8-K Gap: Next Big Thing In Insider Trading Enforcement?

Earlier this month, a group of professors from Columbia and Harvard Law Schools published a seemingly innocuous scholarly paper titled “The 8-K Trading Gap,” which comes to a startling conclusion: data show that insiders of corporate issuers appear routinely to have access to supranormal profits by purchasing the issuers’ securities during the period between the occurrence of an event reportable on U.S. Securities and Exchange Commission Form 8-K and the filing of the 8-K.

SEC rules currently permit issuers to file an 8-K up to four business days after a reportable event.[1] The authors digitized and analyzed more than 160,000 8-K filings over a 10-year period and, after filtering out certain types of filings unlikely to present insider trading opportunities, they observed that almost half of these filings showed no gap at all between the reportable event and the filing (or earlier issuance of a press release); that is, the 8-K was filed (or a press release issued) on the same day as the event it disclosed. But a majority of filings had gaps of at least one trading day, with most lasting one or four trading days, and with more trading by insiders occurring where the gaps were the longest.

The authors then analyzed whether such trading was profitable and, if so, whether it was more profitable than the stock market in general. After determining that such trading was profitable, the authors analyzed the subset of instances in which an 8-K disclosed a new agreement with a customer or supplier. They concluded that for those 8-K filings, insiders who had bought their company’s shares during the gap between the execution of the agreement and the 8-K filing had “directionally consistent — that is, positive — nonzero abnormal returns.” In short, they were gaining access to returns not available in the larger market by trading based on undisclosed corporate information.

Interestingly, the authors also report that such gap-period trades frequently involve open-market purchases of shares by insiders. Such transactions, they note, are inherently suspicious in that they give corporate insiders — who already have significant long exposure to their own firms, whether through actual securities positions or simply their own fates being tied closely to their
firms’ fortunes — additional long exposure, which seems undesirable.

The authors also recognize the tension between issuers’ expressed need for some leeway in the timing of 8-K filings and the goal of preventing unlawful insider trading, but they also observe that the type of trading described in the article did not appear to have been considered in the SEC rule-making that resulted in the four-business-day rule.

Having read this scholarly article, at least one observer asserted that trading by insiders during the period prior to filing an 8-K is “perfectly legal.” See “‘Trading the gap’ gives insiders a big advantage in stock trades. And it’s perfectly legal.” Wonkblog, Washington Post, Sept. 15, 2015. But it is not: trading by an insider — at any level, from the mailroom to the C-suite — while in possession of material nonpublic information about the insider’s employer — which 8-K-reportable information frequently is — may in fact constitute classic insider trading, and potentially exposes the insider (and perhaps also the issuer) to civil and criminal enforcement action.

Insider trading enforcement continues to be a key focus of both the U.S. Department of Justice and the Securities and Exchange Commission. Most of the prominent insider trading cases brought over the past few years have been “tipping” cases, in which third parties trade on material nonpublic information of an issuer. But these types of cases recently have become much harder for the government to bring and to win because of new developments in the law governing tipping cases, which continues to evolve almost daily. While these developments play out in the courts, the government may well be expected to turn to bringing arguably “easier” insider trading cases, including cases involving classic insider trading rather than tipping.

In light of the continuing governmental focus on insider trading and this scholarly article, which has received extensive publicity, issuers should revisit their policies to make sure that they protect the company and its employees from potential insider trading liability during the “8-K gap.” At least three policies seem worth considering:

- **Close the Gap:** Many companies have policies prohibiting employees from trading during certain periods, such as the traditional “blackout” period in the run-up to a quarterly earnings announcement. As the article’s authors observe, the fact that extensive trading goes on prior to the filing of an 8-K indicates that not all issuers have similar policies that cover the 8-K gap. Issuers therefore should consider implementing policies prohibiting trades by employees during the period between most reportable events and the filing of the 8-Ks disclosing them. Such a policy, of course, brings with it the burden of communicating to employees each time such a period begins. However, the opportunity to avoid insider trading allegations and the accompanying potential harm to the issuer seems well worth it, and most issuers already have such a communications protocol in place for pre-earnings blackout periods in any event.

- **Minimize the Gap:** Issuers also should consider taking measures to make the gap as short as possible to minimize the opportunity for potentially problematic trading by insiders. An issuer might, for example, implement a policy requiring the filing of the 8-K to occur on the same day as the reportable event, or as soon as practicable.
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thereafter where there are concrete reasons that would not be possible or desirable. Under such a policy, it also would be worthwhile to document the decision-making that leads to any filing that occurs subsequent to the day of the reportable event.

- **Avoid the Gap:** SEC Rule 10b5-1 permits an issuer’s insiders to set up so-called “trading plans” providing for pre-scheduled transactions in the issuer’s securities, which are presumed not to constitute illegal insider trading if they meet the rule’s requirements. By trading pursuant to such plans, insiders can continue desired trading activity without risking insider trading accusations.

It is important to note that none of these policies addresses the possibility that an insider might, for example, intentionally delay formally executing a material agreement while knowing it is certain to be signed in order to buy time for the insider to trade before the four-day period begins. Such behavior can only be detected, if at all, by scrutinizing employees’ work behavior along with their trading in the issuer’s securities.

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[1] These rules were amended in 2004 to shorten significantly the available period between event and filing. Until then, an issuer had up to 10 days after the end of the month in which the event occurred to file the 8-K — which resulted in a delay of up to 40 days in some cases.