these transactions are exempt from the short-swing profits rule.[167] That means that insiders are allowed to (for example) buy shares from the public or the corporation and sell them (for a profit) a few days later to the corporation.

This exemption is justified on the theory that that insider transactions with the corporation are unlikely to be on the basis of non-public information.[168] Yet the opposite may sometimes be true. Insiders are, by definition, influential with respect to the corporation. They might sometimes cause the corporation to buy shares at a time that the insider knows the price will soon fall. Or they may cause the corporation to frequently buy back shares, but only participate when they know the price will soon fall.[169]

For a possible example, consider CompX International, which manufactures locking mechanisms for office furniture.[170] On October 26, 2007, one the company's largest investors sold all of its shares for $10 million in cash plus different securities.[171] One week later, CompX announced rotten sales and income figures for the quarter.[172] The stock price plunged 40% within two weeks.[173] It is readily conceivable that the investor knew about the poor earnings

[167] Transactions between an issuer and its officers or directors, 17 C.F.R. § 240.16b-3 (2024). *See infra* Part I.

[168] First, the insider is subject to fiduciary duties in dealing with the corporation, which may constrain some opportunism and lower the need for securities law oversight. Ownership Reports and Trading by Officers, Directors, and Principal Security Holders, 70 Fed. Reg. 46080 (Aug. 09, 2005). Second, the corporation is a sophisticated counterparty, which knows very well who it is trading with. This is quite unlike a retail investor buying from (or selling to) a corporate executive, who is concealed behind the anonymity of the market. The corporation can often protect itself. Third, many of these transactions are initiated by the corporation, and thus do not permit the insider to strategically time anything.

[169] If the corporation also frequently sells stock to the public, the net effect will be as if the insiders were themselves trading with the public. *See generally*, Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. Pa. L. Rev. 801 (2014).

[170] About CompX International, (last visited Oct. 1, 2024), https://compxinternational.com/about/ [https://perma.cc/4VXT-GYRB].

[171] CompX Int'l Inc., Statement of Changes in Beneficial Ownership (Form 4) (Oct. 30, 2007), https://www.sec.gov/Archives/edgar/data/1338019/000002424007000082/xslF345X03/f4compx071030_ex.xml. 10 million dollars matched the fair market price for 463,000 shares. An additional 10 million were also disposed, in exchange for new securities. *Id*. Note that this footnote also asserts that it is subject exemption under 16b-3, though it is not clear why J would be the right code in that context.

[172] *CompX Reports Third Quarter 2007 Results*, PR Newswire (Nov. 1, 2007), https://www.bloomberglaw.com/product/blaw/document/JQUMFZ3T6SQP [https://perma.cc/R8SE-NS3C].

[173] *CompX International Inc. (CIX) Interactive Stock Chart*, Yahoo Finance!, (last visited Aug. 2, 2023), https://finance.yahoo.com/quote/CIX/chart [https://perma.cc/4HE5-FH4Q].

at the time of the sale: the selling investor was an investment fund owned almost entirely by the brother[174] of CompX's board Chairman.[175] It is likewise possible that this familial connection is part of why the corporation was willing to repurchase stock at that exact moment from the dominant investor.

By selling to the corporation, the insider may avoid the dreaded S-code. That is because most sales to the corporation are properly coded with something other than S. Transactions with the corporation that qualify for exemption from the short-swing profits rule are usually coded under "A," "D," "I," or "M." A few are properly coded "J."[176] And "J" is also appropriate for most transactions with the corporation that do not qualify for exemption for some reason.[177]

D. Forced Sales

Suppose insiders possess adverse information and instead of selling stock, they sell call options on the stock they already own. To make matters clear, let us also assume that these short-calls are deep-in-the money to ensure their exercise. When the call options mature, they will be exercised against the insiders and the insiders will be forced to deliver their shares against these sell-obligations. Technically speaking, this is not an open market sale, and it can be labelled as an 'other' transaction. Nevertheless, from an economic perspective, the effect is almost identical to an open market sale.

An example may be useful here. We go back to Nikola Corporation. As shown below, Trevor Milton reports exercises of options on Forms 4 and 5. Interestingly, however, exercises of these options result in disposition of shares for Milton. Furthermore, the exercise prices being less than the stock price of $18.98 on December 3, 2020, namely $10.4, $4.52 and $1.60 indicate that these are in-the-money short-calls being exercised against Milton.[178] In fact, this is a forced sale through the use of deep in-the-money short calls.

What code do these transactions require? In fact, there is no code for forced sales. Milton labels some of these X4 on Form 5, denoting that these are exercises that should have been reported on a timely basis on Form 4, but being reported late on Form 5. Late reporting on Form 5 requires an explanation which Milton does not provide. X-code is an innocuous code that is typically associated with non-informative trades. Insiders can justifiably also label these as 'other," since no other code fits precisely. From an economic

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[174] Simmons' ownership in Contran was material to an important Delaware corporate law decision. *See* Kahn v. Tremont Corporation, 694 A.2d 422 (Del. 1997).

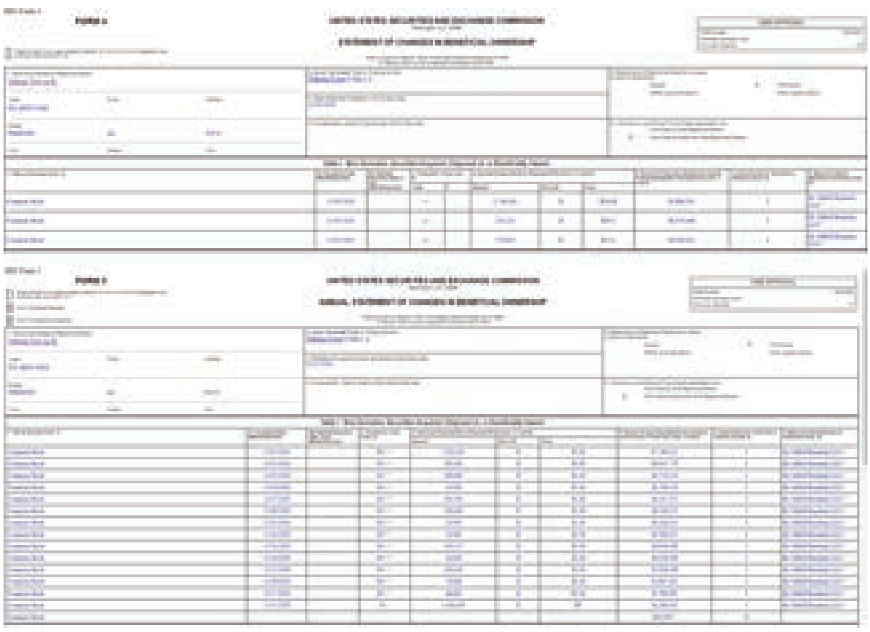
[175] *Will Harold Simmons Take Out All of CompX?*, MERGERS & ACQUISITIONS (June 7, 2004), https://www.themiddlemarket.com/news/will-harold-simmons-take-out-all-of-compx [https://perma.cc/9GZN-LKN3].

[176] *See, e.g.*, ROMEO & DYE, Model Form 160.

[177] *See*, *e.g.*, *id.* at Model Form 99, 100, 127.

[178] In subsequent Form 4s also filed in December 2020, Milton reports exercise of price of $1.6, indicating these are deep-in-the-money short calls.

perspective, these transactions are similar to, and in fact they can be made exactly identical to, an open market sale.[179] What this example illustrates is that by creating idiosyncratic transactions, one can convert informed open market sales into opaque, innocuous sounding, non-informative codes such as X or J to avoid regulatory attention.



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We have discussed seven identifiable forms of insider trading by other means. And we provided anecdotes to illustrate each of them. With some sense of how these strategies work, we can now seek evidence that they do occur. That evidence comes from the next several sections.

IV. Empirical Results

Having set out the rationales that might motivate insider trading by other means and generated plausible examples of six different strategies for opportunistic use of the J code, this Article now turns to the data. To what degree do insiders strategically code their trades to conceal their exploitation of nonpublic information? This Part presents evidence and analysis consistent with

[179] If the exercise price is set close to zero, then this short call will be identical to an open market sale.

insiders frequently exploiting the protective halo of the J code to insider trade by other means. IV.A. describes our empirical methodology, and IV.B. shares the results.

A. *Methodology*

1. The Data

The insider trading data come from the Thomson Reuters Insider Filing Data Feed (1986 to 2023). Our sample includes U.S. common stocks. The time period is from April 1991 to December 2022. The reason our data starts in April 1991 is that the SEC changed the definition of J-codes on April 1991. Prior to this date, J-codes referred to private purchases. Following this date, J-codes referred to "Other" transactions. The final dataset has over 8,500 unique Committee on Uniform Securities Identification Procedures ("CUSIP") numbers and over 90,000 observations. Stock price, outstanding shares, and stock return information were obtained from the Center for Research in Security Prices ("CRSP").[180] CUSIP numbers, unique to each firm, were used to match insider trading data from the Thomson Reuters dataset to price and return information from the CRSP dataset.

The Insider Filing Database includes all trades reported to the SEC Ownership Reporting System. The data contain all "Other" dispositions by officers, directors, and beneficial owners (direct or indirect owners of more than 10 percent of any equity class of securities) of publicly traded firms. "Other" is designated by the transaction code J.

We focus our study just on dispositions, so all observations with an acquisition/disposition code equal to A were eliminated. This limitation makes sense for five reasons. First, most J-acquisitions are not discretionary. They are initiated by the counterparty and the insider simply receives the distributed shares. Second, we expect suspicious coding to apply to many dispositions, but almost never for acquisitions. Officers and directors typically acquire shares through their employment, or they start with shares since they are founders. Even non officer/director investors tend to acquire their 10+% interest from the company itself, early on. They do not buy a majority of these shares on the open market. Accordingly, if they rarely buy shares, insiders will rarely buy shares opportunistically. Third, shares acquired through employment are typically exempt from insider trading regulations. Fourth, insiders have more control over the timing of J-coded dispositions than acquisitions,

[180] The CRSP database is a subscription-only database that comes with a subscription to the Wharton Research Database. *See Wharton Research Data Services*, *supra* note 100.

making it harder for the latter to reflect information.[181] Fifth, focusing exclusively on sales (regardless of their code) makes our study more conservative. Numerous articles have found that sales are less likely to exhibit information than purchases.[182] Some studies have also excluded insider sales altogether in order to focus on information trading and used only insider purchases.[183] As a test of this proposition, we did examine the information content of other acquisitions and found none. There are no abnormal stock price movements around insiders' other acquisitions. Consequently, we excluded these observations from our analysis and focused our efforts on other dispositions.

We start with cleansed data from Thomson Reuters to deal with potential misreports and incorrect outliers.[184] Our initial data set contains 219,559 J-coded dispositions. Next, we require that these firms' stock price and return data are available in CRSP. We also require that the underlying asset being disposed is common stock. These restrictions eliminate about 39,000 observations from our data set, leaving us with a sample of 180,970. Hence, imposing CRSP return data eliminates all transactions in small, over-the-counter corporations' stocks.

We also eliminate all promptly reported J-coded trades. Since our objective is to determine whether insider hide their information-based trades in J-codes, it makes sense to eliminate all promptly reported trades which would be subject to a higher level of scrutiny.[185] This restriction eliminates over 48,000 observations. This fact indicates that only about one-third of the observations are promptly reported. These two restrictions bring our final sample to about 96,405, leading to a loss of about 116,000 observations. Later in this Article, we provide an empirical justification for this choice. Finally, to deal with potential misreports and incorrect outliers, we use cleansed data from Thomson Reuters.[186]

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[181] Most large J-coded acquisitions, such as stock splits, are not discretionary on the part of the insider. Other transactions are discretionary, but they are likely to involve a broker. And a broker acts as a check on insider trading by screening suspicious transactions for informed trade. But many dispositions can be consummated without a broker. For example, distributions of stock from an investment fund to its limited partners does not require a broker, so insiders can time such distributions more easily.

[182] *See, e.g.*, H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. Fin. Econ. 189, 189 (1986); Josef Lakonishok & Inmoo Lee, *Are Insider Trades Informative?*, 14 Rev. Fin. Stud. 79, 79 (2001).

[183] *E.g.*, A. Can Inci, M.P. Narayanan & H. Nejat Seyhun, *Gender Differences in Insiders' Access to Information,* 52 J. Fin. & Quant Anal. 1 (2017).

[184] Thomson Reuters uses various checks to ensure data quality and assigns codes based on its filters. We use only cleansing codes H "High Quality" and R "Passes all Reasonableness checks."

[185] Other articles have identified the tendency of insiders to delay reporting of their more suspicious trades. *See, e.g.*, Robert Jackson et al., Late Filings and Insider Trading: Broken Windows or Opportunism? (May 2022) (available at https://www.hbs.edu/faculty/Shared%20Documents/conferences/2023-IMO/Session8-late_filings.pdf).

[186] Thomson Reuters uses various checks to ensure data quality and assigns codes based on its filters. We use only cleansing codes H "High Quality" and R "Passes all Reasonableness checks."

The database also provides three dates associated with an insider transaction. The transaction date is the date of disposition, when an insider ceases to own the shares. The report date is the date when a transaction is made public by the SEC. The signature date is when the reporting form is signed by the insider.[187] We focus our analysis on the disposition dates.

2. Sample Characteristics

Table 1 shows the sample characteristics of the dataset. The final sample is large, comprehensive, and covers April 1991 through December 2023 inclusive. It includes all J-coded dispositions of their firms' shares by all insiders in all publicly listed firms available on CRSP. As shown in Table 1, the overall sample contains dispositions by insiders in 11,411 unique firms that have existed during this time period. The total number of dispositions is 180,970. Given the comprehensive cross-sectional and time-series nature of the dataset, this Article's conclusions apply to all "other" dispositions by insiders and are not sample-specific.

Table 1 also shows that the average disposition is about 890,000 shares. Disposition size increases with the size of the firms. In small firms, the average disposition size is about 520,000 shares, and in large firms, about 2.2 million shares. The total number of shares disposed is also large, equaling about 160 billion shares. Compared to any other transactions' codes, the number of shares underlying J-coded disposition is unusually high. Hence, in this sense, J-codes are very special.

Since J-coded transactions do not always report a stock price,[188] we used the closing stock price for the month just prior to when J-coded disposition took place to compute dollar amount traded. Using this method, the average dollar value dispositions per firm is about $174 million, while the total dollar value of the disposals is about $1.5 trillion.

While not shown separately, we can also compare our J-coded dispositions to insiders' open market sales coded "S." During the same time period of April 1991 to December 2023, Thomson-Reuters registers more than 3,919,680 open market sales for CRSP listed firms. This is about 20 times the comparable "other" disposition transactions. However, when we look at the number of shares involved, the picture reverses: total shares sold via open market sales equal about 134.7 billion shares, which is about half of the total J-code share dispositions of 160.8 billion shares. Hence, while fewer in number, J-coded dispositions involve more shares than open-market sales. This comparison speaks to the importance of J-coded transactions as a way of disposing of shares. We get a similar picture when we compare the total dollar

[187] Not all three of these dates are recorded for every gift transaction.
[188] *See, e.g.*, *supra* note 136 and accompanying text.

value of these transactions. The dollar value of open market sales coded "S" is about $3.3 trillion, which is again smaller than the $3.4 trillion in J-coded dispositions. The bottom line is that the availability of the stealthy J-coded dispositions, rather than open market sales, has made them the preferred method of disposing shares for insiders. This finding also speaks to the urgency and importance of policy changes needed to close off evasion of insider trading regulations.

TABLE 1: SAMPLE CHARACTERISTICS OF INSIDERS' "OTHER" DISPOSITIONS, 1991-2023

	Small Firms	**Mid-Cap Firms**	**Large Firms**	**All Firms**
Number of firms	8,799	1,920	722	11,441
Number of dispositions	112,875	43,108	24,987	180,970
Average disposition size (Number of shares, million)	0.52	1.087	2.21	0.89
Total dispositions (in million shares)	58,864	46,877	55,294	160,775
Average dollar amount (Per firm, in million $)	56.0	475.4	2,750.8	296.3
Total dollar amount (in billion $)	491.6	912.8	1,986.1	3,390.5

3. Measurement of Abnormal Returns

Next, we turn our attention to the information content of J-coded transactions. We compute abnormal returns by subtracting the return to the equally weighted index of New York Stock Exchange ("NYSE"), American Stock Exchange ("AMEX"), and National Association of Securities Dealers Automated Quotations ("NASDAQ") stocks from the returns for the stocks disposed by insiders.[189] This approach controls for market movements and implicitly assumes that average beta or risk exposure is one. Given that the sample contains over 11,000 firms, this assumption is satisfied. Hence, abnormal return $AR_{i,t}$ for stock i and day t is computed as $AR_{it} = (R_{it} - R_{mt})$ for each firm i and day t. R_{it} is the simple daily return on the stock i disposed by insiders on day t. R_{mt} is the daily return to the equally weighted index of

[189] Our approach here is the same as in Avci et al., *supra* note 134, at 1152–53. Using as the benchmark the total return to the value-weighted market portfolio instead of the total return to the equally weighted market portfolio gives similar results. We prefer the equally weighted returns because few (about 6 percent) of the firms in our sample are large. and the equally weighted index of NYSE, AMEX and NASDAQ firms is a better match for small and mid-cap firms. Lakonishok and Lee (2001), supra note 182 also use the equal-weighted market index as the measure of market portfolio firms.

NYSE, AMEX, and NASDAQ stocks on day *t*. For each event date *t*, these returns are first averaged across all disposed firms *i* to compute average abnormal returns:

$$AAR_t = \frac{1}{n_t}\sum_{i=1}^{n_t} AR_{it}$$

The average abnormal returns are then cumulated across the event dates as

$$CAR_T = \sum_{t=1}^{T} AAR_t$$

We then multiply CARs by minus one and convert abnormal returns into abnormal profits. Hence, positive values of abnormal profits show the amounts insiders profited by avoiding the abnormal stock price drops after the disposition date. These cumulative abnormal profits are then graphed to examine the behavior of abnormal profits around J-coded disposition dates.

As a sensitivity test, we also used mean-adjusted abnormal return approach which is robust.[190] We compute abnormal returns as follows:

$$AR_{it} = (R_{it} - R_{ia})$$

Where R_{ia} is computed as the average daily return to stock *i* between years 2 and 3 after the J-coded disposition date. Hence, we use the subsequent realized average returns to compute the expected returns to each stock:

$$R_{ia} = \frac{1}{250}\sum_{t=501}^{750} R_{it}$$

where *t* refers to the number of trading days after the J-coded disposition date. Using mean-adjusted returns also gives qualitatively similar results and hence are not shown separately.

We also use Fama-French 3- and 5-factor models to measure abnormal performance. Using ordinary least squares (OLS) with Fama-French risk-adjustment yields mixed results as the regression suffers from pronounced heteroscedasticity. Nevertheless, insiders' abnormal profits are positive and significant at short intervals and become insignificant as the holding periods increase. Using weighted least squares (WLS) to address the heteroscedasticity issues yields qualitatively similar results as our main findings. Insiders' abnormal profits are significant and positive for all holding periods.

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[190] *See* Steve Brown & Jerold Warner, *Daily Stock Returns and The Case of Event Studies*, 14 J. FIN. ECON. 3 (1985).

Another issue is that Thomson-Reuters insider-trading database is sparsely populated between 1986 to 1996. Dropping all observations prior to 1996 improves the statistical properties of the regressions for the Fama-French risk adjustment approach, while resulting in similar overall qualitative findings.

B. Empirical Findings

We now examine the evidence regarding insiders' dispositions pursuant the J-code. The figures in this section present our findings visually. Our results are highly statistically significant given the large economic magnitudes and large sample sizes. As an example, our overall results are statistically significant at better than 0.00001 level. Hence, we can easily reject the interpretation that our results are due to random noise. Our findings are consistent with insiders using J-codes when they know something negative about the stock's prospects, and thus making an early disposition to avoid these losses. It is these avoided losses that we call these insiders' abnormal profits.[191] Moreover, we find evidence for many of the strategies we discussed in Part III.

Each figure in this Part demonstrates the profits a trader would make by selling on the day that insiders disposed of stock pursuant to a J-trade and investing the proceeds in the market index, relative to doing nothing.[192] If insiders possess no inside information when they dispose of stock pursuant to a J-code, then the figures should display a flat horizontal line around zero. That would mean that a trader gains no benefit from trading on the same day insiders dispose with a J-code, because every day before and after is just as good. On the other hand, a V-shaped profit result would suggest that insiders have timed their J-dispositions very well. It indicates that the prices tended to be rising before and falling after the insider's disposition.[193] In other words, insiders tend to dispose their shares at or near the maximum prices relative to the market. Although both halves of the V are significant, it is the right side that bears more on whether trades are informed.[194]

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[191] These are all measures of abnormal profits, not absolute profits. A trader who makes abnormal 3% profit may actually net a loss or a phenomenal gain, well above 3%. That is because market, and individual stock, returns move for reasons other than inside information. If the market dropped 10%, our stock must have dropped by 13%. Hence, we get stuck with a 10% drop instead of a 13% drop, and hence an abnormal profit of 3%. Our study reveals how much more a trader would make, above and beyond those exogenous market price movements.

[192] Another way to consider the baseline is relative to a sale at a different time. A trader who sold 150 days after a J-coded transaction will tend to sell for 5% less than the insider.

[193] This can be slightly counterintuitive, since the Y-axis indicates abnormal profits. But these are the abnormal profits enjoyed by trading at the same time as the insider, relative to owning or selling at a given past or future date.

[194] Abnormal returns relative to the left-hand show that the insider successfully abstained from selling while the market price was increasing. This is not illegal. *See* Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 455–56 (2003). Whereas abnormal returns on the right hand show an actual transaction, at a time the stock was very likely to subsequently decline in value. It is unsurprising that the abnormal returns on the left side are steep, since insiders can often lawfully delay dispositions until after good news is announced. It is likewise unsurprising that

1. Findings For J-Coded Transactions

Figure 1 begins by showing abnormal profits for J-coded dispositions and ordinary S-coded sales. The literature has frequently found that when insiders sell, they tend to slightly outperform outsiders.[195] However, there are some more recent studies that find that insiders do not trade profitably when they sell stock. For instance, Lakonishok and Lee state:

> Insiders have many reasons to sell shares but the main reason to buy shares is to make money. Our results support this view. Only insider purchases appear to be useful, while sales are not associated with low returns … Strong sell signals remain useless in predicting stock returns.[196]

Similarly, Jeng, Zeckhauser, and Metrick write: "We find that insider purchases earn abnormal returns of more than 6 percent per year, and insider sales do not earn significant abnormal returns."[197]

Some of this difficulty can be attributed to smaller samples and problems with measuring abnormal returns. The typical explanation for lower profitability of sales is that insiders sometimes sell when they know about pending bad news, thus avoiding losses, but they also sell for a variety of other reasons. For example, insiders may wish to diversify their portfolios or obtain cash for consumption. In contrast, insiders only buy for information reasons. Consistent with the literature, we find that insider S-sales are somewhat well timed, creating an abnormal profit of about 2.6% over the next year. This figure is also highly statistically significant.

In contrast with open market sales, the abnormal profits following J-coded other dispositions is much larger, about 6.6%. Hence, if some insiders are shifting their informative trades to J-codes, this can also provide an explanation of the lower measured profitability of insiders' open market sales. We will explore this issue in more detail below.

In Table 1, we showed that the total dollar volume of J-coded trades equaled $3.4 trillion. Since the abnormal profitability of J-coded trades equals 6.6% in Figure 1, insiders' total abnormal profit equals $224 billion. This is an enormous cost that insiders are imposing on the unsuspecting public through the use of stealthy J-coded transactions.

S-codes show steeper left side gains. A trader who delays a trade until good news is announced has nothing to hide and so can report with S-code. It is only when their sale precedes a negative announcement that the trader has reason to decline their S-trade or cover it with a different transaction code. Hence the flatter curve on the right side.

[195] *See, e.g.*, Jeffrey Jaffe, *Special Information and Insider Trading*, 47 J. BUS. 410 (1974); H. NEJAT SEYHUN, INVESTMENT INTELLIGENCE FROM INSIDER TRADING 73 (MIT Press 2000).

[196] Lakonishok & Lee, *supra* note at 182.

[197] Leslie A. Jeng, Richard J. Zeckhauser, & Andrew Metrick, *Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective*, 85 REV. OF ECON. & STATISTICS 453, 453 (2003).

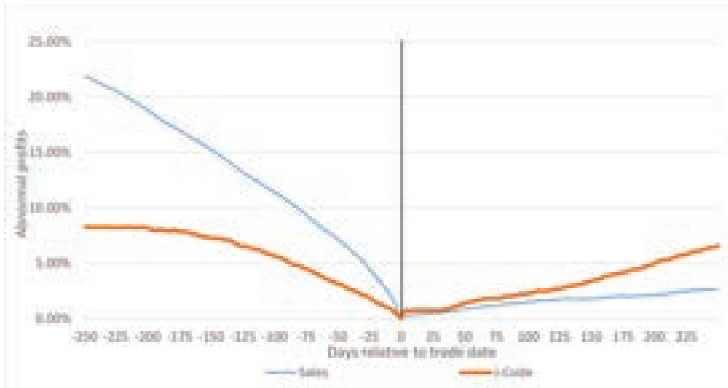

FIGURE 1: ABNORMAL PROFITS AROUND OPEN MARKET SALES (S-CODE) AND OTHER DISPOSITIONS (J-CODE)

This evidence shows that J-coded transactions are significantly more likely to reflect inside information than S-coded transactions. In other words, traders make open-market sales for many reasons, whereas the motivation for "other" transactions is more likely to be transferring expected losses to outsider trading partners. Although not shown in their own Figure, we checked whether these strong results recur for all of the peculiar transaction codes.[198] They do not.[199] There is something special insider trading by "other" means.

The vertical jump in abnormal profits immediately after the J-coded disposition date suggests immediate stock price drop following the disposition. One possible explanation for this finding is that these J-coded transactions can be executed closer to important corporate announcement dates without raising suspicions about the trade itself. Another possibility is that insiders (or the receivers of the shares) are actually selling these J-coded shares in the open market that then results in a price pressure.

Figure 1 is our headline result, but further analysis bears fruit. First, we restrict our analysis to late reported transactions defined as a reporting delay of three or more days.[200] We also eliminate small trades defined as fewer than 1,000 shares, as Seyhun has previously shown that most profitable insider transactions have trading volumes higher than 1,000 shares.[201] Our J-coded

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[198] To see these codes again, see Figure 1, *supra* Part IV.B.1.

[199] Tax-related sales contain small levels of information. Swaps do not seem to contain any information. Private sales to the company shows small information content at 2% abnormal profit. The most informative group is the Other category (code=J). Information content of other disposals, J-codes even exceeds that of open market sales, as well.

[200] See M.P. Narayanan & H. Nejat Seyhun, *The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation,* 21 REV. FIN. STUD. 1907 (2008), and Sureyya Burcu Avci, Cindy A. Schipani & H. Nejat Seyhun, *Ending Executive Manipulation of Incentive Compensation,* 42 J. OF CORPORATION L. 101 (2016), who show that insiders report their most valuable trades with substantial delays.

[201] *See* H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189 (1986).

sample is now reduced to 96,606 trades, while our S-coded sample is reduced to 655,410 trades. Our results are shown below in Figure 2. Later, we present a more detailed investigation for our two filters.

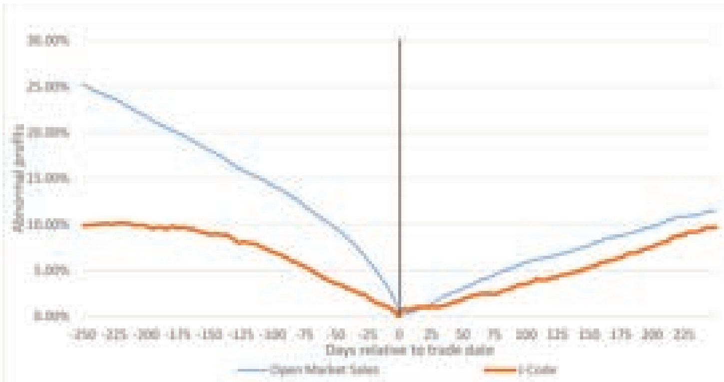

FIGURE 2: ABNORMAL PROFITS AROUND LATE REPORTED, LARGER VOLUME, OPEN MARKET SALES (S-CODE) AND OTHER DISPOSITIONS (J-CODE)

Once we restrict our attention to trades that are more likely to be informationally motivated, abnormal profits jump for both J-coded trades as well as S-coded open market sales. For S-coded trades, abnormal returns now equal 11.6% while for J-coded trades, abnormal returns equal 9.7%. Hence, both late reporting and larger volume of trading appear to be important drivers of the value of information.

Given the lower profitability of insider sales, many studies in finance have tried to separate routine, liquidity-based insider trading from informed or opportunistic insider trading. For instance, Cohen et al.[202] define routine trades as those with similar trades in the same calendar month in the past three years and find that opportunistic sales are much more informative. Our evidence above indicates another way of focusing on more informed insider sales: Simply eliminate small, promptly reported open market sales, and also include J-coded dispositions as sales.

Once again, there is a vertical jump in abnormal profits immediately after the J-coded disposition date even for late reported transactions. This finding suggests that the stock price reaction cannot be in response to the reporting of the transaction itself since in most cases, the transaction is not yet reported, and the market is not aware of the transaction. This finding strengthens the inference that these J-coded transactions are being executed immediately prior to important corporate announcement dates without raising suspicions about the trade itself. Another possibility is that insiders (or the receivers of the shares) are actually selling these J-coded shares in the open market that then results in a price pressure.

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[202] Lauren Cohen, Christopher Malloy & Lukasz Pomorski, 67, J. OF FIN. 1009 (2012).

Next, we ask who makes these J-coded trading profits? Figure 3 supplies the answer.

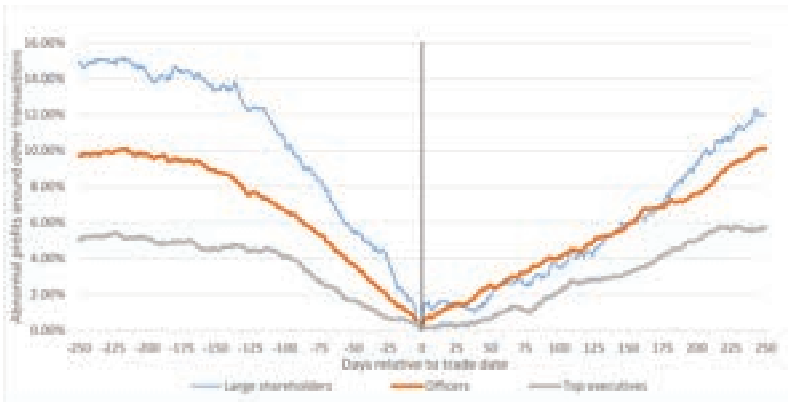

FIGURE 3: ABNORMAL PROFITS FOR J-CODED TRADES, AROUND TRANSACTION DAYS, BY INSIDER RELATION

Here, the answer is somewhat surprising. For top executives,[203] the profit is the smallest, around 5.7%. For outside directors and most officers, the abnormal profit is about 10%.[204] For large shareholders, profitability increases to about 12.0%.

Figure 3 is consistent with the interpretation that while the top executives are typically the most informed,[205] they do not seem to clandestinely use J-coded other dispositions for their most informed trades. But large shareholders, who have much larger investments in the firm, outperform everyone at the firm, indicating that many large shareholders rival senior employees in their knowledge of company secrets and desire to avoid scrutiny. This level of shareholder knowledge is at odds with much of the literature, which concludes that large shareholders do not possess any trading advantages[206]

[203] Here, we mean, the president, chief officers, executive vice presidents, board chairs, and individuals who are both officers and directors or both officers and large shareholders.

[204] For this result, we considered all officers and directors other than the ones evaluated under "top executives."

[205] *See* H. Nejat Seyhun, *Insiders' Profits, Costs of Trading, and Market Efficiency*, 16 J. FIN. ECON. 189 (1986).

[206] *See, e.g.,* Hollis A. Skaife, David Veenman & Daniel Wangerin, *Internal Control Over Financial Reporting and Managerial Rent Extraction: Evidence from the Profitability of Insider Trading*, 55 J. ACCT. & ECON. 91, 93, 101 (2013); Jagolinzer, *supra* note 95, at 233; Shijun Cheng, Venky Nagar & Madhav V. Rajan, *Insider Trades and Private Information: The Special Case of Delayed-Disclosure Trades*, 20 REV. FIN. STUD. 1833, 1857 (2007); H. Nejat Seyhun, INVESTMENT INTELLIGENCE FROM INSIDER TRADING 73 (MIT Press 2000); Avci et al., *supra* note 134, at 210; Jeffrey F. Jaffe, *Special Information and Insider Trading*, 47 J. BUS. 410, 410–11 (1974).

but it is consistent with our prior work.[207] Large shareholders seem to be able to extract information from management, especially those sophisticated enough to deploy J-codes.

The fact that large shareholders can trade extremely profitably and potentially avoid legal sanctions using J-coded dispositions also reduces their incentive to use open market sales for their informed transactions.

Once again, there is a 1.6% vertical jump in abnormal profits for large shareholders within the first five days after the late-reported J-coded disposition dates. This finding strengthens the inference that these large-volume J-coded transactions are being executed immediately prior to important corporate announcement dates without raising suspicions about the trade itself. Another possibility is that insiders (or the receivers of the shares) are actually selling these J-coded shares in the open market that then results in a price pressure.

Our evidence in Figure 4 shows the relationship between the amount of stock traded and the likelihood that the J-coded trade is motivated by non-public information.

FIGURE 4: ABNORMAL PROFITS AROUND TRANSACTION DATES, BY VOLUME OF TRANSACTION

Figure 4 demonstrates a positive monotonic relation between the value of the non-public information and dollar value of shares disposed.

For both small volume and intermediate volume, abnormal profits are around 6%-7%. For large volume of trading, abnormal profits jump to 15%. What is also amazing is that abnormal returns jump to 1.9% within the first five trading days for large volume of trading. In other words, the more shares one disposes of, the more likely a J-coded transaction is to be informed, and there is more urgency to the information. Hence, insiders seem to dispose of greater amounts when they have more valuable information and when the information release is imminent.

[207] *See generally*, Avci et al., *supra* note 134.

These are similar yet stronger than what we observe in other transaction codes used for insider trading.[208] Although not displayed in a Figure, we checked whether this pattern occurred for other unusual transaction codes, including ones that are plainly not amenable to insider trading. We find only a weak pattern.[209] This evidence further corroborates the narrative that J-coded dispositions are especially motivated by access to material non-public information.

Next, we analyze Other-disposition category by reporting delays. Earlier, we had used late reporting as a filter and excluded all other dispositions that were promptly reported.[210] When the Other category is analyzed by reporting delays, including promptly reported trades, once again, a monotonic relation emerges, as Figure 5 shows.

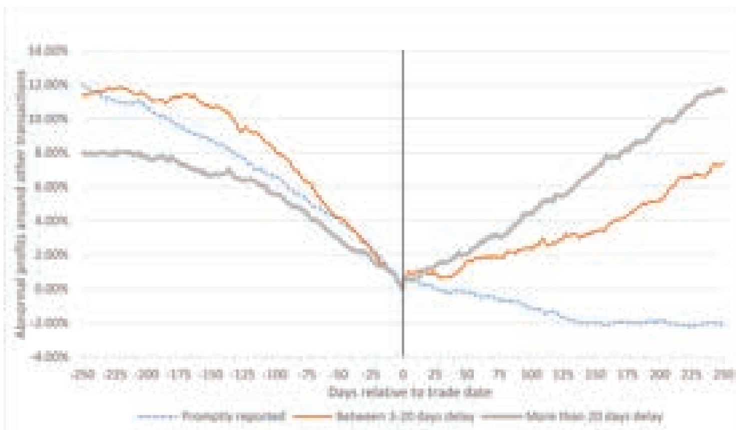

FIGURE 5: ABNORMAL PROFITS AROUND TRANSACTION DATE, BY REPORTING DELAYS

In words: the greater the reporting delay, the greater the decline in value after the trade, resulting in greater losses avoided. Furthermore, promptly reported dispositions exhibit a jump immediately, similar to late reported trades, but they have no information content whatsoever in the long run since

[208] *Id.* at 679–80.

[209] We also examined the information content of the various (tax, private sales to the company), categories for large trades as well. What is labelled as F-trade, tax related sale, shows an abnormal profit of 2% for large trades. Often, insiders hide behind this label and claim that these trades were involuntary due to the tax burden of an options exercises. However, when the dollar amounts get large, some of these trades also contain information. Large private sales back to the company show abnormal profit of 3%. Swaps show an abnormal profit of 10%. These declines are much bigger than the decline following an open market sales. Once again, this finding indicates that insiders may be attempting to camouflage their information-related sales by hiding behind other types of trades that are typically considered non-information related reasons. This is why these types of trades are treated separately.

[210] The motivation behind this screen goes to M.P. Narayanan and Nejat Seyhun. *See, e.g.*, M.P. Narayanan & H. Nejat Seyhun, *The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?,* 21 REV. FIN. STUD. 1907 (2008);Avci et al., *supra* note 134.They show that insiders report their most valuable trades with substantial delays.

the abnormal profit equals -2%. The fact that the promptly reported J-coded trades, which have no long-term information content, also show a market reaction suggests that these J-coded transactions may in fact be accompanied by actual sales, thus resulting in a price pressure in the short run.

For trades reported with a delay of between 2 and 20 days, abnormal profits reach 7.4%. For trades reported with a delay of more than 20 days, abnormal profits reach 11.6%. These findings are consistent with the hypothesis that the more information-motivated trades are reported by greater delays to hide the fact that they contain material, non-public information.

Next, we combine trade size with reporting delays. The most informative category is large trades reported by greatest delays. Another observation is that the actual stock price reaction immediately following the J-coded transaction is positively correlated with the share volume of the reported J-coded disposition. The fact that late reported J-coded trades show a monotonically positive relation to the reported share volume again suggests that these J-coded transactions may in fact be accompanied by actual sales, thus resulting in a price pressure that varies with the disposition size.

Once again, we get a strong positive relation between information content and reported disposition volume. This finding is consistent with the interpretation that, while reporting J-coded dispositions, insiders are likely selling the same shares in the open market, causing significant price pressures. The decline in prices now reaches about 20% during the one year after the trade. In other words, a trader who sells her shares when insiders sell (but have delayed reporting) pursuant to a J-code can save 20% of the value of the stock.[211] When we further restrict our sample to large firms, abnormal profits further jump to 26%. We show these results in Figure 6.

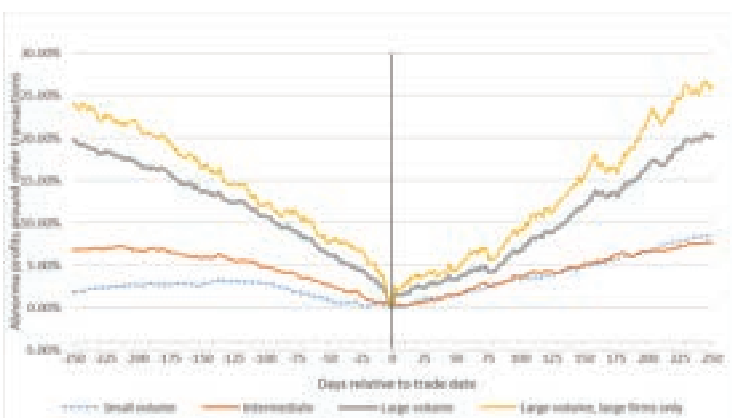

FIGURE 6: ABNORMAL PROFITS FOR LATE-REPORTED J-TRADES AROUND TRANSACTION DAYS, BY VOLUME TRANSACTION

[211] A trader who wanted to *make* money would only have to bet against the stock, such as by selling the stock short.

The amount of information associated with reported J-coded dispositions is extremely unusual. One rarely observes patterns of insider trading this profitable using S-coded open market sales only. This finding is consistent with the hypothesis that the larger J-coded trades are more likely to be associated with more important information accompanied by actual open market sales.

One concern a reader might have is whether this strategic behavior by insiders is an historical curiosity or whether such behavior continues to this day. To address this concern, we separated the information content of J-codes by decades in Figure 7.

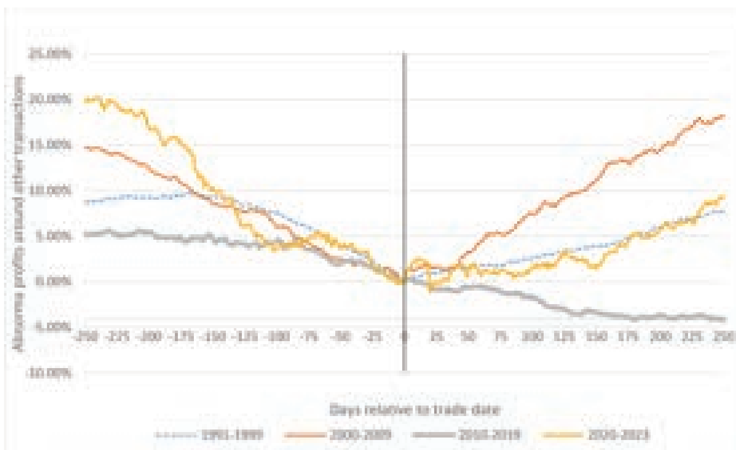

FIGURE 7: ABNORMAL PROFITS AROUND TRANSACTION DAYS, BY DECADE

During the initial decade of the 1990s, the information content of J-codes was close to average, about 7.7%. During the next decade, when a lot of fraudulent options backdating took place,[212] the information content of J-codes also exploded. During this decade, the abnormal profits reached an astounding 18.2%. During the next decade, 2010-2019, the SEC changed the rules for insider trading to curb the backdating practices. In fact, during this decade, information content of J-coded trades also fell. There does not seem to be any information content to J-codes during 2010-2019. Finally, during the last four years, the information content of J-coded transactions has increased once again. Over the last four years, abnormal profits have reached almost 9.5%. The evidence in Figure 7 indicates that the strategic J-coded transactions are still alive and well.

[212] *See* Narayanan & Seyhun, *supra* note 200.

2. Findings Tied to Textual Explanation

Recall that J-coded transactions are obliged to provide a textual explanation. The content of these footnotes may give us a clue as to what sorts of informed transactions are happening under the guise of "other." We discussed three broad patterns of insider trading by other means in Part III. Here, we report evidence consistent with each.

First, we provide a test of the forced sale explanation. Our discussion above indicated that the term "forced-sale" coupled with a J-code can be used to hide informed trading. To identify these dispositions, we searched the footnotes for the terms "forced sale," "mandatory sale," "mandatory redemption," "involuntary redemption," and "involuntary sale." Our search yielded 40 observations during the last twelve years, between 2012 and 2023. The abnormal profits are shown below.

FIGURE 8: ABNORMAL PROFITS AROUND FORCED SALES (J-CODE)

Abnormal profits for forced sales quickly jump to about 10% after two weeks and reach an amazing 34% after one year. Hence, J-coded trades using the words "forced sales" exhibit extreme profitability. It is also instructive to note that the decade of 2010-2019 showed hardly any profitability in general for J-coded trades (Figure 7). Despite this, "forced-sale" J-codes are highly profitable. This evidence further reinforces the narrative that J-coded transactions are deliberately used to shield informed trading.

In a similar vein, we also analyzed footnotes that used the term "forfeit." Once again, we found strong profitability here. Abnormal profits reached 11% for these J-trades.

Second, we hypothesized that insiders distribute stock pro rata to their limited partners (and, perhaps, family members) in order to allow those downstream users to sell without any public filing. We find strong but limited evidence that this occurs, using the keyword "pro-rata." Abnormal profits reached a significant 3% here.

J-coded transactions that use the words "VC" or "Venture Capital" in their explanatory footnote outperform the market by a significant 4%. Such a search term plainly validates the theory that venture capital firms may opportunistically distribute stock.[213] Other informed footnotes included keywords such as "estate," with 11.9% abnormal profits.[214] While this finding could have many causes, it is consistent with a distribution to limited partners theory, since that term is often associated with filings by real estate investment funds.

Second, we sought confirmation that miscoded transactions, which elected transaction code J without sufficient justification, might exhibit abnormal profits. For several types of miscoding, we did find confirmation. One is the use of J-codes for 10b5-1 transactions, despite the presumptive incorrectness of this choice. For this transaction type, we examined dispositions by insiders with footnotes containing the words "10b5-1," or its variations. We find abnormal profits of 7.1%. Insiders using 10b5-1 plans, and reporting them under code-J, avoid 7.1% in losses by disposing these shares prior to the stock price fall. This evidence is consistent with the interpretation that the motivation for J-trades where the disposition has taken place under a safe-harbor plan is based on adverse private information possessed by the insiders.

We also found that footnotes referring to stock options and "exercise of options" predicted robust abnormal profits (14.4%). Given the centrality of derivatives to many disguised sales (such as forward sales, long puts, short calls),[215] we might expect the use of options to partially proxy for strategic transactions. And we can consider the use of J-coding to be strategic in many of these cases, given that the standard transaction codes provide six codes other than J that are usually a better fit than J.[216]

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[213] *See, e.g.*, Repare Therapeutics Inc., Statement of Changes in Beneficial Ownership (Form 4) (May 7, 2021), https://www.sec.gov/Archives/edgar/data/1808158/000089924321018685/xslF345X03/doc4.xml. In this case, a VC fund with the words "venture capital" in its name disposed of shares at a time the stock was worth more than $30 per share. A few months later, the stock price would fall more than 50%. *Repare Therapeutics Inc. (RPTX) Interactive Stock Chart*, Yahoo Finance!, (last visited Aug. 1, 2023), https://finance.yahoo.com/quote/RPTX/chart [https://perma.cc/AWE3-4ZYJ].

[214] We tested combinations such as "distribution," "pro rata" and "for no consideration." Those words appear in many J-coded distribution explanations. *See, e.g.*, Nikola Corp., Statement of Changes in Beneficial Ownership (Form 4) (Mar. 2, 2021), https://www.sec.gov/Archives/edgar/data/1731289/000156761921005347/xslF345X03/doc1.xml. As for "estates," another possibility pertains to gifts and bequests, discussed below. The fact that the transfer involves insiders' estate, it is likely not to be an arm-length transaction.

[215] We also note that swaps showed abnormal profits. *Supra* note 211. Swaps are often part of synthetic transactions. A trader who swaps away all risk and cash-flows from an asset has effectively sold it.

[216] *Supra* note 67 and accompanying text.

Other potential markets of miscodings also yield some obvious abnormal returns.[217] Dispositions with terms such as "stock-for-stock," "change of control" and "asset purchase," achieve an abnormal profit of 13.3%; "cashless exercise" 5.6%; and "gift" or "charitable donation" with 6.7%. Hence, once finance literature discovered that gifts could be informed, some insiders use code-J instead of code-G.

There were also some negative surprises. Blank footnotes achieved small positive abnormal profits. We were expecting a bigger splash here. We need to keep in mind that analyzing textual context is not going to work 100% of the time since insiders can easily substitute other, less revealing text in place of footnotes if they worry about being discovered in this manner.

Third, we hypothesized that transactions with the issuer might exhibit excellent timing if insiders use their position at the corporation to cause it to buy from them, or they take advantage or preexisting plans. For this test, we looked for J-coded transactions with footnotes that mention "SPAC" or "merge." These transactions achieved an abnormal profit of 6.5%. Another keyword that is interesting is "exempt."[218] The exemption to the short-swing profit rule for transactions facing the corporation is codified in Rule 16b-3. When insiders transact with the corporation, they often refer to 16b-3 in a footnote.[219] We deemed this a sensible proxy for issuer-facing transaction.[220]

We find evidence consistent with insiders selling to their corporation on the basis of non-public information. When footnotes make reference to "exempt", we find that the associated transactions exhibit abnormal profits of 6.2%.[221] Plainly, the associated transactions exhibit high levels of information.

One plausible explanation for the results is that insider trades against their corporation may not be as benign as regulators seem to assume. Insiders may be able to exploit their position despite their fiduciary obligations and the sophistication of their corporate counterparty. Or perhaps many of these transactions are miscoded, and the use of a J code with 16b-3 serves as a fabricated basis for a quite suspicious transaction.[222]

On the other hand, these J-coded transactions could mention 16b-3 in order to explain why their transaction is *not* able to benefit from that exemption.

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[217] We searched terms related to gifts, references to collateral, and blank footnotes.

[218] Also included are 16b3 and 16(b)3.

[219] *See, e.g.*, Liberty Media Corp, Statement of Changes in Beneficial Ownership (Form 4) (July 18, 2023), https://www.sec.gov/Archives/edgar/data/1560385/000122520823007609/xslF345X05/doc4.xml.

[220] Not all issuer-facing transactions qualify for 16b-3 treatment, so our proxy is slightly under-inclusive. Though many non-exempt transactions nevertheless mention 16b-3 in order to clarify that they are not exempt.

[221] We also noted that large transactions coded as a transaction with the issuer also exhibit abnormal returns. *Supra* note 211.

[222] Note that nearly all 16b-3 transaction are better coded as something other than J. *See, e.g.*, Romeo & Dye, *supra* note 66, Forms 127, 136, 151, 160, 209 (asserting "J" is inappropriate for a given 16b-3 transaction).

"J" is the appropriate coding for many instances where an insider sells to the corporation, but 16b-3's requirements are not satisfied. For example, a 16b-3 transaction must be approved by the board or a majority of shareholders.[223] A transaction would not qualify for exemption if, for example, a CEO simply ordered the company treasurer to issue the CEO some stock options, without discussing the matter with the board. Such a transaction would plainly be worrisome. [224] And it would be reportable on as a "J" transaction.[225]

If that is where the information arises, then 16b-3 is indeed successful in pushing out closely related but potentially informed transactions. Unfortunately, our methodology is ill-suited to distinguishing these possibilities. We can only flag for investigators that reference to 16b-3, whether to state its applicability, inapplicability, or anything else, should lead to more careful scrutiny.

V. Implications

The evidence is consistent with widespread insider trading by other means. In fact, number of shares involving J-coded trades, dollar volume of J-coded trades and abnormal profitability of J-coded trades exceed those for S-codes. This is both surprising and problematic. It has serious implications for what we know and what we should do. This Part considers the epistemic and normative implications of our findings. Section A explains how these findings destabilize scholars' presumed knowledge about the level and nature of insider trading—as well s how to update the literature accordingly. Section B discusses the importance of regulatory scrutiny, as well as oversight by non-regulators. It is important that strategic filing be constrained and insider trading by other means policed no less than conventional insider trading. Of course, that is challenging, because of the obfuscatory nature of J-filings. Accordingly, Section C proposes superior systems for coding transactions, and Section D considers expanding the scope of obligatory reporting.

A. Scholarship

A vast scholarly literature studies insider trading. Our review of the literature, however, reveals no previous examination of J-coded transactions. All prior articles have excluded J-coded transactions from study. For example, Jose Marin and Jacques P. Olivier chart the relationship between insider trades

[223] Transactions between an issuer and its officers or directors, 17 C.F.R. § 240.16b-3(a) (2024).
[224] Whether a transaction qualifies for a 16b-3 exemption is frequently litigated. *See* Louis Loss & Joel Seligman, Securities Regulation, 2454 (4th ed. 2001).
[225] Romeo & Dye, *supra* note 75, Form 99.

and future stock prices.[226] This widely cited paper considers only S (sale) and P (purchase) coded transactions. It does not examine J-coded transaction.[227] Other papers either clearly focus only on sales (S) and purchases (P), or they are unclear in their description of methodology, such that we cannot be sure from the text whether or not they included "other" transactions.[228]

The choice not to examine J-coded transactions probably seemed entirely logical before a study (such as ours) explicitly proves both logically and empirically that they contain information. And there is no reason to include them a priori. Many J-coded transactions are unlikely to contain any information. Stock splits, for example, do not alter an insider's net economic exposure to the corporation nor are they something the insider can discretionarily elect at an opportune moment. Excluding such transactions would have been a safe and legitimate step to avoid muddying things. A second reason for past exclusion of J-coded transactions is likely historical.

Prior to April 1991, code J and S had a different meaning than they have now. While S now corresponds to any sale, it used to correspond only to "open market" sales. J was the term for non-open market sales. In other words, J referred to privately negotiated sales, between traders who knew each other's identities. S connoted the normal, anonymous trade on a stock exchange. It is understandable that a researcher might prefer to focus on open-market sales. And many studies now exclude J-coded transactions *in order to* focus on open market sales. Unfortunately, this is now a vestigial error. S and J both contain open-market trades (as well as "private" trades). Scholars have replicated past methodologies without updating in light of the SEC's changed guidance.

The methodological decision to leave out J-coded transactions has been consequential, because J-codes are, on average, *more* informed than other transaction types. Accordingly, the exclusion could materially understate the incidence of illegal trading.

In particular, any study that finds low levels of informed insider selling (or none at all) risks understating the reality with respect to exploiting adverse information. Pervasive insider selling might exist, and yet a study would not

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[226] *See* Jose M. Marin & Jacques P. Olivier, *The Dog That Did Not Bark: Insider Trading and Crashes*, 63 J. FIN. 2429, 2429–30 (2008).

[227] *Id.* at 2445. *See also* Avci et al., *supra* note 134, at 663 (excluding J coded transactions).

[228] *See, e.g.*, Leslie A. Jeng, Andrew Metrick & Richard Zeckhauser, *Estimating the Returns to Insider Trading: A Performance Evaluation Perspective*, 85 REV. ECON. & STAT. 453, 470 (clearly excluding J transactions prior to 1991, but unclear about whether subsequent J-coded transactions are excluded) (2003). That study "focuses on open-market purchases and sales by officers and directors. We exclude options exercises, private transactions, and all transactions by beneficial owners . . . ." That langauge implies a focus on just S (and P) transactions, since many scholars identify those with "open market purchases and sales." Other studies focused on other jurisdictions exclude *the equivalent* of J-coded transactions, for companies not subject to US securities laws and therefore not filing using a Form 4 as such. *See, e.g.*, André Betzer & Erik Theissen, *Insider Trading and Corporate Governance: The Case of Germany*, 15 EUR. FIN. MGMT. 402, 412 (2009); Jana P. Fidrmuc, Marc Goergen & Luc Renneboog, *Insider Trading, News Releases and Ownership Concentration*, 61 J. FIN. 2931, 2941 n.20 (2006).

find it, if the study excluded the richest vein of sale trades. For example, highly cited papers by Lakonishok and Lee, Jeng et al., and Inci, Narayanan and Seyhun find no evidence that insiders sell their shares at more opportune moments than uninformed outsiders. But these studies exclude J-coded disposition transactions.[229]

We have good news and bad news for the finance literature. The bad news is that in the light of our paper, any paper that seeks to infer something about the information advantage of insiders, based on sales only, may need to be augmented. Any study failing to detect robust insider selling profits would be advised to include "other" dispositions as well. To be comprehensive, insider trading by "other" means should be factored in. We also have good news: All insider trading studies that find little or no information content to insiders' sales can be updated by adding other dispositions, as well as filtering out small and promptly reported open market sales, creating many potential new publication opportunities.

B. Scrutiny

Insiders will trade by other means so long as "other" avoids serious scrutiny. Our impression is that they are right to think it does.

One possibility is that J-codes are unmentioned by investigators because they are not associated with insider trading, but that possibility is unlikely in light of our empirical findings. It is more likely that plaintiffs and prosecutors obtained their candidate cases through a process that did not accord due weight to J coded transactions. Perhaps they surveilled S coded transactions for telltale signs of insider trading, but they did not surveil J coded transactions. Or perhaps they received tips about suspicious transactions, and they were quicker to credit such tips where a clear pattern of insider trading was demonstrable from S codes alone. Alleged lawbreaking that involved J coded transactions may have confused investigators or deterred them by presenting as more trouble than more familiar cases, or perhaps the J code simply reassured investigators that everything was legitimate. A strange transaction that calls itself "other" sounds very fancy and professional.

Nevertheless, investigators have been unduly passive with respect to insider trading proxies. Code J is a strong signal that insider trading may be underway. Investigators should, at the very least, treat suspicious J transactions as worthy of inquiry. Indeed, they should probably go further and prioritize J-coded transactions more aggressively than ordinary S transactions.

This recommendation is even stronger where the filing bears other worrying marks. J transactions are required to include an explanatory footnote.

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[229] *See, e.g.*, Lakonishok & Lee, *supra* note 182, at 84.

Filings that lack an explanation, or which use the wrong transaction code, are out of compliance with the law. Transactions with the issuer, or distributions from investment funds, may appear to be benign, but our tests indicate that these are especially likely to be suspiciously timed. Accordingly, investigators should take these keywords to be informative proxies.

Most centrally of all, investigators should take late-filed J-coded transactions to be highly suspicious. Our findings indicated that intense abnormal returns with J-coded transactions are reported long after the transaction took place. In most cases, these transactions are already improper, and are worthy of investigation for that reason. But even if delayed filing is sometimes justified, the overall trend remains strong. Investigators should scrutinize even lawfully delayed J-coded transactions because such transactions are strongly associated with abnormal profits.

Likewise, investigators should examine more closely the transactions between insiders and their corporations. We found that J-coded transactions discussing SEC Rule 16b-3 were suspiciously well timed, despite the SEC's view that these transactions are often benign. Plainly, the story is more complicated.

When scrutiny unearths false or deceptive Form 4 filings, prosecutors should take aggressive action. Actions under Section 16(a) are rare and tend to focus on failure to file,[230] rather than misreporting.[231] But there is no reason to treat fraudulent filings any more gingerly. Nor should prosecutors limit themselves to actions under Section 16(a). The workhorse of securities enforcement is Section 10(b) and Rule 10b-5, but it has been underutilized as a basis for deterring abusive Form 4 filings.

Plaintiffs and prosecutors have referenced allegedly false Form 4s in connection with 10b-5 actions, but never successfully argued that the false Form 4 itself satisfied the necessary element of a material misrepresentation.[232] Instead, they have argued that a false Form 4 helps to support a different element, scienter. An executive who would falsify their Form 4 is one that might have had the necessarily culpable state of mind in making other allegedly false statements.[233]

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[230] *Supra* Part II.A.3.

[231] *See, e.g.*, SEC v. Powell, No. W-11-CA-161, 2012 U.S. Dist. LEXIS 204247 (W.D. Tex. Jan. 25, 2012) (denying defendant's motion to dismiss where SEC alleged that delayed Form 4 tended to prove scienter).

[232] *See, e.g.*, In re Ditech Networks, Inc. Derivative Litig., No. C06-5157 JF, 2007 WL 2070300, *5 (N.D. Cal. July 16, 2007) (Dismissing for lack of particularity plaintiff's allegations that defendants "committed a variety of manipulative and deceptive acts, including . . . producing and disseminating . . . false Form 4s" under Rule 10b-5.)

[233] *See, e.g.*, In re Zagg, Inc. Sec. Litig., 797 F.3d 1194 (10th Cir. 2015). In this case, the court dismissed the action because it found the Form 4s to not be false as alleged. *Cf. Powell*, *supra* note 231.

Yet we think that an intentionally false Form 4 may itself constitute a material misrepresentation sufficient to establish liability under 10b-5. Investors and analysts care about whether and why company insiders are trading. It alters the total mix of information if a company CEO is busy dumping a large portion of her shares, signaling bad prospects for the company. It is a highly newsworthy event. This is precisely why an insider might wish to delay or misrepresent their disclosure. Hiding a straightforward sale behind an inaccurate or deceptive coding, or falsely explaining the sale (as a gift or perhaps as an involuntary transaction), deceives the market that justifiably relies on these filings. To be sure, the victims of this deception are not the ones who traded contemporaneously with the insider. They bought or sold days before the deceptive Form 4 is filed. But subsequent investors trade in light of these opportunistic filings and should be able to vindicate their interests directly or by way of government enforcement.

C. Systemization

Philosophically speaking, the problem with J-coded transactions is due to the SEC creating a kitchen-sink category of all other trades in April 1991. We recommend the opposite approach. Each component of J-coded transactions must be separated and individually reported. We provide guidance to the SEC below.

In the same vein, other kitchen-sink categories that the SEC created in April 1991 should be undone. The SEC took two separate, perfectly valid categories, open-market purchases (P) and private purchases (J) and combined them into a single category, with code P. This approach serves nothing but dilutes and destroys the information content of the true open-market purchases. We recommend that this kitchen-sink approach be undone, and the two original categories be restored since open-market purchases and private purchases are entirely separate transactions. Similarly, the SEC took two perfectly valid, separate categories—open-market sales, S and private sales, K—and combined them into a single, S-coded category. This too should be undone for the same reason.

It is easier to ask investors and investigators to scrutinize "other" transactions if the task is commodified. Right now, it is challenging to read, understand, and audit J-coded transactions. Insofar as discernible patterns of J-code use exist, the SEC should create new transaction codes to cover those examples. Secondary sources currently identify categories of transactions that lack a code and so, they reason, should go into J. [234] If there is a use stable

[234] *See, e.g.*, 1 Jacobs, *supra* note 38, § 8:25 (stock splits).

and common enough to warrant an entry in a treatise, perhaps it should get a transaction code of its own.

Doing so will keep J as a pure instance for uninformed "other."[235] If J-coded transactions continue to be informed, then the SEC's work will have remained incomplete. The SEC should continue to look for loopholes that insiders use and continue to bring more clarity and transparency to insiders' reports.

Our approach will also make it easier to study transactions and spot inappropriate uses. For example, we observe discernible patterns of J-code use where an investment vehicle distributes shares to its investors (who may then dispose of it) and where loans, options, and forward sales are implicated. Creating new codes for those types of transactions would be an inexpensive and logical improvement to the filing environment. Scrutiny will become more realistic if it becomes easier.

D. Scope

Scrutiny also becomes easier if more transactions are subject to reporting. Expanding the scope of reporting law carries costs, but it may be warranted. We entertain one possible reform here.

Some forms of trade laundering concern a transfer of shares for less than full value to some other person, who lacks any reporting obligation. For example, an executive uses shares to barter for real estate or ownership in a private equity fund or for any other private investment. An insider sells in-the-money call options and then delivers shares as a forced-sale. A philanthropist may transfer shares to a trust in return for non-pecuniary income. An investment fund may distribute shares to its investors, none of whom are individually 10% owners. Once they do so, public reporting ceases. These cases are screaming for reform.

That is because reporting obligations attach only to insiders (and their immediate families). Insiders must report their transfers to non-insiders, but the subsequent non-insiders take on no reporting obligations. This asymmetry permits trade laundering;reporting obligations disappear as shares get further from the inside.

The law's current response to this is to sometimes preserve the insider's reporting obligations. Reporting obligations do not disappear if the insider remains an indirect or beneficial owner of the securities. Thus, an insider must continue to report transactions even after transferring shares to a wholly-owned

[235] Indeed, our proposal embeds an insight about one criterion for optimal code architecture. If any code systematically exhibits abnormal informed trading profits, reform is required—either new code divisions, or new investigations of the coded transactions, or both. Only when each code shows no greater informed trading than the rest will we know that transaction codes have been optimized for investigators.

corporation or to a friend (who will sell upon instruction and return the money to the insider). If one is concerned that some reporting is eluded through excessive transfer to non-insiders, a natural response is for investigators to be more aggressive in locating indirect and beneficial ownership. But that is an incomplete solution. Some trade laundering plainly does not entail indirect or beneficial ownership, as when an insider transfers shares as a bona fide gift to their child, or where a venture capital fund distributes shares to limited partners. In such cases, the only way to see reports on subsequent stock sales is for the reporting obligation to follow the shares.

Regulators should consider whether to tag below-market-value trades with derivative reporting obligations equal to those that would apply to the giver. For example, if a trader would need to report a sale of stock, followed by a gift of cash, then the trader should not be able to dampen the informational signal by giving shares (which the recipient then sells). The benefits of reporting are best served by having the recipient report their subsequent transaction. If the recipient is a person of no interest, and if the shares are sold in the distant future, then observers may pay no mind. But if the sale is prompt, and the seller is someone who might plausibly have learned something from the insider, then observers might infer that the transaction reflected indirect use of corporate information. Investigators might audit the contributor and the recipient to see if information was shared, for example.

Imposing this derivative filing obligation might be burdensome for some filers, so perhaps a de minimis exception might be appropriate. But in many cases, a derivative filing obligation seems appropriate.

Second, our empirical evidence strongly demonstrates that the important regulatory-evasion problems clearly lie with late-reported transactions. In fact, insiders appear to report only about one-third of the J-code dispositions on time, while reporting two-thirds with substantial delays. Hence, the scale of evasion is pervasive. Consequently, it is imperative that SEC close this screaming loophole as soon as possible, by imposing significant fines and penalties on late-reported transactions.

It is also important to treat any miscoded transaction or any non-reported transaction as a late reported transaction as well. Furthermore, these fines must be sufficiently large to discourage any strategy of late reporting, miscoding, or non-reporting. We suggest that fines should be commensurate both with the magnitude of the transaction as well as the length of time by which the transaction is late. One way to do this is to impose an interest-rate penalty, such as 1% per day, compounded daily on the amount reported late. Furthermore, the SEC should consider authorizing a private right of action for anyone to pursue these illegal transactions or creating a whistle-blower award program. Meaningful penalties and private enforcement will make it prohibitively expensive for insiders to engage in strategic late reporting, miscoding, and non-reporting games.

Conclusion

This Article investigated the information content of stock dispositions that insiders had designated as "other." We used a comprehensive database of almost 180,000 trades going back more than thirty years. We found these transactions to be suspiciously well-timed. When an insider sells more than 100,000 shares, takes more than 2 days to report the trade, and reports that the trade fits in no other reporting category, then the odds are good that the stock price is going to fall something like 20%. Other indicators, such as leaving the filing incomplete or reporting something that does not need to be reported with this transaction code, are likewise powerful predictors of a coming stock crash. It is plausible that insiders sell to dodge the losses they anticipate, and then cover the transaction with a protective transaction code. This theory is enhanced by ample case studies (at companies from Enron to Peloton) that look like insider trading by other means. We believe we have discovered a massively popular strategy for insider trading.

The strategy is popular because investigators do not punish traders for miscoding, nor do they push past the protective codes to prosecute the underlying insider trading. This is in part because, prior to this article, investigators may not have been on notice of the problem; it would have been easy to think that "other" transactions deserve "other" forms of oversight than ordinary sales.

It is also in part because investigatory scrutiny has been difficult. The reporting system is not built to maximize oversight, and in some respects, it has actually gotten weaker in the last thirty years. In order to regain public confidence that capital markets provide a level playing field for all investors, the SEC has more work to do to restore transparency, honesty, and accuracy to the insider reporting system. We provided some guidance for doing so.